Distr.
GENERAL

UNCTAD/COM/84
2 July 1996

ENGLISH ONLY

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

COLLATERALIZED COMMODITY FINANCING,

WITH SPECIAL REFERENCE TO THE USE OF WAREHOUSE RECEIPTS

Report by the UNCTAD secretariat

GE.96-51241

Part of the background research for this report has been made possible through project TP-INT/93/A09, "International commodity marketing and commodity price risk management", financed by the Government of the Netherlands. It has benefited greatly from interviews with and comments from a large number of experts from banks, trading companies, law firms, and others, including André & Cie, Banque Paribas, Booker Tate, BZW, Comfin Trading, Credit Lyonnais Rouse, CRM, Cubazucar, Czarnikow, ECOM, ED&F Man, Gill & Duffus, Inglewood Gestion, JP Morgan Securities, London Commodity Exchange, Merrill Lynch, Natural Resources Institute, Rabobank, Socadec, Société de Banque Suisse, Société Générale de Surveillance, SGS Redwood Services, South African Sugar Association, Standard Bank of South Africa, Standard Chartered Bank, Union Bank of Switzerland, United Overseas Bank, Vitol, and White & Case.

It should be noted that this report gives a general overview of the issues involved in collateralized commodity finance. Taking into account the often marked differences in rules, regulations, practices and conditions applicable in countries and applied by different counterparties, readers are strongly advised not to act on the basis of the information in this report alone, but to check carefully the particularities of their case before making any commitments.

CONTENTS

INTRODUCTION

1. The financing needs in the commodities sector are very large, for two main reasons:

- **the overall size of commodity trade**:
  Exports of primary commodities, including fuels, amounted to US$ 857,953.6 million (Free-on-Board terms) in 1993. This is 23% of total world merchandise trade. Most commodities do not go at once from producer to consumer, but change hands several times; thus, the total amount of money involved in commodity trade is several times larger than this export figure.

- **the relative size of individual deals:**
  Contracts for commodity imports and exports often concern quite large sums of money: for example, a tanker of crude oil has a value of at least US $ 10 million; a cargo of raw sugar is worth around US $ 3 million. A large part of contracts for other commodities are also worth more than a million dollars, and even when commodities are sold by container, a relatively small physical quantity, their value can be so high as to cause a credit need - for example, early 1995, one standard container of robusta coffee was valued, at its port of loading, at over US$ 60,000. While the financial size of commodity deals is normally large, the capacity of traders to finance these deals themselves is limited. Most often these companies have a small equity base, and, as they normally work on very small margins and make profits through the large volumes that they transact, they need to leverage their own capital as much as possible. This forces them to rely to a major extent on outside finance.

2. Developing countries and countries in transition account for almost half of world exports and imports of commodities.[1] Producers, processors, traders, exporters and importers from these countries are confronted with a need for external financing, even more so than their counterparts in developed countries who normally have more equity. Unfortunately, they face many obstacles in gaining access to credit, a situation which has only worsened in recent years. The reasons for this worsening credit situation are manifold. Among other things, production, exports and imports have been privatized, implying a fragmentation of particularly the trade sector; government trading agencies can rely to a lesser extent than before on central government trade financing; and the ability of domestic banks (the natural counterparts for private sector producers, processors and traders) to provide trade finance has often worsened due to a number of economic factors, including austerity programmes. As one observer described it for the Commonwealth of Independent States (CIS) republics, in some countries where exporters used to be able to provide supplier credit, when export structures were privatized they started to need payment at the moment of loading, a situation which developed into a need for international buyers to provide pre-export finance to these exporters.[2]

---

[1] The remainder of this paper focusses on developing country actors/conditions, although most of the discussion is equally applicable to Commonwealth of Independent States (CIS) republics and a number of other countries with economies in transition.

[2] A.G. Stockell, "Current warehousing, inspection and port facilities in the former Soviet Union", presentation at the Second Annual Conference on the Metals Industry of the Former Soviet Union, London, 10-11 October 1994.

3. Rather than the interest rates received or the expected profits, the main concern of credit suppliers (banks, trade houses, sellers) is whether they will be reimbursed or whether the products they pre-paid will effectively be delivered. As their profits on even highly profitable deals are relatively small compared to the size of the deal itself, one deal which goes awry can wipe out the profits of many successful ones. The risk of default is thus the greatest hindrance to the provision of credit, and as the risk of default is relatively large in developing countries and countries in transition, credit providers are often extremely wary of supplying funds to actors from these countries, unless they can be given sufficient guarantees or collateral.[3]

4. Therefore, giving more security to credit providers may improve the situation of poor access to credit with which most developing country actors are confronted. Commodities seem perfectly suited for this role. The simple idea behind using a commodity to secure a loan is the same as that of mortgaging a house, whereby a bank lends against the security of the house as collateral; even if the owner of the house (the borrower) falls bankrupt, the bank is not exposed because it has recourse to the house. Collateralized financing can make access to credit easier and cheaper, helping developing country producers and exporters to reduce (to an often very considerable extent) their costs, thus making them more competitive. It also allows importers to provide greater security and more guarantees to their suppliers and banks.

5. Enhancing the use that is made of commodities for collateral purposes has three secondary economic benefits. Firstly, as an alternative source of ready finance is created, the pressure for immediate sales is reduced. This improves the functioning of markets, and reduces price volatility: for example, coffee producers no longer need to sell most of their coffee directly after harvest to obtain cash: they can store it instead for later sales and obtain credits on the basis of the coffee stored. Metal producers in an economy strapped for foreign exchange (e.g. the Republics of the CIS) can similarly obtain finance against the security of local metal stocks, rather than having to attempt to maximize exports. Secondly, a large-scale use of warehouses as "transit points" for exports stimulates the emergence of a more or less fixed relation of local prices to world market prices: the physical price becomes the sum of a reference price (e.g. the London robusta price) and a location plus quality premium/discount. Such a process would enhance the usefulness of the futures markets for price forecasting and hedging purposes for developing country exporters, and would also increase their competitive power (because it is known what should be the premium/discount, under normal circumstances). Thirdly, because the quality of commodities in a warehouse needs to be carefully specified and checked, developing country grading systems, and perhaps more importantly, the trust of the international trading community in these local grading systems, are likely to be improved. This in turn makes it easier to sell on description, rather than by sample - which can reduce transaction costs to a considerable extent. These three secondary effects are not further discussed in this paper.

6. This report discusses the use of commodities as collateral for trade financing for producers, processors, importers and exporters, the obstacles to such use, and ways these

---

[3] This report concentrates on relatively "solid" forms of collateral. An alternative form of security is more informal, and known as "collateral substitutes". Collateral substitutes are, for all practical purposes, not enforceable through courts, and have little or no market value; nevertheless, they can be quite effective in ensuring contract performance. Examples of collateral substitutes are peer pressure and interlinked contracts (e.g. the possibility of a credit provider to close off access to cheap agricultural inputs when the borrower defaults). See for a detailed discussion *Collateral, collateral law and collateral substitutes*, International Labour Office, Geneva 1996.

obstacles can be overcome. It is divided into four chapters. The first chapter looks at the different types of collateralized financing available. The second and third chapters then focus on one form of collateralized financing, namely that using warehouse receipts; in these chapters, the concept of warehouse receipts as collateral is discussed in more detail, particularly focussing on the conditions that may make a commodity "good" collateral for lenders, and the influence of warehouse location and characteristics on the value, for collateral purposes, of the commodities stored. The concluding chapter discusses possible ways to enhance access to collateralized commodity finance for actors in developing countries and countries in transition.

Chapter I

THE USE OF COLLATERAL IN COMMODITY FINANCING

7. This first chapter starts with a description of the basic principles of using collateral to facilitate access to commodity finance, and the main ways in which banks and trading companies can structure their commodity loans. Then, some of the more advanced ways in which commodities can be used as collateral are discussed. The chapter then continues with an introduction to a more basic form of collateralized finance, namely warehouse receipt finance. This is followed by a discussion of the legal aspects of using warehouse receipts for collateral purposes, and a description of the role that warehouse receipts can play in commodity trade finance, for producers, traders, processors, importers and exporters.

A. Enhancing access to finance by providing extra security: the principles

8. Some form of financing is normally available for commodity transactions, from domestic or international sources, even without the provision of collateral.[4] This can be simple balance-sheet financing (based on the perceived strength of the company receiving the finance); limited recourse financing in which the bank basically relies on a buyer's commercial relationship with an exporter to be reimbursed[5]; or transaction-based finance in which some arrangements have been made to make reimbursement more likely (the use of escrow accounts; the assignment of contracts; negative pledge covenants which forbid the borrower from pledging his commodities to another party, thus ensuring that they remain available to the market; or insurance by one's country's export credit insurance agency). However, for entities from developing countries or countries in transition, financing costs for unsecured transactions can be very high, with interest rates of over twenty per cent. The purpose of collateralized finance is to reduce risks to the credit provider, and thus, make it easier for him to lend and allow him to charge a lower risk premium.

9. Several different forms of collateralized financing have been developed over the years - for a general overview, see chart I. Any asset which can be isolated from the company that is to obtain the credit and which can provide a more or less predictable cash flow can in principle serve as the basis for collateralized financing. Acceptable collateral can include cash; commodities; stocks and negotiable bonds; certified checks; irrevocable letters of credit; certificates of deposit; and parent company guarantees. For companies which are undercapitalized or which face temporary cashflow problems, accounts receivable financing (in which the payments due from customers are assigned to a bank as collateral for a credit line) can

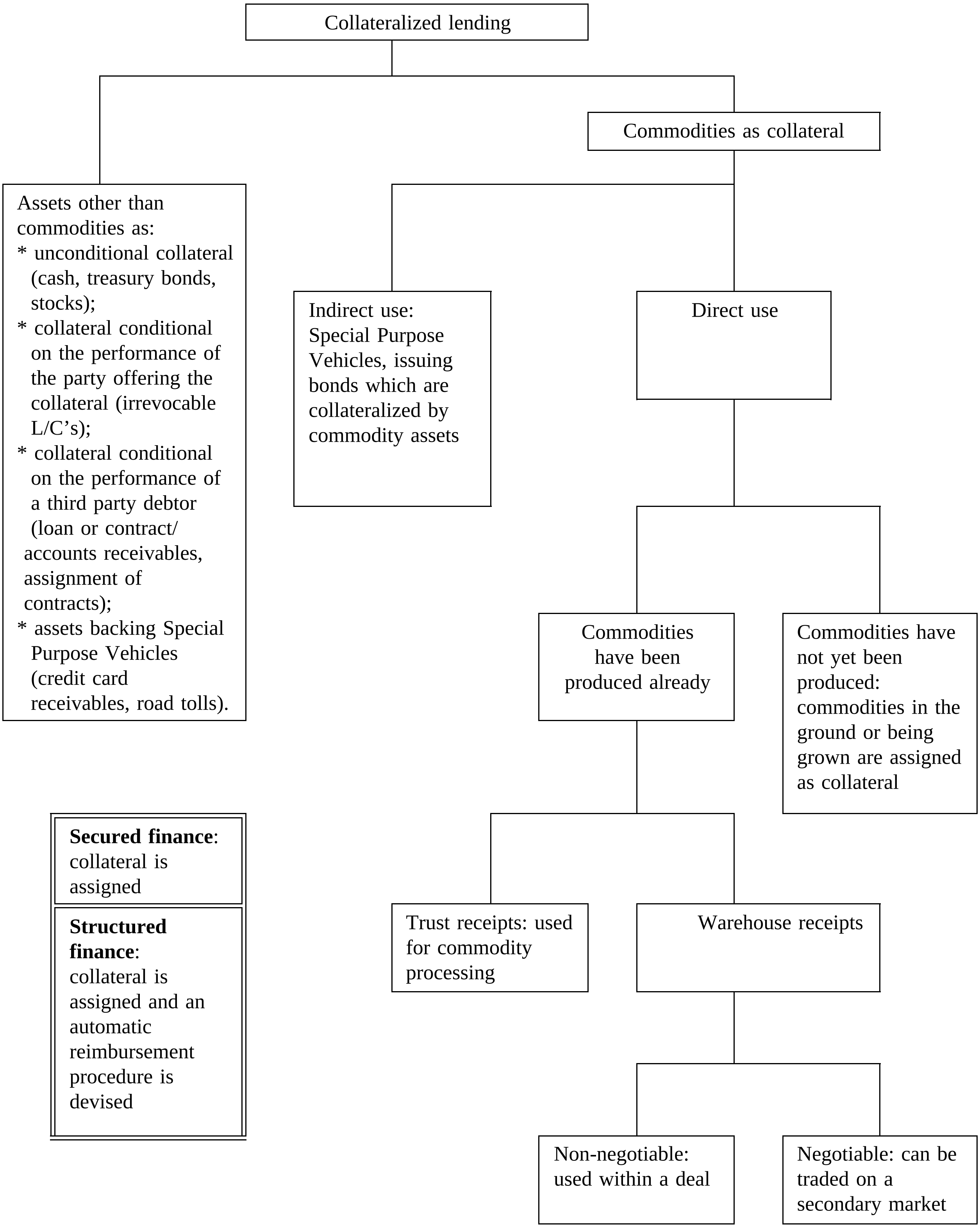
---

[4] Collateral can be defined as an asset (a marketable property, physical or financial) which can be pledged or physically transferred by a borrower to a lender; the borrower retains the right to any earnings from the asset, and the lender can only dispose of the asset when the borrower defaults on his payment obligations.

[5] See for a discussion on this type of finance, in which banks basically share in the risks of trade houses, various presentations made at the occasion of the "International Forum on Structured Commodity and Trade Finance", London, 11-12 December 1995, including Richard Barnes, Creditanstalt, *What are structured commodity finance transactions and why have they become an important financial tool for international commercial banks and borrowers*; and Johan Buitenga, ING Bank, *Limited recourse financing of pre-export purchases of commodities*.

CHART I

THE COLLATERALIZATION OF CREDITS: A SCHEMATIC OVERVIEW



be a good solution to their credit needs (see Annex I). In more complex structured financing deals, many other types of receivables have been used as collateral: e.g. consumer credit card receivables, automobile loans, student loans, and airline ticket receivables. Although various types of collateral are indeed used in commodity trade finance, they will not be easy to provide for many developing country companies which often have only one source of wealth: the commodities they produce or have in stock.[6]

10. For international commodity transactions, the most easily available collateral are the commodities themselves. There are many different ways to use commodities as collateral, as will be discussed below, and the collateralization mechanism can be used for different purposes. It can facilitate the financing of related transactions: for example, coffee stocks can be given as collateral to secure a coffee trade financing credit. It can also be used to reduce the financing costs on unrelated transactions: for example, a country's gold reserves can be used as collateral for a currency swap or for loans; strategic metal reserves or oil exports can be used as collateral for a loan programme; or, as has been done in the United Republic of Tanzania, the assignment of proceeds of coffee exports to an escrow account can secure a credit for oil imports.

11. Using commodities as collateral changes the risks of the lender: from having recourse only to the borrower, the lender has obtained recourse to the commodities. If the lender defaults, he can take action to seize the commodities, even if these have been sold in the mean while to another party. The extra safety thus provided can be significant; for example, if a country has obtained pre-export finance collateralized by its oil exports, and it defaults on its payments while still exporting oil, the lender has the right, by international law (under certain conditions), to seize the oil, even if it was bought and paid for by another company. This implies that as long as the country does not reimburse its loan, international buyers will be wary of buying the commodities that were pledged as collateral. This provides a strong incentive for the borrower to reimburse its loans - and experience has shown that indeed, even countries that were defaulting on a large part of their foreign debt performed quite well in reimbursing their collateralized loans.

12. Chart II below gives a simplified, schematic overview of various ways of commodity lending. Balance sheet lending is the traditional form, but only a few, large companies now can rely solely on this type of finance. A large part of commodity pre-export finance is now organized using the assigment of contracts and escrow accounts to provide some security - even thought the buyer needs to pay only if the contract is fulfilled. A transaction using commodities as collateral builds in extra security. It can be either secured or structured. In a secured transaction, commodities or commodity-producing assets (e.g. farms) are used as collateral for finance. This can be on the basis of the assignment of contracts or ownership titles, or on the basis of pledging warehouse receipts.

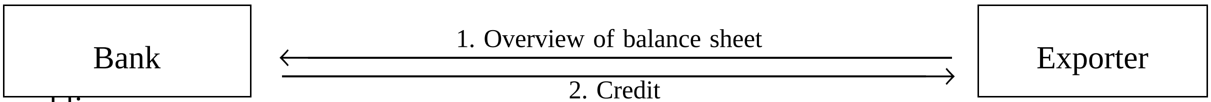
---

[6] This does not imply that such forms of collateral can not be used at all: especially for government lending and for large infrastructural projects, the assignment of receivables (such as the fees that airlines pay for the use of a country's airspace, electricity charges or road tolls) has been used to arrange lower-cost loans to developing countries.

CHART II

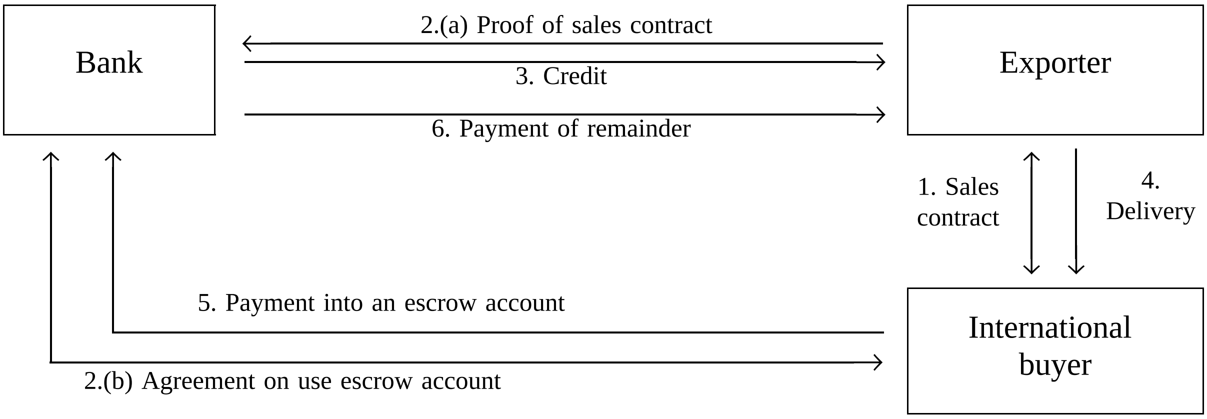
OVERVIEW OF MAIN FORMS OF COMMODITY TRADE FINANCING

Balance sheet financing

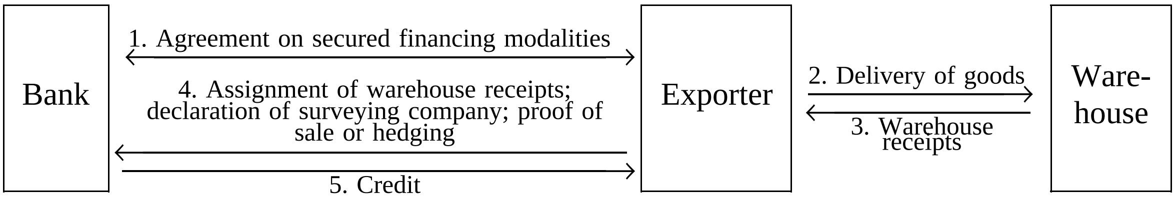


aughlin

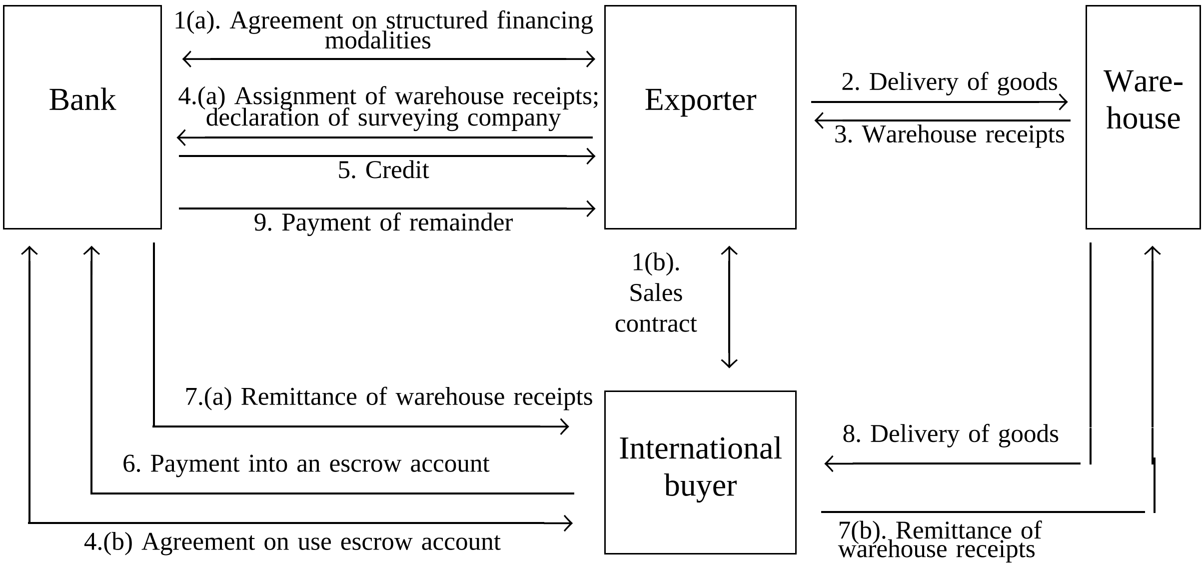
"Traditional" financing using an escrow account



Secured financing using warehouse receipts



Structured financing using warehouse receipts



13. In the case of financing on the basis of warehouse receipts, the financing bank will ask for:

- the warehouse receipts (in the case of a credit provided by a foreign bank, these receipts are most likely to be checked by a local corresponding bank).[7]
- accepted certificates of quality or active warehouse control by an international surveying company.[8]
- and proof that the commodity is pre-sold or hedged. Confirmed sales contracts and also Letters of Credit with a red or green clause (see annex II) opened by foreign buyers are accepted as such proof.

14. In transactions that are secured in this manner, no special arrangements are made to ensure repayment of the credit; but when the borrower defaults, the bank has recourse to the commodities. Structured transactions provide more security because specific repayment procedures are included. They are, however, more expensive to arrange than secured transactions. For international trade transactions, when arranged by an western bank the fixed costs can easily reach US$ 50,000 even if no significant legal charges need to be incurred, so they are in practice only used for credits of 1 million US$ and above, with most deals being for more than 5 million US$.[9] For locally-financed transactions, costs can be much lower, especially if a good physical and legal infrastructure is in place.

15. Structured financing transactions contain two components:

(a) Arrangements which ensure that, if the transaction proceeds normally, the credit provider is automatic reimbursed - that is, the loan is self-liquidating. This includes, for instance, an arrangement between the foreign buyers and a credit-providing bank that the buyers will pay to the bank, rather than the exporter; the bank then pays the exporter what it has received, after deduction of its original credit plus charges.

(b) Arrangements which ensure that, if the transaction goes wrong, the credit-provider has recourse to a collateral - he can sell it, and thus get his money back. These

---

[7] Instead of, or pending issue of, actual warehouse receipts banks may also accept telex releases from reliable warehouses - in this case, the depositor of the commodities instructs the warehouse to hold to goods on behalf of the bank (as holder of a security interest), and the warehouse then telexes the bank informing it it is holding x parcels of y goods to the bank's order pending further instructions; the bank then responds by telex or fax advising the warehouse not to dispose or otherwise release the goods without express written authority of the bank. This mechanism is used much for larger cargoes, where it can take quite a lot of time to issue the actual warehouse receipts (e.g. in the case of metals which need some transformation before being eligible for LME warrant, or coffee that needs grading before it is eligible for LCE warrant).

[8] In the case of gold, arrangements are somewhat different: the gold which secures the loan is stored either in the vaults of the lending bank or in the vaults of a central bank such as the Bank of England, which issues "vault receipts" (the equivalent of warehouse receipts), after which these receipts are pledged. Central Banks are normally more aware of modern financing techniques than other government departments or parastatals, or than private sector banks and exporters; it is also relatively easy to store and transport gold. For these reasons, the use of Central Bank gold reserves as collateral for loans is probably the most widespread form of collateralized finance (at least in terms of country coverage) utilized by developing countries - even several least developed countries in Africa have resorted to this technique.

[9] It should be noted that once the reimbursement procedures are in place, the financing can in principle easily be repeated year after year, at little additional cost.

arrangements are normally backed up with insurance cover, to protect against the risk that for one reason or the other (theft, nationalization, export bans), the collateral is no longer available.

B. Advanced financing techniques using commodities as collateral

16. Commodities can be used as collateral in various ways. One of the most straightforward ways, and the main topic of this paper, is through the use of warehouse receipts. But there are other ways. In developed countries and in the larger developing countries with a relatively advanced financial sector, complicated collateralized financing deals are often the most rewarding, in particular if large sums are involved.

17. One common form is the assignment of the ownership of the commodities or other assets that are to serve as collateral to a specially created entity (a "special purpose vehicle"), which issues securities (so-called "asset-backed securities"). Both banks (packaging for instance warehouse receipts) and producers (as long as they have a good track record, a decent credit, and operate in a fairly stable industry and pricing regime) can originate the issue of asset-backed securities; nevertheless, taking into account the costs of structuring the special purpose vehicle and placing the issues, this is only worthwhile for larger amounts - probably upward from 10 million US$ for the most simple structures; although the sums needed in the minerals and oil sector can easily reach this level, for agricultural projects, the main way of using this financing vehicle is probably through the bundling of various interests into one special purpose vehicle. In order to obtain an investment-grade rating, the securities that are to be issued normally have to be enhanced by one or more financial institutions (which put their credit in the place of the issuer of the securities). The assets on which the issue is based are monitored by another special entity (for instance, a non-related bank) which ensures that the financial flows resulting from them (e.g., through their sale or exploitation) are properly distributed. The whole is rated by at least one of the established rating agencies. The securities are then distributed either privately or publicly, expanding the scope of financing sources beyond banks to the capital markets; private placements are by far the more common, in particular for issues by lower-rated entities. The need for securitization and for private placement implies that the involvement of one of the banks specialized in this (and there are only a handful of them) is virtually essential; fortunately, several of these banks are now actively interested in developing country securities issues. Table 1 gives an example of the simplest form of an asset-backed securities issue, with the assets being a contract for forward delivery of crude oil, the enhancer a triple-A rated entity (Salomon Inc.), and a one-time final payment.

Table 1

An example of a Special Purpose Vehicle: the Salomon Phibro Energy Oil Trust

<table>
<tr><td>August 1990</td><td colspan="2">1. The Phibro Trust is established.
2. 16 million Trust units are sold; total earnings: 68 million US$
3. With the payment of this 68 million US$ (minus Trust expenses), the Trustee enters into a forward contract with Phibro Energy for 4 million barrels of crude oil, for delivery in September 1995.</td></tr>
<tr><td>September 1995</td><td>Delivery of 4 million barrels of crude oil, to be sold on the open market (with Phibro providing a guarantee as buyer of last resort).</td><td>If default by Phibro Energy, unconditional delivery guarantee from Salomon Inc.</td></tr>
<tr><td>November 1995</td><td colspan="2">Distribution of the net proceeds of the sale: each holder of a trust unit will receive the net realized price of one quarter of a barrel of crude oil.</td></tr>
</table>

Table 2

Asset-backed securities issues by developing countries

Issuer	Country	Country risk rating (S&P)	Issue's risk rating (S&P)	Commodities exported
Pemex	Mexico	BB	A	Oil
AHMSA	Mexico	BB	BBB-	Steel
Corpoven	Venezuela	B+	BBB	Oil
Bitor	Venezuela	B+	BBB-	Orimulsion
Alcoa do Brasil	Brazil	B	BBB-	Aluminium
Shell Minerals	Brazil	B	A	Minerals
Aracruz Celulose	Brazil	B	BBB	Pulp
Samarco	Brazil	B	BBB-	Iron ore
YPF	Argentina	BB-	BBB	Oil exports
Freeport McRohan	Indonesia	BBB-	A	Gold

Source: Based on a presentation given by Finlay McFadyen, Paribas Capital Markets, at the occasion of a conference on "Structured Commodity and Trade Finance", London, 11-12 December 1995.

18. In 1995, the size of the asset-backed securities market was over 400 bn US$, mortgage-backed securities not included. By far the largest part of this was accounted for by securities issued in the United States of America; developing countries accounted for about 10 bn US$.[10] Most of the issues by developing countries were in Latin America, and were backed by export flows of minerals and fuels (in Chile and Turkey, notes were issued backed by long-distance telephone receivables, respectively US$-denominated credit card spending). Table 2 gives an overview of the main issues so far (as concerns developing countries), with an indication of the improvement in borrowing terms which resulted from structuring the borrowing through a Special Purpose Vehicle (note that under normal circumstances, the credit rating of a company's borrowing would not be better than that of the country in which it is, irrespective of the financial strength of the company). To what extent the credit rating is improved still depends partially on country risk, as well as on the particularities of the deals (for instance, can price risk management mechanisms be built in). Nevertheless, the use of hard currency earnings on contracts with reputable international buyers gives a considerable measure of comfort to investors. In addition to the benefits of a lower (and fixed) interest rate and borrowing which in effect is off-balance sheet, companies can use asset-backed securities to leverage their short-term earnings into medium-term finance. From the point of view of the country, the use of asset-backed securities allows to obtain funds from a new public, leaving the banks' country credit lines available for normal loans fully intact.

19. This financing form is quite new, and still relatively unexplored in developing countries, completely unexplored in the countries with economies in transition. The first significant deal by a developing country was in 1993, when Pemex, Mexico's national oil company, created the "Pemex Receivables U.S. Masters Trust", which issued certificates that were placed privately among large investors; payments from this trust were secured by the assignment to the Trust of the proceeds of the sale of Mexican oil to a number of American oil companies, and by a bank letter of credit guaranteeing interest payments for a certain period. Another example was a US$ 350 million private bond placement by Argentina's biggest oil company, Yacimientos Petroliferos Fiscales (YPF); the bonds were backed by export contracts YPF has with Chile's petroleum

[10] Finlay McFadyen, Paribas Capital Markets, in a presentation for a conference on "Structured Commodity and Trade Finance", London, 11-12 December 1995.

entity.[11] Box I gives a more detailed description of another recent issue of asset-backed securities. Even though this type of structures has not been used for soft commodities so far, it has been suggested that developing country banks can use the warehouse receipts on the stocks of several producers (and processors) as collateral for asset-backed securities, issuing them through a special purpose vehicle which is securitized by one of the major specialized international banks.[12]

BOX I

AN EXAMPLE OF A COMMODITY-BACKED NOTES ISSUE - SAMARCO MINERAÇAO, BRAZIL [1]

Samarco, the world's third largest iron ore pellet exporter, wished to expand its pelletising capacity, which would cost approximately US$ 220 million; this investment would generate extra revenues of some US$ 50 million a year. Rather than raising extra shareholder money or lending these funds through its normal channels, Samarco decided to use the expected future earnings flow from the expansion to finance the expansion - pulling itself up by its hair, as it were. A seven-year notes-issue was arranged, for a total of US$ 67 million (the remainder would be financed locally), with quarterly payments of interest and principal starting after three years (when the project would come up-stream). A number of contracts with international steel companies was pledged to an off-shore Special Purpose Vehicle, and the Trustee was entrusted with the distribution of the earnings of the pledged contracts over the noteholders (institutions in the United States of America and Japan) and Samarco (which received what remained after payment of interest and principal, and an allowance made for the constitution of a reserve account). With this debut in the international capital market, Saramco was able to raise funds at a rate lower than that paid by the Brazilian government.

[1] Based on a presentation given by Finlay McFadyen, Paribas Capital Markets, at the occasion of a conference on "Structured Commodity and Trade Finance", London, 11-12 December 1995.

20. This indirect use of commodities to collateralize a financing deal is still relatively rare, although it would appear useful to explore ways to expand it. More commonly, commodities which are to be used as collateral are directly pledged to the lender, or the lender is given title over the commodities (in the case of gold, it may be transported directly to the lending bank's vaults). These commodities may be physically available in a warehouse; but they can also still be in the field, or in the ground, as long as local legal conditions permit their use for collateral purposes. There are some complications, though. Use of crops still in the field is especially risky if the country involved has no crop insurance system; if the harvest fails, a bank or trading company providing finance can only roll over its credit to the next year.

21. More generally, the use of commodities not yet physically available carries with it a relatively large risk of multiple usage: it is difficult to check how many times the borrower has used the same commodities as collateral for credits, and in the case of default, this would dilute the ownership rights (the establishment of a central registry for this type of transactions would to a large extent remedy this problem; in the large majority of developing countries, such a registry is currently non-existent). In countries where it is relatively easy to control whether certain commodities have already been pledged as collateral for loans, this type of collateral has been used for quite a long time - in effect, the development of the United States oil industry in the 1930s and much later, that of the North Sea oil fields, was to a large extent financed through loans for which the only collateral was the oil still in the ground, and similar techniques are now starting to be used in developing countries (e.g. Angola or Colombia). In the late 1980s, a large international trading house lent considerable sums to Jamaica's alumina refinery against the security of future alumina earnings; in 1995, Dubai's aluminium smelter obtained low-cost funds

[11] See "YPF suffers hangover from the tequila effect", *Petroleum Economist*, June 1995.

[12] Aiden Applegarth, UBS, in a presentation for a conference on "Structured Commodity and Trade Finance", London, 11-12 December 1995.

in a similar manner.[13] Countries such as Viet Nam finance crops through countertrade-type deals (known as "buy-backs"), with a foreign trading company providing the seeds and the inputs, to be reimbursed with the products to be grown; similarly, it obtains investment funds for its coal industry. A number of sugar-producing countries had their sugar campaign financed in this way - the latest (and by far the largest) case is that of Cuba, where foreign companies have been enticed to provide loans for the expansion of sugar production in specific provinces, with the reimbursement guaranteed through the proceeds of the sales of Cuban sugar.[14] In countries where the government controls both exports and imports, collateral for import finance can be provided by the export agency - this mechanism has been used in the 1990s, for example, by Ghana and the United Republic of Tanzania (cocoa, respectively coffee exports were used as collateral for oil import finance).

Table 3

Protection of the credit provider with and without commodity collateral

	Borrower defaults on payment obligations [1]	**Borrower falls bankrupt**
No collateral	Costly and lengthy legal recourse and informal pressure are only ways to be reimbursed.	Credit provider is just one of many creditors.
Commodities in the ground as collateral	If exported, goods can be seized, as long as ownership title is clear.	No possibility of recourse if commodities do not exist; if they exist, delays, and possibly legal problems if goods had been committed more than once.
Warehouse receipts as collateral	If exported, goods can be seized. Recourse is possible to warehouse company, for unauthorized release of goods.	Goods can be sold at once by bank (assuming a proper legal framework). If goods do not exist, recourse to the warehouse company.

[1] In most countries, a minimum number of creditors is needed to file for bankruptcy; a default to one creditor, even if this is the major one, is not enough to make a company enter bankruptcy procedures. For larger financing transactions, it is often considered worthwhile to include sufficient individual creditors in the deal to file for bankruptcy if the borrower defaults.

C. Warehouse receipt finance

22. The previous section discussed the various ways in which commodities can be used to make lending safer. Some of these ways are only practical for large financing transactions, others still carry significant risks. Warehouse receipt finance may be more appropriate for the conditions of many developing countries. Warehouse receipt financing is possible for relatively modest amounts. Also, as table 3 shows, it is safer to use commodities that have already been produced for collateral purposes. For these reasons, this form of financing can be of considerable interest for producers in developing countries and economies in transition. This section describes the principles of warehouse receipt finance, as well as the key characteristics of warehouse receipts. Legal aspects will be discussed in the next section, and the actual use that can be made and that has been made of warehouse

---

[13] See *Dubal loan a perfect fit for the project*, Corporate Finance, December 1995. In this 250 million US$ syndicated loan, repayments (which will take place in the years from 1997 to 2000) were linked to aluminium prices, in such a way that Dubai Aluminium was protected against declining prices, while continuing to be able to benefit from increasing prices. Despite this protection, the costs of the loan were considerably less than those available through a more conventional loan.

[14] See *Cuban commitment pays off for ING*, Trade Finance, January 1995.

receipts in commodity finance will be discussed in more detail in section E.

23. If the commodities to be used as collateral are stored in a warehouse, the warehouse operator issues warehouse receipts, in one form or another (depending on a country's legal and regulatory system). These receipts then form the basis of financing. Rather than relying on the producer's (or exporter's) promise that the goods exist and that the proceeds of their sale will be used to reimburse the credit provider, the goods are put under the control of an independent warehouse operator (the credit provider still needs to ensure himself that the goods have not been pledged previously). The warehouseman becomes legally liable for the goods he stores. If these goods are stolen, damaged or destroyed, through any fault of his, he and his insurance companies have to make up for the value lost (additional insurance can be obtained for catastrophic events). The integrity of this warehouse operator is secured by government licensing and controls, and by outside guarantees which the warehouseman has obtained from bonding companies (subsidiaries of banks which provide against defaults) and insurance companies.

24. Commodity trade finance collateralized by warehouse receipts requires relatively much paperwork, compared to unsecured finance, and also involves higher control costs - the fees for the warehouseman and of inspection services, registration fees for warehouse receipts etc. (although it should be noted that in practice, these costs generally amount to only 0.5 to 2 per cent of the value of the deal, which is often negligible compared to the savings on the interest rate paid). But on the other hand, commodity companies with a weaker capital base and a short or a poor track record, which would not otherwise be eligible for international loans (at interest rates normally much below domestic rates) can in this way obtain low-costs credits.

25. Warehouse receipts are commonly used by commodity dealers in the process of financing goods stored in a warehouse prior to sale and transportation, or prior to and during processing. The borrower arranges for the storage of goods in an independently controlled warehouse which issues warehouse receipts for the merchandise deposited. These warehouse receipts are in some countries considered as title documents, with their possession considered as evidence of the ownership of the goods represented; while in others, they are merely considered as proof of deposit - this will be discussed in more detail in section C. Compared to a simple bill of sale (which gives title to commodities to the credit-providing institution), the use of warehouse receipts as collateral provides the additional benefit that the commodities are no longer in the possession of the borrower, and hence, if the borrower defaults, the lender has easy recourse to the commodities. Banks or trading companies normally have few problems to advance funds against commodities that are being stored in a reliable warehouse and have been assigned to the bank or trading company through warehouse receipts.

26. Once the bank or trading company has the warehouse receipt in its hands, it advances to the borrower a specified percentage of the value of the goods represented by the receipt. The amount it lends is primarily based on the acceptability and the ease of control of the collateral - the identity of the borrower (whether this is a triple-A rated company or a one-person firm) is of very little relevance. It should be noted, though, that once banks have positive experiences with their borrowers, they are likely to be willing to increase the percentage of the collateral's value they are willing to lend. The funds advanced are to be repaid with the cash collected from the sale of the goods.

27. The main advantages of warehouse receipt financing are[15]:

(a) In all countries it is much easier to deal with security given in the form of a possessory pledge as the identity of the collateral is incontestable and the intention of the borrower to pledge the collateral is clear, avoiding disputes as to ownership and competing claims.

(b) In the case of a loan default collateral covered by documents of title can be auctioned or sold promptly and at minimal cost "as is where is" by the lender by negotiation of the document or written notification to the warehouse operator.

(c) A lender holding a warehouse receipt has a claim against the issuer (the warehouse company) as well as the borrower in the event of the non-existence or unauthorised release of the collateral.

(d) In some countries, such as Central and Eastern Europe and the CIS, the existence of competing creditors and unpaid sellers is often difficult to verify with certainty. Having a document of title to goods in store can then cut off the claims of such competing creditors.

28. Warehouse receipts can be negotiable or non-negotiable. A non-negotiable warehouse receipt is made out to a specific party (a person or an institution). Only this party may authorize release of goods from the warehouse. He may also transfer or assign the goods to another party, for example a bank. The warehouse company must be so notified by the transferor before the transfer or assignment becomes effective.

29. The non-negotiable warehouse receipt in itself does not convey title and, if it is in the name of, say, an exporter, it cannot be used as possessory collateral; it needs to be issued in the name of or transferred to the bank in order for the bank to obtain possessory collateral rather than just a security interest. The difference is important in that, firstly, if the bank has possessory collateral, it has direct recourse to the warehouse storing the commodities when the commodities are delivered to another party, and secondly, in the case of bankruptcy of the borrower, it is much easier for the bank to sell the commodities in a speedy manner. On the other hand, the surrender of the non-negotiable receipt to the warehouseman is not necessary to get release of all or part of the stored merchandise. All that is needed is a delivery order signed by the party in whose name the receipt is issued - or to whom it has been transferred (usually the financing institution) - instructing the warehouseman exactly what types and quantities of goods are to be released to the person named in the order. This makes the use of non-negotiable receipts for short-term trade finance rather easy.[16]

---

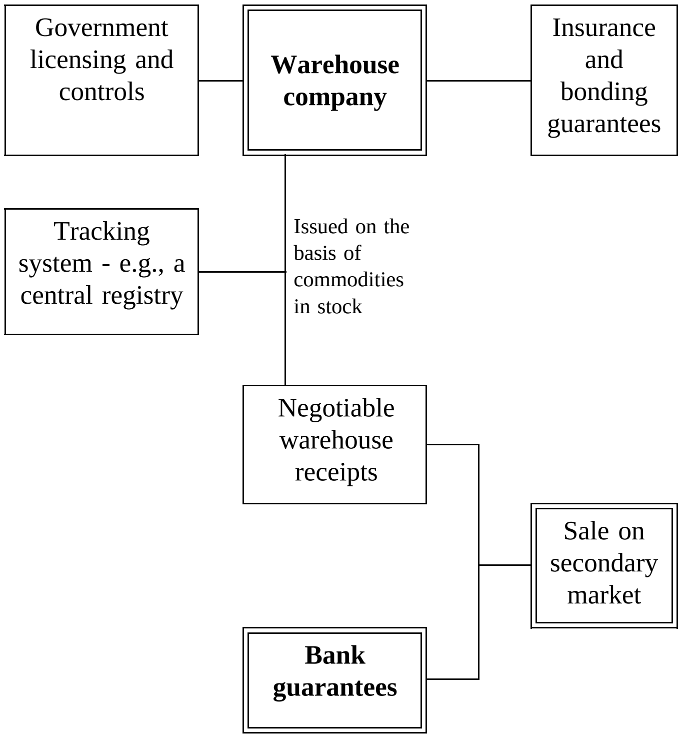
[15] N. Budd, A brief description of the field warehouse pledge as an appropriate security device for developing countries and the new market economies, presented at the UNIDROIT/International Bar Association Conference on current trends in the modernisation of the law governing personal property security, Rome, 28 November 1994.

[16] It also causes an extra risk for the bank: the borrower may have surrendered his warehouse receipts to the bank, but as long as the warehouse operator has not been notified of this, the borrower still has the possibility to take the commodities out of the warehouse: a simple order, signed by the party to which the original warehouse receipt was issued, is enough to effect a delivery out of the warehouse. To obtain additional security, banks therefore have to "perfect" their security interest in the commodities for which they have been remitted warehouse receipts by registering this security interest or by entering into a "constructive pledge" (see section C.). If a country's legal and regulatory environment does not allow for this perfection of a security interest, warehouse receipt finance will be an unattractive option for banks.

30. A negotiable warehouse receipt is made out to the order of a named person or to bearer. It is a negotiable commodity paper, and it serves as possessory collateral. When the bearer of a properly endorsed receipt surrenders it to the warehouseman, he receives delivery of goods stored against this negotiable receipt. If the commodities stored have been properly graded, delivery of a negotiable warehouse receipt may replace normal physical delivery.

CHART III

NEGOTIABLE WAREHOUSE RECEIPTS AS A TRADABLE INSTRUMENT



31. The large advantage of negotiable warehouse receipts is that they can be traded on a secondary market. For this to happen, a bank (or eventually a large trading firm) would have to attach a "banker's acceptance" to the warehouse receipt, indicating that it is guaranteeing it (thus substituting its own credit for that of the issuer). The warehouse receipt, with the banker's acceptance attached, can then be sold to other parties. This could have major economic benefits:

(a) Trading in warehouse receipts means trading in titles to goods, which in effect implies trading in commodities for forward delivery. Although actual delivery would be extremely rare (the borrower would normally prefer to reimburse his loans), the financial value of the warehouse receipt (if properly construed) would follow commodity prices, thus allowing an effective commodity price hedge for domestic producers, processors and others.

(b) If a more or less "normal" differential between the commodities in a certain location (for example a port) and a foreign futures market is established, the warehouse receipts could act as a way for domestic producers or exporters to make delivery to the exchange, even if the warehouse is not listed by the exchange. This would be through the "Exchange of Futures for Physicals" mechanism established by most exchanges: rather than closing out a short futures position, the producer/exporter would deliver the warehouse receipts to a foreign buyer (receiving or paying the normal differential) who would then take over the short position.

(c) Making warehouse receipts negotiable is likely to attract a larger pool of capital to commodity financing[17], and also reduces the liquidity pressure on the bank which first

[17] This is evident, for example, in the functioning of the London Metal Exchange (LME). Metal stocks are high without putting much pressure on world prices, simply because banks hold a major part of stocks. It is estimated that early 1994, some 55 to 60 per cent of the world's metal stocks were held through the LME, and that banks held 80 per cent of these - that is, banks controlled almost half of world metal stocks, which was made possible by the LME's warrant (or warehouse receipt) system. (*Metal Bulletin,* 27 January 1994).

financed the commodity. This is especially the case if such warehouse receipts can be discounted by the country's Central Bank, or even by one of the developed countries' Central Banks - in which case the warehouse receipts would become valid no-risk collateral even for international banks and trade houses.

32. Simply making warehouse receipts negotiable is not enough to create a secondary market. Potential buyers also need trust in the system. This implies that:

(a) Warehouse operators permitted to issue negotiable warehouse receipts should be specifically licensed by the Government to do so, and their functioning should regularly be checked.

(b) There has to be a tracking system for the warehouse receipts, to ensure that at each moment in time, only one party has legal title to the commodities held as collateral. One possibility would be for the warehouse operator to register every change of ownership of the warehouse receipt; when the system is more developed, a central registry (preferably in a government department) probably becomes more efficient.

(c) The warehouse receipts have to convey clear and unequivocal rights to the entities holding them. It is probably best if the various warehouse operators in a country agree to one common document or, if they fail to do so, that the government prescribes standard documentation (in countries where warehouse receipts are used, governments normally prescribe the minimum contents of these receipts).

(d) The country's legal system needs to be appropriate for this type of financial transaction. For example, when the warehouse goes bankrupt, the owner of the receipt has to be able to lay immediate claim on the commodity.

(e) The system needs to be sufficiently flexible to allow a normal functioning of the cash markets, with the original borrower using the commodities, for example for exports, thus reimbursing his loan.

33. Contrary to non-negotiable warehouse receipts, negotiable warehouse receipts cannot easily be claimed in part: if a buyer is found for, say half of the goods in storage, the negotiable warehouse receipt would have to be redrawn to allow continuing warehousing of the remaining half, which entails considerable extra cost. This makes them less suited to the financing of continuing operations, that is, in cases where the pool of commodities in the warehouse continually changes. Negotiable warehouse receipts are in practice mainly useful for stocks that are held for longer periods, e.g. security or seasonal stocks, or for stocks of commodities that are more or less fungible, e.g. metals or grains.

34. One of the main costs of warehouse receipt financing for banks are those related to the time needed to check and set up the financing facility. For a warehouse receipt from a European or United States warehousing company there is no problem, but if it is issued by a developing country warehousing company, banks not only have to check on how reliable the company is, but also the legalities of its country's law. For example, if a bank holds a non-negotiable warehouse receipt issued to a borrower, and the borrower goes bankrupt, the bank has to be able to execute its ownership rights without undue difficulty, even if its name does not occur on the receipt. This discovery process entails personnel and legal costs which may be difficult to estimate in advance, in addition to the large investment of time trying to make a transaction of

this kind secure. This type of costs can be considerably reduced if governments clearly stipulate the rules and regulations surrounding warehouse receipt finance (keeping into mind that these rules and regulations may need to be changed in response to a changing trading and financing environment). In practice, international companies often prefer to deal with western warehousing or transport companies; these can lease local warehouses which issue warehouse receipts, backing them by a counter-guarantee by the western head office.

D. Legal aspects of using warehouse receipts as collateral[18]

35. Apart from a number of practical conditions which need to be fullfilled before a warehouse receipt can be acceptable collateral (as is discussed below), a number of legal factors are also relevant for determining whether and how warehouse receipts can be used for collateral purposes. In this section, the legal modalities that may turn a warehouse receipt into a valid collateral are discussed; the wider legal aspects, including with respect to the licensing of and controls over warehouse operators and the enforcement of the rights of lenders, are discussed in later sections. It should be noted that the law applicable to commodity warehousing and to warehouse receipts is different from country to country; even the terminology used is often different. Many civil law (also called code law) countries (with laws based on French and Spanish models) have specific laws dealing with commodity warehousing, although they may not have a comprehensive regulation as concerns warehouse receipt financing; some common (English) law countries (or even states within federal countries) also have specific warehousing laws, but in most, warehousing regulations are based on the general rules on "bailment" (see below) and pledges, and more generally, on long-standing business practice. The description in this section can therefore only be a broad one.

36. Chart IV below gives a broad overview of the ways warehouse receipts can be used for collateral purposes, from a legal point of view. The basic principle is that the lender is provided with a security interest in a collateral, in casu a warehouse receipt. If the borrower defaults, the lender can sell or otherwise dispose of the collateral to obtain at least partial reimbursement of his loan. There are three ways for the lender to obtain a security interest:

* he can be given a legal title to the collateral (this is known as "mortgaging" in common law countries, although in many others, the term "mortaging" is only used for the provision of immovable goods or even only land as collateral);
* he can register his security interest with a central (normally government-controlled) depository;
* or he can be given possession of the collateral.

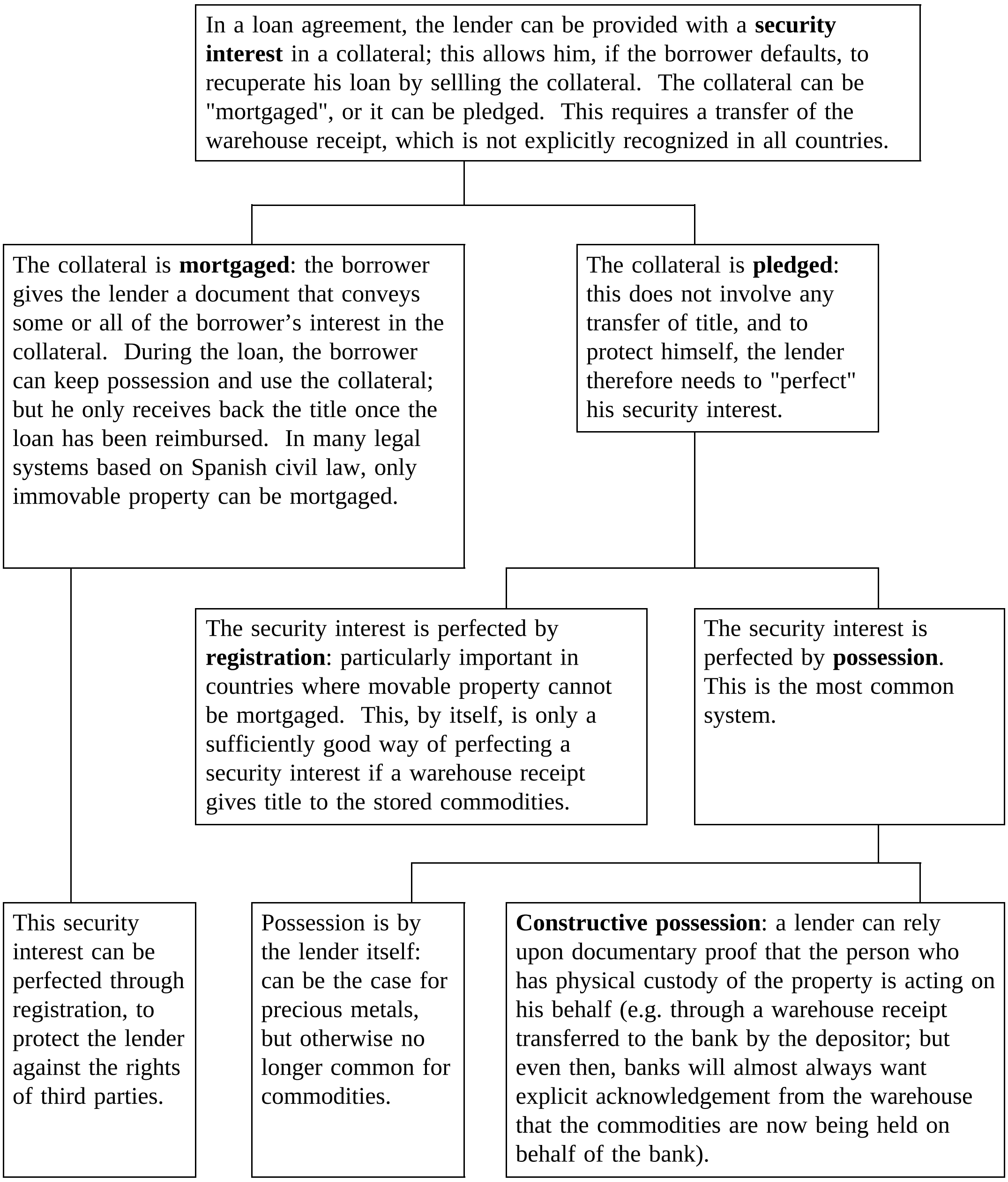
37. In the latter two forms, the borrower does not give up title to the collateral, but merely "pledges" it to the lender. The lender normally has the strongest claims if he obtains possession of the collateral. One way to do this is for the lender to take direct control over the commodities: e.g., putting gold into its own vaults, or as was frequently the case in the past and occasionally still the case in Latin America, have its own warehousing subsidiary store the commodities. Alternatively, the lender can use an independent agent (an independent warehousing company) to control the commodities on his behalf. In both cases, warehouse receipts can only be used as good collateral if it is legally recognized that they can be transferred

---

[18] This section draws heavily on Annex 2, "Legal Issues", from Jonathan Coulter and Andrew W. Shepherd, *Inventory credit; an approach to developing agricultural markets*, FAO Agricultural Services Bulletin 120, Rome, 1995.

Chart IV

THE WAYS THAT WAREHOUSE RECEIPTS CAN BE USED AS COLLATERAL - LEGAL ASPECTS



from the original depositor of the commodities to others. In a number of countries, it is not clear whether such a transfer can be legally enforced: some countries list the types of documents that can be transferred for collateral purposes, without mentioning warehouse receipts.

38. Whether the construction is one of a mortgage or a pledge, the lender has rights to the collateral if the borrower defaults. However, this does not protect him against the rights of third parties. For example, a producer could first use agricultural crops being produced on his land as collateral for a loan, and then, after these crops have been harvested and stored in a warehouse against the issuance of warehouse receipts, use these receipts as collateral for a new loan: the commodities have then been pledged or mortgaged twice. To avoid this risk, the lender needs

to "perfect" his security interest. In theory, this can be by registration (although many countries do not provide this possibility), or in the case of a pledge, also by taking physical possession. If a lender has physical possession, it should be clear to other potential lenders that the commodities are already pledged as collateral for a loan (although there still is the risk of earlier pledging of the commodities by the borrower). If the security interest is registered, all potential lenders can consult the registry, making it easy to discover whether a certain asset has already been used as collateral and thus, whether another lender has first priority to the collateral in case of a default. By perfecting a security interest, the lender thus obtains priority over the claims of others in the case of a default by the borrower; even if the borrower then had wrongfully sold the collateral to a buyer who acted in good faith (but who had obviously failed to obtain all relevant information), the lender can still claim the collateral.

39. It should be noted that even if the possibility of just registering a security interest exists, this usually does not provide the lender equal protection to actually possessing the commodity (or the warehouse receipt that conveys possession of the commodity). In the case of a default, the delays in taking possession of a collateral can be large, and courts at times do not give the expected priority to the lender (one evident risk is that if procedures are slow and warehouse operators have, as they usually do, first lien to the commodities in order to ensure payment for storage charges, the warehouse operator will in effect obtain most of the benefit from the liquidation of the stock). Similar problems at times also arise for holders of warehouse receipts, but this is less common.

40. In quite a few countries, it may not be possible to "mortgage" warehouse receipts simply because warehouse receipts are not considered as documents of title. They are documents of title only when, by law or by long-standing business custom, the receipt is recognized as sufficient evidence that the person to whom it is issued has title to the property described. In some countries, the law explicitly recognizes warehouse receipts as documents of title; for example, India or the United States of America. But in other countries, they may be legally considered only as evidence of possession by the warehouse operator on behalf of the depositor.[19]

41. If warehouse receipts do not convey title, then evidently, their use for collateral purposes, including as a pledge, is made more complicated (for this reason, it may be preferable for developing countries which wish to improve their financing possibilities to codify the status of warehouse receipts in law, using existing models from other countries). If they are title documents, then their transfer to a bank automatically gives the bank possession of the commodities deposited in the warehouse. If the borrower defaults, the bank can present the documents to the warehouse operator to obtain the commodities, and liquidate them. If they are not title documents, the transfer and registration of the receipt may not give the lender any security: the warehouseman only has obligations to the depositor and not to a purchaser or new possessor of a warehouse receipt, until the moment that notice of the transfer has been communicated by the transferor to the warehouse company. Therefore, if the warehouse receipt does not have the legal status of a title document, the solution used is generally a tripartite arrangement between the lender, the borrower, and the warehouse, in which the warehouse operator explicitly acknowledges to the lender that it is holding the commodities on the lender's

[19] Note that in many countries with laws based on Spanish law, two sets of warehouse documents are issued, one certificate which acknowledges the deposit and effectively conveys title to the commodities deposited, and one certificate, called "warrant", which records the initial monetary value of the commodities deposited; only if both documents are presented simultaneously, the warehouse operator will release the goods. In common (that is, Anglo-Saxon) law countries, "warrants" is the name given to warehouse receipts that explicitly convey title to goods stored.

behalf - this is known as an "attornment" arrangement. This tripartite arrangements makes the warehouse receipt functionally equivalent to ownership of and title to the stored commodity, and allows quick liquidation if the borrower defaults.

42. In conclusion, the use of warehouse receipts for collateral purposes is easiest if firstly, it is determined by law that they are title documents, and secondly, it is determined by law that they are transferable - nevertheless, this is not essential, and as long as nothing in a country's law prevents this, a tripartite arrangement between lender, borrower and warehouse operator can also allow for this collateral usage. To ensure that the system is not abused, a central, publicly accessible registry for registering security interests is also required. But even if legally, warehouse receipts can be used for collateral purposes, they will only be used as such in practice if the various economic actors involved understand warehouse receipt financing operations, and a number of other conditions are in place to ensure the integrity of the system - more about this below.

E. The role of warehouse receipts in various forms of commodity finance

1. The financing of domestic production, trade and distribution

43. One of the principal problems of domestic commodity marketing in many developing countries is the lack of credit throughout the marketing chain. Agricultural producers are often forced to sell a significant part of their crop directly after harvest, to obtain the cash they need for social ceremonies (this is normally the season when celebrations are held) and for paying government taxes (in many countries, an annual tax is levied on farmers, payable directly after harvest). This causes a glut in the marketing chain. By itself, this would not create major problems, were it not for the fact that traders also do not have the money to store large amounts of commodities for a longer period - even if pre-export finance is provided to some of the larger exporters, this may not go far down the marketing chain. This exacerbates seasonal price movements, and may lead to inefficient marketing behaviour (ports become congested directly after harvest, and are underutilized later in the year). Metals and fuels producers and refiners in most countries export directly - the problem of scarce funds (with which many have been confronted in recent years) is largely a problem of poor access to pre-export finance. On the distribution side, with the abolition of government marketing agencies in many countries, private importers have had to take over not only the government's import role, but also its role in storing the imported commodities - and because of their lack of finance, this has often proven difficult.

44. An expanded use of warehouse receipts can solve or at least abate many of these problems. In some countries, local entities issue warehouse receipts that are acceptable as collateral for local banks. The use of such receipts for domestic trade is not the subject of this paper, but it should be noted that in (very) few developing countries, warehouse receipts are being used to improve domestic grain trade.[20] Warehouse receipts can also improve the domestic part of export trade, bringing national or international finance down to the level of farmers and small traders. For example, the "quedan" issued by sugar (and grain) mills in the Philippines provide sugar and paddy growers with easy access to credit.[21] These "quedan"

[20] See Jonathan Coulter and Andrew W. Shepherd, op.cit.

[21] A quedan indicates the volume stored, the name of the producer and mill, the quality of the product, and, in the case of sugar, the end-use. For sugar, the end-use influences the value for collateral purposes: there are different quota, and sugar stored under the "B" quota, for domestic sales, has a higher per-unit value that "A" sugar (for exports to the United States of America) or "D" sugar (for the world market).

indicate the quantity of sugar or paddy stored by a mill for processing, but belonging to a grower; growers can use them to obtain bank loans. Similarly, under the Pepper Ownership Scheme introduced by Malaysia's Pepper Marketing Board (PMB), farmers which store pepper at the PMB's designated warehouse obtain an ownership certificate (specifying owner, quantity and quality of the pepper) which can be used as a collateral for loans. In Eastern Africa, the PTA Bank is trying to set up similar schemes which would allow coffee farmers to obtain low-cost loans against coffee stored.

45. Warehouse receipts can also reduce the credit needs of importers. Where traders are unwilling to provide buyers' credit to importers, they can use warehouse receipts to ensure cash payments for products exported to the country. This practice of "pay against commodities" is quite common in countries of the CIS and since the devaluation of the CFA franc, in West-African Franc-zone countries. Rather than selling directly to local buyers, traders prefer to deliver to a local warehouse. When the commodity is discharged from the warehouse, simultaneously cash is paid by the buyer, eliminating all payment risks. Warehouse receipts will show the ownership of the commodity, and insurance cover on such goods held overseas in readiness for quicker delivery to buyers is available to protect against the loss of the goods or a ban on the re-export of the unsold commodities.

2. The financing of commodity processing

46. Processors are among the key beneficiaries of improved financing systems. The value of the commodities they have to keep in stock is often high, especially in relation to their processing margin. This problem is even stronger in developing countries than in developed ones, as poor road infrastructure and logistics make just-in-time delivery prohibitively difficult. The processor owns commodities, but naturally, their storage in an independently controlled field

BOX II

THE PTA BANK'S EXPERIENCE WITH WAREHOUSE RECEIPT FINANCE

Like in other parts of Africa, the collapse of marketing boards and other organized state trading agencies in the early 1990s created a completely new environment for commodity trade in eastern and southern Africa. Farmers were no longer protected against price risks; most trade fell into the hands of often small and inexperienced domestic traders, exporters and importers; and local banks were not in a position to provide the needed trade finance. Already in late 1992, the Eastern and Southern African Trade & Development Bank (PTA Bank) recognized there was a need for a new initiative, and started a programme that would allow it, through local banks, to finance smallholders and local traders.

The PTA Bank decided to adopt the concept of the "Price Guarantee Contract (PGC) Facility", basically finance on the basis of warehouse receipts and other security arrangements, with price protection built in through the use of commodity options - this would allow the PTA Bank to provide funding to even small traders and farmers' associations without worries about counterparty risk. In 1994, it started a pilot programme in eight of its member countries, focussing on the coffee and cotton price sectors. Training, for staff of the PTA Bank and other banks which could become involved as well as for potential beneficiaries of loans, played a crucial role in this pilot phase. In 1995, the first PGC Facility loans were signed; beneficiaries were a number of coffee exporters and cotton mills, who thus were able to receive funds at a cost considerably lower than that common for commodity loans in the region. One farmers' association and a coffee roaster also benefited. Apart from a lower interest rate, these processors and exporters benefited from the disappearance of the liquidity problems which had previously limited their commercial possibilities (credits automatically increase with the size of turnover).

The PTA Bank is now in the process of using these new lending procedures to finance other commodity sectors, and to finance further upstream. In the latter respect, the Bank is now able to provide credit to larger farmers and to local farmers' associations for green (that is, unroasted) coffee; these groups were previously largely excluded from the formal banking sector.

Based on information provided by Commodity Risk Management S.A., Geneva.

warehouse is impractical because the processor requires the goods for further processing to make the final sale. In such cases, and if the bank has a great degree of trust in the processor, it may be willing to release the goods to the processor against the signing of a trust receipt in which the processor:

- acknowledges receipt of the goods or the title documents (warehouse receipts) from the bank;
- recognizes the bank's security interest in the goods he is receiving;
- states that he is acting as the bank's trustee in delivering the goods to the customer;
- promises to remit the proceeds from the sale of these goods to the bank in payment of the loan (or to return the goods to the bank if they are not sold);
- agrees to keep the goods fully insured against all insurable risks.

47. In releasing the goods that acted as collateral to the processor, the bank loses its physical possession of the goods - this is replaced by a mere security interest, which may be more difficult to enforce if problems arise. The signing of the trust receipt does not prevent the dishonest misuse of the goods or the proceeds. The bank will therefore release goods on a trust receipt only when it has full confidence in the reliability and moral responsibility of the processor. Although some larger processors (for example metal processors in China, or sugar processors in the CIS) manage to obtain international finance which is to be reimbursed by the proceeds of the sales of their locally-sold products, in general it would appear that locally-based banks are best placed to evaluate the commercial reliability of processors. One regional bank in East Africa is already providing funds on this basis to cotton processors, and it would appear that there are possibilities for local and regional banks to expand this type of funding.

48. If the funding is to a producer or exporter which has to have its commodities processed (with the processor "tolling" the commodities for a fixed fee) before sale is possible, banks also have to ensure that the processor cannot seize the commodities if, for example, the producer or exporter has financial problems. In practice, this makes it very difficult to finance this type of operations if the bank does not have an office or representative in the country concerned.

3. Pre-export financing[22]

49. Through pre-export financing, exporters are pre-paid for the products they are going to export - or even, that they still have to produce (part of the sugar campaign of several developing countries was, in the recent past, pre-financed by trading companies). The costs of inland transport to a port of exports, the purchasing of raw materials for pre-export processing, processing costs and even the storage costs until export documentation has been arranged can all be covered by pre-export finance. There are three additional advantages in pre-export finance. Firstly, for the purpose of construction and exploration large lump-sum expenditures are required which a pre-export deal can provide to a producer. Secondly, a producer or exporter can also benefit from lower borrowing costs because of the fact that a bank has obtained the assigned future sales contracts as well as title to the commodities as a loan collateral. Thirdly, pre-financing agreements can improve a country's marketing position. In a tight market these contracts are likely to attract highly reliable customers that are concerned with the security of

[22] Only pre-export finance provided by foreign institutions (banks or trade houses) is discussed here. Several developing countries with relatively advanced financial systems (e.g. the Republic of Korea, the Philippines, India, Indonesia) also operate schemes to provide pre-export finance to their producers, at times in hard currency; however, most of these schemes are focussed on manufactured exports, not commodities.

supply. Pre-export financing is thus an important financial tool for many cash-poor exporting countries, helping them to overcome constraints which prevent them from raising additional funds on a traditional basis from international financial institutions.

50. Normally, the procedure is that a bank or a trader provides a credit facility to an exporter or producer in exchange for title to the products or a pledge of the products[23] that will be sold - products that either have already been produced (in this case, the normal procedure is to use warehouse receipts - see chart V below for an overview of the procedures) or that will be produced (or extracted) with the funds that are provided. If a trader provided the finance, he will generally take delivery of the commodities and deduct the advance (plus charges) from the amount to be paid to the exporter. In the case a bank was pre-financing, payments are generally made directly by the buyer to the bank (rather than to the exporter/producer), which pays only the balance, minus loan reimbursements, to the exporter.[24] In cases where an exporter has a relatively good reputation, the bank may accept payment through an evidence account (where the bank knows which finance is available and how it is used, but has no direct control), rather than an escrow account (controlled by the bank itself).

51. In agricultural markets and metals markets, some form of prefinancing is part of many contracts. In most cases, letter of credit (L/C) procedures are used - see Annex II for a description of the various forms in which pre-export finance is provided through L/C's. In some cases (in particlar when using so-called "green clause" L/C's), part of or all the prefinancing becomes available only once the exporter has delivered commodities into a warehouse, and the warehouse receipts are assigned to the bank.

52. In the case of oil, international financing is often possible only once the oil has been pumped into a tanker. Nevertheless, several large pre-financing deals have been concluded since the early 1980s. An early example is a deal signed in 1982 between Mexico and the US, where, as part of an economic rescue package, Mexico received a $1 billion credit in return for future supplies of low-priced oil to the US Strategic Petroleum Reserve (SPR) (an early predecessor of the much larger rescue package of 1995, again securitized by Mexico's oil earnings[25]). Less forced by exceptional economic circumstances and probably more representative, Argentina, Colombia, Ecuador and Cameroon arranged pre-export financing securitized by part of their oil exports in the mid-1980s, Angola in 1989; and even when they defaulted on other loans, the loans backed up by oil exports were reimbursed fully and in time. Another example is Iran where pre-financing agreements (with some countertrade characteristics) in 1989 and 1990 alone yielded the country over US$ 2.5 billion in credits, which helped reconstruction following the

---

[23] As is argued in N. Budd, *Financing operations for commodity producers - a guide to pre-export financing of physical commodities in origin countries*, International Financial Law Review, January 1991, obtaining a title to or possession of the commodities rather than just a security interest provides much more safety in most countries.

[24] This makes it less attractive for the exporter to default as, apart from defaulting to the bank, he will also be defaulting to one or more of his foreign buyers. As large traders normally keep eachother informed of this type of defaults and act accordingly, exporters can be made to pay heavily for defaulting on their contracts.

[25] Oil revenues were pledged as collateral for a US$ 20 billion rescue package provided by the United States Exchange Stabilization Fund. Foreign buyers of Mexican oil would deposit their payments on a special account at the Federal Reserve Bank of New York; if Mexico defaults on its repayments, the US government has recourse to this account. See *Collateral deal gives life to an ailing economy*, Petroleum Economist, March 1995.

long war with Iraq and also tapped substantial new (Japanese) sources of finance.[26]

53. It should be noted that in terms of the financing structures being used, pre-export finance is an area in full expansion - banks have found it worthwhile to devise new ways of funding their new (and often high-risk) potential clients in developing countries and countries in transition, often on request of the foreign trade houses that buy from these countries, and basically by devising various ways in which these potential clients can mortgage their future earnings flows. The role of warehouse receipts in this process is declining, primarily because the ability to use warehouse receipts as collateral depends to a major extent on the availability of reliable warehouse operators, and on the national legal and regulatory framework, both factors out of control for individual developed country trade financing banks. Local banks may play a role, for example in providing a performance guarantee for an exporter (the foreign bank lends to the exporter, which is supposed to deliver goods to a buyer who will then reimburse the bank; in case the exporter does not deliver, the local bank's performance guarantee ensures reimbursement of the foreign bank).[27] However, where performance guarantees are not available or prohibitively expensive, other structures need to be devised, often including the use of foreign buyers as (explicit or implicit) guarantors. Even though pre-export financing deals are often repeatable (giving rise to a credit line rather than a one-off credit), the availability and costs of guarantees from local banks or foreign buyers, as well as the time and legal efforts involved in structuring the transactions still pose strong limits - limits that could be made less stringent if a good system for using warehouse receipts for collateral purposes were to exist even in high-risk countries.

[26] See Intercapital Brokers Ltd., *The complete guide to oil price swaps*, December 1990.

[27] See R. Barnes, op.cit.

Chapter II

CHARACTERISTICS OF A GOOD COLLATERAL

54. Anything which is readily saleable, movable[28], exportable, can be traded on one of the exchanges, has sufficient value and can be assigned to a financial institution can serve as a collateral for a loan. But not every commodity is equally useful for collateral purposes. The value of a collateral is determined by:

a. The quality of the commodity
b. The transparency of the market
c. Liquidation costs
d. The price volatility of the commodity
e. The durability of the commodity
f. The location of the commodity

Table 4

Characteristics of a good collateral

Characteristic	Reason why important
Standard and certifiable quality	Provides the certitude of a good marketability of the commodity
Market transparency	* Allows knowledge on real value commodities * May allow price risk management
Deliverable to an organized market place	Makes sale easier and thus reduces liquidation costs
Reasonably low price volatility	Provides security that the value of the commodities, even if not hedged, will continue to be sufficient to cover the loan
Good durability	Provides more security: if the bank has to liquidate the stock, delays do not have a very negative impact on its value.
Good location	Ensures that, if the bank needs to liquidate, it can obtain and sell the stock, and receive the currency it requires.

A. The quality of the commodity

55. The quality of the commodity needs to meet the market's requirements. This has to be verified by an independent agent. This implies that the perceived quality of a commodity for collateral purposes is not determined only by purely physical factors, but also by the possibility to verify the product's specifications and the reliability of the verifier. The specifications and means of verification obviously vary from commodity to commodity.

B. The transparency of the market

56. Ideally, the commodity should be quoted on an exchange on which a sufficient volume is traded; or alternatively, it may be quoted by a well-established price information vendor, with an over-the-counter risk management market developed on the back of this price information. This permits not only a correct identification of the commodity's value, but also a protection of the value of the collateral against price declines: finance can then be provided against a much larger part of the value of the commodities, as no "cushion" against price declines needs to be calculated in.[29] Sesame, for example, is not quoted on an exchange so it is difficult to use it

---

[28] Movability is an important precondition for using commodities as collateral. A factory with a high value, or even farmland can be used as a collateral but in the case of a default it would not be possible to ship it to its final buyer (so it would not be considered a "good" collateral by an international credit provider) whereas this can be done with any commodity - softs, metals and fuels.

[29] In most cases, the maximum a bank is willing to finance is 70-80 per cent for a commodity like coffee where there is an organized futures market; where there is no relevant futures market, for instance in the case of rice, only about half of the total value of the commodity is likely to be financed.

as a collateral. Rice is also not often used as a collateral because there is no organized futures market except in the United States of America, which is not of much use for trade outside of that country.

57. If no liquid futures exchange exists for the commodity, a minimum condition for using it as collateral is the existence of an independent and transparent pricing mechanism. For example, for major ores, it is relatively easy to find prices (using independent sources such as Metal Bulletin), even if they are not traded on an exchange. Alternatively, major national auction markets (such as the tobacco markets in Zimbabwe and Malawi) also provide sufficient liquidity and transparency to allow effective collateralized financing. On the other hand, commodities with a narrow and non-transparent market, even if they are high-value (e.g., minor metals) are difficult to use for collateral purposes. Exceptions do exist; for example, in a 1993 financing in the United States, timber land was provided as security (with the timber grown on the land providing the cash flow - and while a plywood futures market exists in the United States, limited liquidity makes its use for large transactions very difficult, nor does it quote prices very far forward) for US$ 385 million worth of notes issued by a specially-created "special purpose vehicle".[30]

58. In any case, even in the case of a commodity for which no reliable price quote exists, the commodity can be used to add to other guarantees - for instance, a trader may buy rice from a government agency in Pakistan and pay against warehouse receipts, with back-up guarantees provided by the government treasury.

C. Liquidation costs

59. When financing, a lender will take into consideration not only the possible decline in the market price of the collateral over the time of storage, but also the cost of actually liquidating the merchandise, should it be necessary to do so. If there is a default and the merchandise in a certain warehouse becomes the property of the bank, the bank will want to sell the goods as soon as possible. In such a situation, some banks and traders estimate that on average about 30-40 per cent of the market value of the goods may be lost, because of discounts that have to be taken on the price, and because storage until the time of sale, transportation etc. have to be paid. These liquidation costs will be less if the goods can easily be sold on an auction or delivered to an exchange.

D. The price volatility of the commodity

60. Those who store a commodity are exposed to the price fluctuations of this commodity. An example is provided by the case of a commodity distributor who buys a certain commodity for a certain price and holds it in storage for 6 months for onsale to his domestic customers. The distributor does not know what the price of this commodity will be the day he decides to sell it. For a number of commodities, a large part of this risk can be covered by using futures or options contracts. The more volatile the price of a commodity, the riskier it is to store: that means that if commodities are used as collateral and a default occurs, the value of the commodity may no longer cover the advances made by the bank. For this reason, many banks, for example most agricultural banks in the United States, insist that the commodity producers and traders they lend to cover part of their price risks.

---

[30] The Committee on Bankruptcy and Corporate Reorganization of The Association of the Bar of the City of New York, "Structured Financing Techniques", *The Business Laywer*, Vol. 50, February 1995.

BOX III

PROBLEMS WITH USING CRUDE OIL AND PETROLEUM PRODUCTS AS COLLATERAL

1. Crude oil and petroleum products are the single largest group of exports of developing countries. They are different from most other commodities in that, even though production is often externally financed, trade finance normally cover only the phase between loading onto a ship and consumption - the period until loading is not financed. Even though the period between production and loading is short, often only a few days, the sheer volume of oil business makes it interesting to see whether finance cannot be made possible at an earlier stage in the chain.

2. The structural problems that arise with regard to using the products of the energy sector as collateral (in the sense of warehouse) can broadly be classified into those relating to the nature of the products, and those relating to the costs and problems of managing them in storage.

A. <u>Nature of the products</u>

3. Crude oil and petroleum products come in many forms, and their value cannot be determined on the basis of their name alone. Crude oil, for instance, is normally bought not by volume, but by "dry" volume, that is, water excluded (some crudes are produced with a lot of water). Fuel oils also vary greatly in value. To determine the quality and the grade of the product, very precise measurements are necessary; even then, the value of the product at a certain location would still not be well-known, because the pricing formulae for oil sector products are rather complicated.

4. While these problems apply to oil trade in general, they are much more severe for the on-shore storage of in particular petroleum products for collateral purposes. Petroleum products are subject to ageing (evaporation or oxidation can change certain key parameters such as the octane rating of gasoline, or the colour of gas oil), and some are sensitive to contamination. This would make frequent inspection necessary.

5. A problem when arranging smaller financing packages (but an advantage for large financial deals) is the size of physical deals: for crude oil, the optimum size of a single lifting is a minimum of 500,000 barrels - not using all available tanker capacity would result in dead freight claims from vessel owners, making transport relatively expensive. If only 200,000 barrels is committed as collateral, for all practical purposes it would need to be commingled with another 300,000 barrels in order to take possession - and this may cause delays and some extra costs. Additionally, oil is a strategic commodity. A bank wishing to lift oil earlier pledged as collateral may be confronted with government intervention, a risk that inflates the costs of insurance.

B. <u>Costs and problems with managing crude oil and petroleum products in storage</u>

6. Most public oil terminals operate on throughput. For terminal operators, immobilizing their terminal space for longer-term financing (that is, the 60-180 days for which financing institutions normally provide credit) would thus have large opportunity costs. This is in addition to the relatively high operating costs of longer-term storage. For example, several types of fuel oil must be continuously heated if they are to maintain their fluidity. Also, the fuels in a terminal are normally commingled, which makes it necessary to have frequent independent inspection audits which would balance the physical stock with the pledged collateral and the stocks owned by other parties.

7. For these reasons, it would appear extremely difficult to use warehouse receipts, in the traditional sense, as collateral for finance. However, it is possible to use delivery allotments - the right to tap a certain amount of (fungible) oil at a certain storage terminal or pipeline system - as collateral. This is similar to the delivery system of the New York Mercantile Exchange: someone who takes delivery does not get a specific lot of fuels, but can tap the US's oil pipeline network at any of a number of locations. If terminal operators in producing countries are willing, and legally able, to provide such tradable allotments, oil trade finance could well move one step further up the marketing chain.

61. By itself, hedging will not provide sufficient protection when a transaction is pre-financed without collateral. For example, consider the case of a trader buying X bags of coffee from a seller for a fixed price. The trader provides pre-finance to the seller, and enters into a hedge to ensure that the coffee, once delivered, can be sold at a profit. However, if coffee prices increase dramatically, the seller may well default on his obligations, leaving the trader both with a hedge- and a physical trade loss. Also, if an exporter hedges on commodities which are being used as collateral, this provides no security to a bank: if prices decrease, the exporter may well cash in on his hedge profits, and default on his reimbursements to his bank which then will have recourse only to the commodities, much reduced in value. For this reason, the bank or trade house providing the finance will normally insist that it manages the hedge account, i.e. that profits on the hedge (which compensate the reduction of the value of the collateral) will directly be paid to the bank or trade house.

E. The durability of the commodity

62. Generally, if the goods are perishable or out-of-season, a very low percentage of the value of the goods will be advanced. For example, sesame, if stored over a certain time, loses its oil content and becomes worthless as a collateral. The same is the case for some petroleum products (see also Box I). On the other hand, if the commodities involved have a ready market and the logistics of exports are well-organized, financing on the basis of the "flow" of commodities is possible. For example, United States banks provide working capital finance to Mexican vegetable growers; the banks have title to the vegetables grown, and reimbursement is through the use of an escrow account on which United States importers deposit their payments. Developing country flower producers, selling through the Dutch auction market, can gain access to international finance in a similar manner.

F. The location of the commodity

63. A commodity has the highest collateral value if it has been extracted, refined and is in the warehouse or it has left the warehouse and is on its way to the final buyer (freight forwarders certificates, combined transport documents and even railway bills can be acceptable for collateral purposes if the borrower has a reasonably good reputation). Nevertheless, not all warehouses are equally acceptable to the international financing community: the location of the warehouse and warehouse characteristics are of major importance. This is discussed in the following chapter.

Chapter III

WAREHOUSE LOCATION AND CHARACTERISTICS AND THE VALUE OF COLLATERAL

64. Warehouses which are independently managed and are able to provide collateralization facilities do not exist in all countries. This chapter sets out how the ownership of a warehouse, the country in which it is located and its other characteristics influence the value that will be given by national and international credit providers to the commodities stored in it.

A. Types of warehouses

1 Private warehouses

65. In a private warehouse, manufacturing and warehousing take place under the same roof, that is, the primary business of the controlling company is not warehousing but manufacturing, wholesaling or retailing, with the warehouse operated as a part of its general business. There is therefore a close relation between the warehouse and the owner of the stored commodities, making it difficult to prove that bailment exists.[31]

2 Public warehouses

66. A public warehouse is operated by a warehouseman, who stores commodities for third parties for a set fee. As the warehouseman does not obtain title to the commodities stored, but only retains possession, it is easy to prove that bailment exists.

67. There are two types of public warehouses:

* A **terminal** warehouse is separate and distinct from the physical plant of the firm or firms owning the goods stored in the warehouse. It is usually a large storage area, e.g. located in a port, that serves many businesses and is owned and operated by an independent warehouse company. Since this type of warehouse is geographically removed from the depositor's place of business, using such a warehouse for collateral purposes may be inconvenient, and brings with it a risk of transportation (because of which there are added insurance fees compared to the field warehouses discussed below).

* A **field** warehouse, on the other hand, is on or near the premises of the firm depositing the commodities.[32] The warehouse belongs to the firm which want to obtain credit, but in order to obtain credit, an arrangement is set up whereby an independent warehouse operator leases (part of) the storage facility for a nominal fee, and becomes

---

[31] Bailment, an essential prerequisite for warehouse receipt financing, means that the ownership of the commodities resides in one person and the possession of it in another. For bailment to exist, the depositor, while retaining ownership, must relinquish possession of the commodities and the warehouseman must assume continuous and exclusive possession of them. If bailment cannot be shown, the holder of a warehouse receipt probably has no priority over other creditors in the case of a default.

[32] See N. Budd, op.cit., November 1994.

responsible for control of the commodities to be used as collateral. The primary purpose of this kind of a warehouse is to enable the owner of the stored goods to borrow against them and still have the goods close at hand.

68. The cost of field warehousing varies from 1-2 per cent per annum on the gross value of the goods stored. The depositor also pays all the costs of the warehouseman, including the salary of his bonded representative. The banks or other financial institutions involved also incur costs in policing and servicing warehouse receipt loans. Nevertheless, the extra security provided allows low-rate finance, and often the net cost to the borrower is much lower than that of more traditional financing arrangements.[33]

69. In principle, only public warehouses can provide warehouse receipts of use for international trade; with private warehouses, there is no control on whether the commodities against which the receipts are issued are indeed in the warehouse, and whether they have not been used several times as collateral. In practice, however, some trading firms do accept warehouse receipts issued by private warehouses, as additional security in what, in any case, is a financing relationship largely based on trust. At the same time, some public warehouses are hardly suited for the issuing of warehouse receipts, because of weaknesses in management or poor acceptance of the needs of international collateral management (e.g. independent inspections, provision of guarantees); also, in some countries, terminal warehouses are operated by banks which only use these warehouses to store commodities pledged as collateral for the loans they themselves arranged; that is, these warehouses can in effect not be used by other banks or financing institutes - as not all banks in a country are likely to be able to operate their own warehouses, this evidently limits the possibilities for collateralized financing.

B. Country risks

70. Whether a commodity is good collateral depends to a large extent on the country where it is produced or stored. To give one example, the collateral value of Vietnamese coffee stored in a Vietnamese warehouse is much lower than that of the same coffee in a Singapore warehouse (although the recent decision of the Vietnamese state bank to provide finance guarantees has increased this value). In the second case, a bank may wish to advance 80 per cent of its market value at a cost of LIBOR plus 2 %, while in the first case, only 40-50 % of the value would generally be financed, at a cost considerably above that of the interest rate prevailing in Singapore. The country in which a warehouse is located will thus be a major criterium for an international bank or trade house interested in providing collateralized finance. Still, even in what is considered a risky country, the provision of collateral facilitates access to credit. For example, in 1988, a French trading company, Louis Dreyfus, lent some US$ 600 million to Peru for purchases of agricultural products; the company received title to part of Peru's silver stocks (which were partly stored within the country) as collateral.[34]

71. If a country risk is not acceptable to a trade house or to its banker, the trade house will be unwilling or even unable to provide any import credit or pre-export finance to a business

---

[33] See for a practical example Richard P.G. Taylor, *Managing your collateral risk in Africa*, paper presented at the UNCTAD-PTA Bank African Oil Trade Conference, Harare, Zimbabwe, 15-17 April 1996.

[34] This arrangement reduced Peru's borrowing costs so much that the government decided not to export any silver for two years, to increase the size of its silver reserves for future collateral usage.

associate in the country (it will be interested only in cash-paid sales[35]) - unless it can provide the finance out of its own capital, and considers that the expected profit margin outweighs the risks.

72. When evaluating a country risk, traders look at several types of risks, including:
- political risks
- transfer risks
- currency risks
- legal risks.

Table 5

Country risks, and possible remedies

Risk	Possible remedies
Political risk: the risk of political instability or sudden changes in economic policy.	Government can refrain from sudden, arbitrary decisions, replacing its discretionary controls by a clear and stable system of economic policy; at the least, it should exempt transactions already entered into from the results of sudden economic policy changes.
Transfer risk: the risk of a shortage of foreign currency.	Taking into account the resultant savings on foreign trade costs, priority can be given to the provision of foreign exchange for collateralized financing transactions.
Currency risk: the risk of relative changes in the value of the domestic currency.	Governments can permit the use of currency risk management instruments, e.g. forward contracts offered by banks.
Legal risk: the risk that a certain transaction is found to be illegal or unenforceable.	Governments can ensure that a proper legal and regulatory framework is in place, and provide transparency on which transactions are enforceable, which ones are not.

73. Traders and banks will always assess the risks of a rapidly changing political situation in a country. Political instability in a country, either because of fear of war or revolution or because of a change in "business philosophy", makes it risky. An example of a change in business philosophy is that export licenses are suddenly taken away or payments are withheld for political reasons. In the area of collateralized finance, this has hurt some companies which had invested in Russia's oil industry: after investing several millions of dollars each to finance oil refinery operations, they found that when it was time to take the oil out (to repay these investments) their export licenses were taken away. A second example refers to Pakistan: in 1994, there was a decision to impose an "export tax" on cotton (domestic processors complained about increasing prices), so traders were unable to take previously committed cotton out of Pakistan. Similar problems have at times been suffered by those who bought cotton from India, where the resulting price discounts (to compensate for the risks of default when doing business with the country) became so large that at the end, the government had to announce that export bans would no longer apply to previously signed contracts.

74. As political conditions in a country can fluctuate, the risk premiums required to do business with the country vary, often within relatively short time frames (insurance companies and banks review their country risk premiums regularly, at least once a year, at times more frequently; and in between, changes can be made if the situation warrants it). In some, for example, Viet Nam where the Government is gradually putting into place the regulatory framework necessary for a market-based economy, business has become less risky in recent years, and thus, cheaper (meaning the country receives relatively more for its exports, pays less for its imports, and has better access to foreign capital; recently, payment obligations by the

[35] In practice, it may even insist on partial pre-payment to offset the risk of cancellation of the contract before delivery has taken place.

country's importers have even become eligible for forfaiting).

75. The transfer risk is that of a shortage of foreign exchange in the buyer's country delaying payments. This is often the case in countries that have little or no pools of foreign currency because most foreign earnings are already pledged in loan repayments. When countries have serious foreign exchange shortages, their central banks impose various forms of rationing of payments with systems involving import licences and special approvals, prone to delays and errors within the massive bureaucracy required. Payment in an unconvertible local currency is of no use to the foreign company and payment in a currency other than the agreed currency of invoice can create problems for an exporter who is financing the transaction, for example, on an overdraft basis in his domestic currency (even if this other currency is convertible, its payment is unexpected and the exporter would therefore not have covered his currency risks). Transfer risk concerns the cost of delays rather than total loss, because most payments are eventually transferred.

76. Normally, banks and trade houses prefer to provide finance to state companies. When foreign currency is scarce, state companies have a larger likelihood of obtaining allocations for loan repayments than do private companies. Largely for this reason (but also because of the benefits of a centralized quality control system) western trade companies are often among the most vocal opponents of a privatisation of export marketing boards. However, in a few countries, banks prefer **not** to have a government guarantee because in the case of a default this can be rescheduled and transferred into a long term risk which may never be paid.[36]

77. A third risk category is currency risk. Whenever the exporter invoices in a currency other than his own, he runs the risk of devaluation in the currency of credit against the domestic currency, with a resulting shortfall in the amount expected in repayment after conversion. To avoid this, the exporter can usually arrange with his bank to sell his foreign currency receipts forward against his own currency. An example of possible problems is provided by the 1994 devaluation of the CFA franc. If a trader had exchanged french francs against CFA francs at the old parity of 50 FCFA to 1 ff, to obtain funds for the local purchase of agricultural produce, the devaluation would have increased the price of the produce - he would thus be unable to buy the envisaged quantity, hence losing money.

78. A fourth risk category is legal risk. If a Government wishes to reduce the costs of international trade for its country, it is essential is puts in place a sound and transparent legal system, with well defined laws of property as well as laws that enable a foreign bank or trade house to valorize its collateral in an effective way. The country in question should also abide by its own laws and delays in legal procedures should be reasonable.

---

[36] Although bank practices vary, grosso modo it can be said that a bank assesses three types of risk :

a. Its long-term financial risk, for instance, a long-term loan to a government entity for a project. This is a country risk;

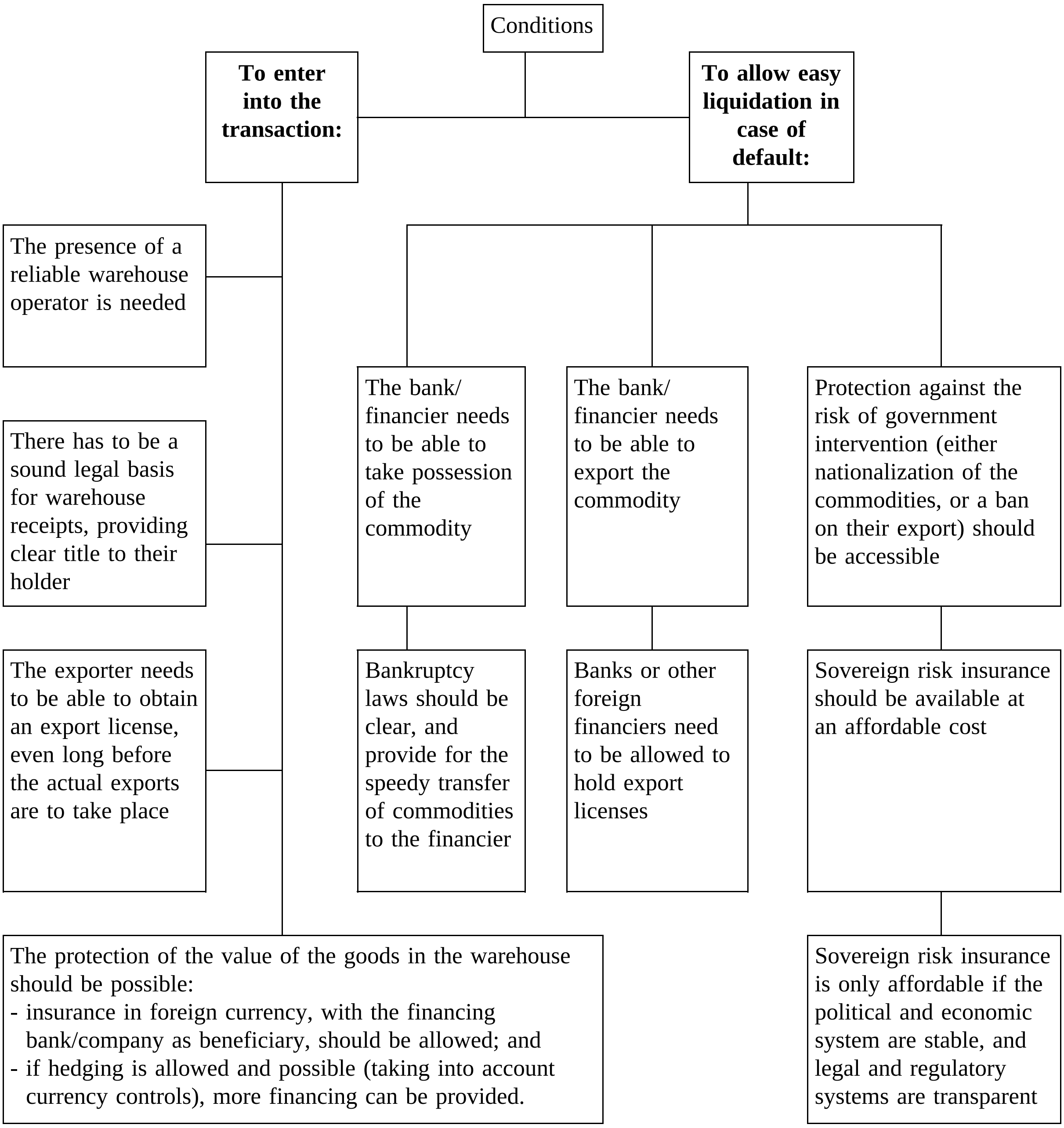
b. Short-term financial risk which is a repayment risk (up to about one year);

c. Performance risk which is risk relating to the ability of the borrower to produce and/or deliver commodities as foreseen - this is the type of risks relevant for warehouse receipt financing, buy-back arrangements, and more in general, most forms of structured commodity finance.

The ceilings for these different types of risk are different, with in general, the highest ceiling available for performance risk; also, the provisions banks, according to Central Bank regulations, have to make for loans in these various categories, are different, with again the least or no provision needed for performance risk (the higher the provisions a bank is required to make, the higher is its cost of capital).

CHART VI

OVERVIEW OF THE CONDITIONS NECESSARY FOR STRUCTURED COMMODITY PRE-EXPORT FINANCE USING WAREHOUSE RECEIPTS



79. The key legal requirements are discussed in an earlier UNCTAD document[37], and chart V gives an overview. In short, the country's legal and regulatory framework should include:

(a) A clear system of title to commodities, and for pledges; including national laws which clearly specify what are the rights and obligations of those issuing and holding a warehouse receipt. In case of bankruptcy of the warehouse company or default by the borrower, the bank or trade company which has provided the credit should be able to obtain the collateral without undue problems. In countries where there are no centralized or uniform procedures for the registration of collateral (for example, the countries of the CIS), secured lending is difficult.

(b) A permissive export regime; if a bank or trade house has to take delivery, it will have to sell the collateral in order to retrieve its credit. Often, a good price can be obtained only on the world market. The trade house or bank should thus have the possibility to export the collateral. In a large number of countries, this condition is not met: only a limited number of companies are licensed to export, or, more stringently, each export requires a specific export license which can be obtained only by certain domestic companies. In cases like this, the company taking possession of the collateral after a default has to pay an often high fee to an exporter to act as an agent, or even (in the case of specific export license for the commodities in question) has to pay the exporter who originally defaulted to bring the commodities abroad. This latter problem plagues commodity financing to, for example, the CIS countries and Egypt.[38]

(c) The trade regime has to be realistic and sufficiently flexible, taking into account changing conditions on world markets. Otherwise, exporters may be tempted to give false registration dates for their contracts, registering their sales in times of low prices but actually selling when prices are very high, for a number of reasons - to avoid taxes, to obtain government export subsidies, or to transfer funds abroad. Similarly, when minimum export prices are higher than world market prices, exporters can load qualities or quantities superior to those specified in the contract, to compensate the buyer for the unrealistically high unit price he has to pay. In cases such as these, the legality of the contract can be questioned, and thus, any insurance on the contract or its concomitant financing can be deemed invalid.

80. In many cases, since one of the parties in the credit transaction is foreign, it is possible to use foreign law, for instance English law (in most countries this is even possible, but more difficult in practice, if the parties involved were all local). In this case, it is clear to all parties when possession, property or risk in the goods sold passes, and what are the rights of the buyer when goods not conforming to the contract are tendered. Of course, this does not imply that the judgement of an English court or arbitration panel can easily be enforced in another jurisdiction - this is different from country to country.

81. One possibility that has been used by local and international traders to overcome country risks is to store the commodities in a neighbouring country. This has been done, for example, with Vietnamese coffee: the journey to Singapore is a short one, and Singapore has

---

[37] N. Budd, *Legal and regulatory aspects of financing commodity exporters and the provision of bank hedging line credit in developing countries*, UNCTAD/COM/56, 3 February 1995.

[38] Based on industry information

well-managed public warehouses and strict laws and regulations, which considerably reduces the risks (and thus costs) of subsequent finance and physical trade transactions. Similarly, most international banks are apparently wary of financing against coffee stocks in Uganda: one problem is that in case of default, to reach the world market the coffee would have to be transported through Kenya, for which insurance coverage can be difficult to obtain. Only when the coffee arrives in the port of Mombasa, preferably in the warehouse of a shipping line, are these banks prepared to accept this coffee as collateral. Other examples include the use of overseas nickel stocks as loan collateral by the Government of Cuba, and the use of gold reserves deposited in London as loan collateral by a number of African governments.

C. Warehouse characteristics

82. The quality of a warehouse is determined by its management, reputation, methods of operation and financial strength. It should be secure against theft, fire and adverse climatic conditions. Physical characteristics i.e. the roof, walls etc. are important considerations, with the exact requirements varying from commodity to commodity. Also, normally warehouses should be close to a major quay, waterway, or occasionally railroad terminal, unless the product stored is high-value.

83. The person who owns and operates the warehouse must be trustworthy, in other words unlikely to sell the commodity stored and disappear with the money. Related to this, the saleability of the commodity stored also has an influence on its possible use as collateral. For example, few banks will be willing to finance rice stored in a warehouse in Africa because the warehouseman can easily sell rice on the local market.

84. If the trader or the exporter stores the commodities in his own warehouse, normally a bank is willing to lend less against collateral in this warehouse because the debtor has control over the commodities it has assigned to the bank. This control creates a moral hazard problem: if the debtor (a local trader, exporter, or eventually producer or farmers' cooperative) owns and controls the warehouse, it is, firstly, much more difficult for the creditor to check the continuing presence of the collateral in the warehouse; and secondly, the debtor may be tempted to use the same products as collateral for multiple loans, which in practice is difficult to detect (but can have grave consequences: in case of default, there would not be a clear ownership title). Because of this, the creditors normally insist that the warehouse be converted into a field warehouse (see section III.A.), with control over the goods in the warehouse and their movements relinquished to an independent warehouse operator.

85. Because of reputation and possibilities for recourse, most banks and traders prefer to use international warehousing companies to secure their collateral in financing deals. One finds some European banks that use local warehouse companies, and probably, there are good possibilities for joint-ventures. In a number of Latin American countries, in particular Argentina, Brazil and Paraguay, there are local warehousing companies considered reliable by international banks and traders. The risks of using such warehousing companies can be mitigated if the company is ultimately (co-)owned by a foreign company, even though these normally take no legal liabilities. For example, recently a West-African warehousing company was found issuing warehouse receipts for goods that were not in their warehouse which lead to the financing bank losing 40 million French Francs. At the end, this company's parent company in France made up for these losses.

86. Sometimes it is much easier for the branch of the bank to be physically present in the

market in question and guarantee the credit being extended (in the not so distant past, many banks had specialized subsidiaries active in commodity warehousing, particularly using field warehouses). Alternatively, a warehouse owned by a local bank (which should not exclude this warehouse's use by other banks) can be more readily used if the western bank has or can obtain a correspondent relationship with the local bank. The local bank will control the warehouse, eventually providing the necessary guarantees, which greatly reduces the risks for the western bank.[39]

87. In principle, to make a warehouse more reliable for an international trader or bank, the warehouse could be asked to obtain a "performance bond certificate", in which a local bank guarantees contract performance. Such performance bonds cost around 1-2 per cent of the face value of the collateral, and are available in many countries. However, in practice, in most cases such performance bonds are issued by specialized local bank subsidiaries, which are often poorly capitalized and thus would provide only very limited cover in case of a default.

D. Insurance[40]

88. Whenever local stocks are used as collateral, their value needs to be protected, and insurance plays a major part in this. In addition to the insurance that the warehouseman needs to take out to protect himself against theft and other operational problems, the collateral needs to be protected against both the risk of disaster (drought, flooding, sabotage) and political risk. The carrying of adequate insurance by the warehouse company is important, both to the depositor and to the financing bank. If any loss should occur because of the fault of the warehouse company or the warehouseman, it is unlikely that these are financially strong enough to make up for the loss. The depositor, normally a merchant, cannot afford any loss, regardless of whose fault it is. Insurance must therefore be arranged by both the warehouse company and the depositor. Since the financing institution has a direct stake in the goods stored, it should make sure that proper coverage is maintained and that any insurance proceeds are turned over directly to itself. Should there be any loss or damage of stored property, and if the insurance coverage is inadequate, a financing institution normally retains recourse not only to the warehouse company (within its legal liabilities), but also to the borrower, for the full amount of the loan plus interest.

89. The availability and cost of such insurance thus is an important issue. Insurance needs to be available in United States dollars or another convertible currency and payable to banks or traders outside the exporting country; insurance cover in non-convertible currency or subject to restrictive exchange controls is of little use in international trade financing transactions (it is thus a problem that many countries have created barriers against the entrance of international insurance companies, while national insurance companies are not allowed to provide cover in non-local currency).

---

[39] Note that for local banks, this type of arrangements is only attractive if they are allowed to function commercially, that is, set themselves the interest rates to be charged for different types of borrowers, for different types of loans. The interest rate liberalization which has taken place in many developing countries has thus created new possibilities for local banks, although in most cases, these possibilities are not yet exploited.

[40] See also "counterpart and sovereign risk obstacles to improved access to risk management markets: issues involved, problems and possible solutions", UNCTAD secretariat, TD/B/CN.1/GE.1/3, 2 August 1994, section IV.E for a more detailed discussion on sovereign risk insurance.

90. When a commodity exists, and is stored (or grown, or still in the ground) in a developing country, it may function as a good collateral for international loans, but only if the credit provider can be assured that in the case of a default, he can seize and export the commodities. There is then a risk that a government intervenes in this process and does not allow the export of the commodities involved (or decides to sell the commodities to another party). Country risk insurance can provide protection against this.

91. The availability of country risk insurance is often limited, both in time and in volume. Insurance coverage is provided by both public and private insurance underwriters. Public agencies include the Multilateral Investment Guarantee Agency, part of the World Bank, as well as government agencies in both developed and developing countries.[41] Government agencies are normally involved in the provision of export credit, and are often prepared to insure these credits as well. In some cases, such national agencies are prepared to underwrite contracts in the national interest where the risks are unacceptable (or rather, only acceptable at too high a price) to commercial insurers; for example, a large part of trade credits to Iraq has been guaranteed by governments, including by developing countries such as India and Malaysia. On the other hand, they usually have rather limited lists of countries for which insurance is available - and naturally, from the point of view of the developing countries who are the counterparties, they provide import credit insurance, not pre-export credit insurance. Developing country agencies often concentrate their limited resources on non-traditional exports, that is, exclude the traditional commodity exports. Private insurers accept virtually every country, including those not covered by national agencies, and can insure every type of trade, including for losses resulting from cancellation of export licenses or other governmental seizure or interference with export[42]. Among other things, private insurers can insure trade debts aring from a commercial contract with a commercial sector producer or exporter that are to be repaid by delivery of goods.[43] Although individual insurers may have limited risk ceilings, the major international insurance brokers all have trade credit and political risk divisions whose occupation is to place such business throughout the world insurance market.

92. However, even though one can, at a price, insure against most country risks with insurers such as Lloyd's of London, in practice all insurance has its limits (including in terms of country ceilings), and comes at a cost that may at times be prohibitively high - the premium charged is inversely related to the borrower's creditworthiness. Also, from the point of view of a bank, the "grace period" involved can be a problem. Sometimes in the case of a default the bank would have to wait anywhere between 9 months to 2 years to be reimbursed (the grace period is longer the more risky the country). Moreover, the terms and conditions of sovereign risk insurance are in general not absolutely clear, which makes it difficult to determine which risks are covered and

---

[41] See for an overview of the latter, *Review of progress in trade-financing facilities of developing countries at the interregional, regional and subregional levels,* UNCTAD/ECDC/254, 22 March 1996.

[42] To claim under a policy of this nature the lender must show that :
a. the commodities exist
b. the title was validly acquired
c. all local legal formalities were observed
d. the insured has taken all reasonable steps to export the commodity.
In many countries it would be difficult to prove that all these conditions have been met.

[43] See Charles Berry, Barry Palmer & Lyle Ltd, *Insuring against non-delivery and non-performance: commercial and political risk insurance*, presentation given at the Conference on "Structured commodity and trade finance", London, 11-12 December 1995.

which are not.

93. Since losses in this class of business are frequently 100 per cent of the sum insured, the cost of catastrophe and sovereign risk insurance is high and the associated conditions are restrictive for the majority of developing countries. Nevertheless, when the political will exists, governments can relatively easily create the conditions that should produce a reduction of overall insurance rates, and a shift in sovereign risk insurance requirements from the category of contract frustration to that of confiscation, thus reducing their countries' costs of international trade an estimated one percentage point at least. The following steps would help to create such conditions:

(a) Local laws relating to exports and export financing have to be made clear. A lack of clear rules or frequent changes in rules can make insurance coverage unavailable, or available only at high premiums. Also, laws need to be such that they do not prevent normal commercial practice.

(b) Local laws relating to title and security have to be made clear. This is essential to ensure that the collateral obtained is indeed "good" collateral.

(c) Foreign companies need to be allowed to take title to commodities, and to hold export licences, even if only a portion of the eventual purchase price has been paid. If foreign companies receive such title and export licences, their risk becomes one of confiscation of the goods, which can be insured more cheaply.

(d) Local laws and regulations should not remain a dead letter, but need to be enforced by the government and by courts of law.

(e) The regulations regarding export licensing need to be made clear, and be adapted to allow for greater security for foreign lenders: foreign companies have to be in a position to receive export licences at the moment that the transaction (provision of pre-finance or a risk management facility) is entered into.

(f) In the case of a privatization of export structures, the government should extend its guarantees to the newly privatized companies, and make clear its policy of doing so. In this way, foreign companies no longer run the risk that all insurance coverage is lost when a counterpart is privatized.

(g) Insurance companies should be allowed to provide a cover in hard currency, and laws such as exchange controls, foreign exchange auctions or quotas should not to be allowed to delay or prevent valid insurance claims payments being made to foreign counterparties as soon as they have been agreed with insurers.

94. Any steps taken by a government in these directions would benefit from being publicized widely. Governments can also make a conscious effort to familiarize the major political risk insurance underwriters and international brokers with their new export policies, in order to ensure that the changing policy environment is indeed reflected in more easily available and cheaper insurance coverage.

Chapter IV

PRACTICAL WAYS OF ENHANCING ACCESS TO COLLATERALIZED FINANCING

95. Actors in developing countries and economies in transition in general cannot obtain access to credit for commodity-linked operations (including risk management transactions) on equal terms with those in developed countries. Larger counterparty and country risks explain most of this difference. Nevertheless, there is nothing predestined to this situation: it can be changed.

96. In this respect, the Group of Experts on Risk Management in Commodity Trade, which met in October 1994, formulated the following policy recommendations[44]:

"(1) When access to credit for developing countries, including risk management transactions, is to be improved, actions which improve the use that can be made of physical commodities as collateral for loans are pivotal. There are a number of actions at the national and international level which could effectively help developing country entities, and such entities from countries in transition, to gain access to credit on conditions similar to those presently enjoyed by similar entities from developed countries. One priority area would be at the national level. In a large number of countries, there is a clear need to improve the legal, regulatory and policy framework surrounding international commodity trade, including regulations relating to export licences, exchange controls and title documents such as warehouse receipts. (...)

"(2) The international community can help developing country entities (and such entities from countries in transition) to gain access to commodity finance and risk management markets by providing direct support to training and awareness-raising on the relationship between national regulations and policies on the one hand, and access to commodity finance and risk management markets on the other.

"(3) Further work is needed on the question of how the international community can help in other ways. (...) In particular the aspect of how the international community can best provide incentives to the private sectors and governments of developing countries and countries in transition to bring their countries' basic physical, financial and legal structure into line with the requirements of international trade and help to reduce counterpart and sovereign risk would still appear to require further analysis."

97. Table 4 gives an overview of possible policy actions. Three areas of action would appear to present themselves. The first is that directly focussed on counterparty and country risk ratings: through their actions (even symbolic ones), governments can reduce country risks; and companies can improve their counterparty reputation. Unfortunately, a very large number of government policy makers, as well as the policy advisors of most development cooperation agencies, are not well aware of the importance of sovereign risk insurance, warehousing conditions and the legal/regulatory framework for the costs of trade and credit. A better consideration of the costs and benefits of national laws and regulations, and appropriate measures

[44] *Report of the Group of Experts on Risk Management in Commodity Trade* (TD/B/CN.1/GE.1/4), November 1994

in this regard, would result in improved access to both foreign and local trade and investment credit (including for risk management operations) and reduce the effective interest rates and insurance premiums to be paid on foreign credit. Developing countries and economies in transition could save hundreds of millions of dollars, if not more, on their costs of international trade and through larger export earnings (in particular through savings on the financing and insurance costs) if they put into place a proper warehousing system, and a sound legal and regulatory framework allowing their commodities to be used as a more effective collateral. This type of action is discussed in some detail in two earlier UNCTAD documents (*Counterpart and sovereign risk obstacles to improved access to risk management markets; issues involved, problems and possible solutions* (TD/B/CN.1/GE.1/3), August 1994; and *Legal and regulatory aspects of financing commodity exporters and the provision of bank hedging line credit in developing countries*, by Nicholas Budd, White & Case, Paris (UNCTAD/COM/ 56), February 1995), and will not be discussed further here.

98. The second area of actions is a better use of the possibilities for the structuring of transactions, so that counterparty and country risks become largely irrelevant. This would imply a more proactive role of companies (including state-owned ones), local/regional banks and warehousing companies. A proper understanding by companies (and relevant government departments) of the mechanisms of structured transactions would already be helful, as it would reduce the costs of setting up the transaction. Regional and local banks should consider their comparative advantage in acting as a conduit for international commodity finance: a local bank could manage the

BOX 2

Overview of possible policy actions

REDUCE COUNTERPARTY AND COUNTRY RISK RATINGS

To reduce counterparty risks:
* professionalization of the way of operating of commodity producers, processors and traders
* self-organization of exporters and importers, providing a balloting mechanism for new entrants
* continuation of government guarantees for newly privatized exporters (to ensure continuing validity of insurance)
* promotion of the development of rating services by domestic banks
* promotion of domestic factoring services

To reduce country risks:
* development of a proper warehousing system, including the required legal and regulatory framework
* permission of insurance in convertible currency
* adaptation of commercial law to the exigencies of modern commodity trade, in particular the law relating to security in and title to goods, and bankruptcy laws
* broadening the system for the issuance of export licenses
* reformulation of foreign exchange controls and minimum export price-regulations in such a way that legitimate business transactions are no longer hindered
* publicity by the government of its measures to stimulate modern marketing and financing practices

INCREASE THE CAPACITY TO USE MORE FULLY THE POSSIBILITIES FOR STRUCTURING COMMODITY FINANCE

* concerted actions to increase the awareness of structured financing techniques among developing country government policy makers, producers, processors, traders and banks, and to enhance their practical possibilities to enter into structured financing transactions
* promotion of the role of regional and domestic banks as conduit for warehouse receipt financing
* consideration of foreign locations for the storage of commodities

FACILITATE THE STRUCTURING OF COMMODITY FINANCE THROUGH INTERNATIONAL ACTION

* external financing of a warehousing infrastructure
* creation of a "global warehousing" facility, with sovereign risks covered by an international agency
* strengthening of systems for the discounting of warehouse-receipt finance-related letters of credit
* promoting the standardization of physical trade contracts
* enhancing the capacity for insuring the risks of warehouse-receipt-related transactions
* modification of the negative pledge policies of international finance organizations

collateral (e.g. through the use of warehouse receipts, with price protection built in either through the use of futures or options, or through a fixed-price sales contract), and a regional (development) bank could rediscount this loan (this is probably more practical than confirming the local bank's letters of credit). Regional banks often have such a good international credit rating that they can borrow on the international capital market without too many problems. In other words, the local bank "upgrades" the credit of the local borrower, and the regional bank "upgrades" the credit of the local bank. If a mechanism for this type of upgrading existed, local banks could also enhance their fee income by playing a larger role in arranging financing transactions for international banks, and in providing performance guarantees. Warehousing companies, now often unwilling to allow the use of their warehouse receipts as collateral for loans, may consider the possible impact on their activities if such use is permitted. One aspect that company managers and government policy makers could consider is whether it may not be worthwhile to store part of one's commodities abroad; as is discussed in the paper, the value of commodities for collateral purposes is to a significant extent dependent on the location of the warehouse, and if one cannot easily improve the standing of a particular location, one may instead shift the commodities to a location which provides better security to a foreign lender.

99. The third area of actions is the facilitation of the structuring of commodity transactions through targeted support from the international community. As noted by the Group of Experts, much research is still needed in this area. Apart from training for company and government decision makers, one could envisage a number of possible actions: the financing of warehousing infrastructure; the creation of a new "global warehousing" facility; the strengthening of systems for the discounting of letters of credit; the promotion of the standardization of contracts, which would reduce legal problems; the enhancement of the capacity of the international insurance community to provide coverage for selected types of transactions; and ultimately, modifications in the negative pledge policies of international financial organizations.

100. Improving the infrastructure for trade should, more than in the past, be considered a normal part of development assistance - indeed, compared to investments in improving the physical infrastructure (roads etc.), investments in the institutional infrastructure of importance to trade are often relatively low, and are likely to provide very good returns for the country. Apart from support for the creation of warehouses (or the conversion of former government warehouses), one could consider support to the management costs of these warehouses.

101. The more ambitious possibility of the creation of a new "global warehousing" facility has been discussed for some time.[45] Rather than adapting a country's legal and regulatory system, an extra-territorial entity (using established international trade law and referring to courts in the United States of America or the United Kingdom) could be created, which would then provide the basic commercial and infrastructural framework for collateralized finance. Once functioning, this entity would allow a country's government and private sector access to commodity finance and risk management on terms equal to those enjoyed by developed country entities. Governments can indeed decide to create such zones, or rather, facilities (although similar in concept to free trade zones, this type of extra-territorial entity does not need to be a single geographical area). However, foreign credit providers would continue to be confronted with the risk of a reversal of the Government's original decision to provide an extra-territorial

---

[45] See in particular John K. Burns, J. Orlin Grabbe, Geoffrey O. Kalish and William H. Plummer, *A proposal to establish the world commodity bank: structuring access to global capital markets to finance commodity and goods storage in developing countries*, International Markets and Commodity Consultants Group, September 1992.

status to certain types of transactions. Given the costs and inherent limits of existing sovereign risk insurance facilities, such a venture is likely to be successful only if an international entity such as the World Bank provided the needed insurance facilities (which it could theoretically do, as it is in a good position to build up a portfolio of country risks, and has effective leverage over most countries - it has already provided sovereign risk insurance in the framework of a number of infrastructural investment projects).

102. As concerns the strengthening of systems for the discounting of letters of credit, one could envisage two mechanisms: firstly, the involvement of an outside actor (such as a new insurance fund) guaranteeing letters of credit; and secondly, the improvement of the capacity of the banking system itself to upgrade letters of credit. In particular when local banks are free to determine the interest rates at which they lend, they would benefit from better management of their counterparty risks. This can be through better identification of counterparties (in larger countries, some type of rating service may well be economically viable), through better monitoring of transactions, and through the improved use of collateral. But even if they improve the management of their lending risks, this is unlikely to provide them with easy access to the international capital markets. If national exchange regulations permit this, regional banks, which work closely with the local banks in their region, are in a good position to take over the credit of these local banks, by discounting their letters of credits, and lending in their own name in the international market.

103. The trade sector itself could increase the value of commodities as collateral by promoting the standardization of contracts; this would reduce legal problems, and moreover, make it easier for banks which had to take possession of a stock of commodities to liquidate it at a reasonable price.

104. To improve insurance facilities, one possibility would be to create a new international facility for sovereign risk insurance. If operational difficulties could be overcome, such an insurance fund would indeed have a positive effect on banks’ and probably trade houses’ willingness to provide longer-term commodity finance, provided that the coverage mechanism is simple, that the procedures for reimbursement of claims are not cumbersome, and that the insurance premiums are not prohibitive. However, these conditions are not very likely to be met if generic coverage were given, taking into account the amounts of capital required and the past experience with country risks of all but a few developing countries. More focused forms of insurance, however, would appear feasible. One possibility would be for such a fund to guarantee the letters of credit of selected developing country banks, so that these have the financial status of prime bank letters of credit (which, in turn, have the potential to be good collateral[46]). Another possibility would be to insure against the risk of non-delivery of physical commodities which are stored in "recognized" warehouses as collateral for commodity financing transactions, and where insurers may be given some kind of lien over these commodities.

105. Finally, modifications in the negative pledge policies of international financial organizations could be considered. Organizations such as the World Bank, International Monetary Fund (IMF), European Bank for Reconstruction and Development (EBRD) and Asian Development Bank (ASDB) include in their loan conditions a negative pledge clause or covenant.

[46] However, it should be noted that as these letters of credit are easy to falsify, and in practice, there has been widespread abuse, under current conditions even prime bank letters of credit are often not acceptable as collateral. Some improvements to the system would thus be necessary - e.g. a central registry of prime bank letters of credit where all banks can check whether a certain letter of credit has indeed been issued by a certain prime bank.

Such a clause broadly prohibits government agencies or "instrumentalities" (such as state enterprises) from pledging or otherwise encumbering their principal export commodities as security for loans (other than short-term trade finance loans) or other financial accommodations, including risk management transactions. These commodities include the gold reserves of the central bank, crops (including future crops), mineral and fuel reserves. Thus, structured finance mechanisms such as the use of escrow accounts fuelled by the proceeds of the export of commodities by a state entity are forbidden. Waivers can be granted, but so far, no such waiver has been given for the types of arrangements discussed in this paper. Waivers can be used only for project finance and only the commodities to be produced in the project can be pledged as collateral. Securing a budget-oriented operation through central bank gold guarantees is not allowed. Operations where commodities different from those produced in the project are pledged, for instance coffee exports to collateralize an oil import loan, are impossible. Instead of the current rigid approach, a case-by-case approach by lending agencies, comparing expected benefits for the country and disadvantages for the lender, would appear warranted; or even better, a generic waiver for certain types of colleralized transactions could be given.

106. In conclusion, any deal with a credit component carries with it a risk of default by the counterparty. Collateralized commodity finance, through reducing the risks of providing credit, enhances the access of credit for entities which do not have a sufficiently good reputation to obtain unsecured funds - or who are located in countries that are considered too risky. However, the use of commodities for collateral purposes requires a number of fairly stringent conditions, in terms of warehousing and banking infrastructure, and in terms of legal and regulatory structures. But once these conditions are in place, the country would become much more interesting not only for foreign credit providers, but also for investors. The lure of cheap finance could thus well act as a "carrot" for improving a country’s trade infrastructure, its ownership rules, its export regulations, and its trade and currency regimes. The international community should support such a development by firstly, providing its financial support and expertise, and secondly, by meeting those countries who do improve their domestic policies half-way - thus providing them with an even stronger incentive to reform - for example, by providing extra security to "agreed" warehouses, enhancing possibilities for re-discounting developing country bank Letters of Credit, creating new sovereign risk insurance facilities, and lifting the barriers imposed by its own lending programmes. Real improvements in the conditions under which developing country commodity producers, exporters, processors and importers do their trading and obtain their finance evidently necessitates actions from both fronts - actions which would appear already overdue.

Annex I

ACCOUNTS RECEIVABLE FINANCING

Accounts receivable financing is normally used when a company is undercapitalized and has a permanent financing need, or when it faces temporary cashflow problems (e.g. because of delays in clients' payments, or the competitive need to provide longer-term credits to customers). In this form of financing, commodities are only a secondary collateral: banks provide credit which is secured usually through the assignment of both receivables (that is, the payments due from the company's clients) and the company's commodity inventory. The loan is normally made on a revolving credit basis against a changing pool of receivables, which implies that the value of the receivables in the pool must be monitored on a daily basis to ensure that sufficient collateral remains. Since the commodities in inventory (and other receivables) may have to be sold at a rebate, the bank will not, in most cases, grant a credit up to the full value of the assigned receivables. Protection is achieved based on an analysis of the quality of the receivables and a determination of their net realizable value. Normally, the value of the receivables pool to be used as collateral needs to be 1.4 to 1.5 times the value of the credit at any given moment. In view of the additional risks, the relative amount financed will be even less for loans to developing country companies (because of lack of information on the customer's creditworthiness, political and transfer risk, and in certain cases also currency risk).

Contrary to factoring (in which a bank or a specialized factoring company takes over the outstanding obligations of customers at a rebate, but in return covers the implicit interest rates of the customer credits and takes over all payment risks), in accounts receivable financing, the borrower, not the bank, assumes all payment risks. The borrower needs to ensure payment by his customers, and he is obliged to repay the full amount advanced against the receivables whether or not any of his clients (or transporters, or warehouse operators) have defaulted.

The use of escrow accounts to ensure that the payments of customers go towards the reimbursement of the bank loan is infrequent - customers are generally not notified of the assignment of their contracts, and continue paying to, what they think, is the supplier's account at the (lending) bank. Explicitly identified escrow accounts are only used when a bank feels that due to the weakness of the borrower's internal accounting procedures, greater control over the borrower's financial flows is required.

Annex II

THE USE OF WAREHOUSE RECEIPTS IN LETTERS OF CREDIT FINANCING

Letters of credit (L/C's), also known as documentary credits, are the most common form of trade finance. The credit is, in essence, a letter addressed to the seller, written and signed by a bank acting on behalf of the buyer. In it, the bank promises that it will pay or accept drafts drawn on itself if the seller conforms exactly to the conditions set forth in the letter of credit. These conditions will normally state that the seller is to submit certain documents such as a negotiable bill of lading, insurance papers, invoices and so on. If the documentation submitted is precisely as specified the bank will pay, or accept the exporter's draft. Chart VI gives a short overview of the concept.

In theory at least, this should provide security to the buyer that the commodities for which he pays are at his disposal, conform to the conditions of the contract; and to the seller that he does not lose control over the commodities until payment has taken place. In practice, however, there are two problems that seem to be intensifying in gravity. In reality, banks pay out on a L/C not if the commodities are delivered as foreseen in the contract, but if the party which is supposed to deliver can hand over the documents listed in the L/C. The bank has no obligation to ensure itself that these documents are real, or even that the commodities exist. The buyer is thus liable to lose his money if a seller submits falsified documents to the bank holding the L/C - this has been a problem, among others, in oil and in sugar trade. There is also an increasing abuse of L/C's in that the condition that the documentation submitted should be **precisely** as specified is put to the extreme - minor typing errors and the like are used as an excuse to cancel a transaction, for instance because a cheaper supply has become available. According to some estimates, 90 per cent of L/C documents for commodity trade carry discrepancies: the conditions are not complied to in full. If there are discrepancies, documents must either be re-submitted (if there is still time within the validity of the L/C); or the buyer must approve to accept the discrepancy. An unscrupulous buyer can use this to reject documents and thus default on a purchase. This is a problem especially in commodity trade, as commodity prices are highly volatile. Nevertheless, L/C's generally form part of commodity trade finance, as the main alternative, cash against documents [a/], complicates access to pre-export finance, and is at times more risky (except when local corresponding banks can be trusted to do all the necessary paperwork without undue problems).

Under some forms of L/C's (green clause L/C's; some advance payment and stand-by L/C's) handing over warehouse receipts is sufficient to obtain finance, making them an easy and fast way of providing pre-export finance. These L/C's as well as the other forms of L/C's may also provide sufficient documentary evidence of a forthcoming transaction for an exporter to obtain a separate pre-export finance from a bank or a specialized government agency. The main forms of L/C's used for providing commodity trade finance are the packing credit; "Red clause" Letter of Credit; advance payment Letters of Credit; "Green clause" Letter of Credit; and stand-by Letters of credit. One technique which can be used with most of these forms of L/C's is called back-to-back letters of credit. These will be discussed here in some detail.

---

a/ When trading partners have known one another for years, cash against documents can be used. Here, the seller delivers shipping documents and other relevant papers as set out in the contract to a bank, and the bank, against payment, then delivers these documents to the buyer who can then take delivery. Since there is no need to open a L/C far in advance it allows smaller buyers to be active on the market, it is cheap and fast, with documents presented to ghe buyer's bank or agent before (prompt) payment is made; also, minor discrepancies in documents cannot stop payment. However, apart from the proper functioning of the corresponding bank, there is little protection against counterparty default.

Packing credit

Packing credit is sometimes also called an anticipatory credit and is a convenient method of finance for a small exporter who is not conversant with shipping practice; this could well be the case for many developing country exporters. For example, if an exporter sells cloth ex-London store and arranges that the purchase price shall be paid under a letter of credit against delivery of a forwarder's receipt b/ or a warehouse receipt, evidencing that the goods are in existence, he is not concerned with the actual shipping arrangements which will be made by the forwarder on the instructions of the buyer. The buyer, on the other hand, is certain that the goods sold are no longer in the possession of the seller when the latter receives the purchase price. In more complicated transactions the red clause letter of credit is used.

"Red clause" Letter of Credit

A red clause letter of credit provides unsecured credit to the exporter. Here, the issuing bank promises to pay part of the estimated proceeds of the commodity to be shipped (as covered by the letter of credit) to the exporter on behalf of the buyer, without tender of documents (that is, it is not necessary to deposit goods in a warehouse before finance is provided. The balance of the proceeds is subsequently paid to the exporter against the presentation of documents under the terms of the letter of credit. There are two types :

(a) Red clause with a bank guarantee (not necessarily from the advising bank). The issuing bank can draw on the guarantee in the case of non-delivery and non-presentation of documents.

(b) Red clause without a guarantee: the advising bank has no obligation to pay the issuing bank. The risk is therefore on the buyer (credit provider) as there is no recourse on the advising bank by the issuing bank.

A red clause letter of credit has certain advantages :

(a) It enables the exporter to obtain pre-export finance, though the amount of credit available is usually limited to only part of the shipment's estimated value.

(b) It ties the buyer and the seller together, because the seller is paid in advance for the goods.

(c) From the point of view of the buyer, a red clause credit might be an efficient way of attracting potential exporters and thus developing alternative sources of supply.

Advance payment Letters of Credit

Advance payment L/C's are the same as "Red clause" L/C's, except that they limit the total amount of the exporter's drawing to a given amount or percentage of the invoice value. This credit is unsecured from the buyer's point of view. The exporter pays international rather than generally high local interest rates.

---

b/ A forwarders' receipt affirms that the goods have been received for shipment.

"Green clause" Letter of Credit

The purpose of this credit is to provide secured credit to the seller for a percentage of the value of the goods to be shipped. A buyer issues an irrevocable letter of credit with an additional clause which says that payments up to a certain percentage are available to the seller, usually against delivery of warehouse receipts; sometimes, a letter of an insurance company that the commodities in warehouse are insured is also necessary. In this case the buyer's risk is lower than under a red clause L/C as he has the warehouse receipts as security.

The advantages of a green clause letter of credit are :

(a) It is a comparatively easy means of obtaining export financing for exporters.

(b) It gives the buyer more control over the credit he is providing than the red clause or the advance payments system. However, in practice, it can only be used when buyers and sellers know each other well.

On the other hand, green clause L/C's only work in countries with established commercial/legal system allowing for warehouse receipts; and perhaps more importantly, they tie up the buyer's credit line (the buyer is borrowing from his bank to provide the credit). Green clause L/C's are used relatively little in international commodity trade.

Stand-by Letters of Credit

A stand-by letter of credit, also called performance bond, is a guarantee declaration of payment by the issuing bank in the broadest sense. The beneficiary, through the advising bank, can claim payment in the event that the principal does not comply with its contractual obligations. In commodity trade, they are often used to ensure contract fulfillment in the case of a tender (in particular by developing countries). This increases the costs of trade (because the trader who is requested to issue a performance bond may well prefer to insure himself against the risk of unfair calls on the bond c/, and some traders may be discouraged from participating in the tender), perhaps unnecessarily so because there are other, more effective ways to ensure contract performance; and moreover, if the company which wins the tender is not serious, a standby L/C is not a very effective tool for ensuring contract fulfillment, taking into account the high price volatility of commodity markets (if, for example, sugar prices increase by 20 per cent between the time of signature of a contract and the moment the delivery process starts, the seller can make an easy profit by defaulting on his obligation: the higher sugar price will more than fully compensate for the few per cent loss of the standby L/C).

Back-to-back Letters of Credit

In a number of countries, a system has been developed which allows companies other than the final exporters (e.g. the processors or plantations who produce the commodities that are then sold by an export house) access to pre-export finance. Under this system, the exporter issues a domestic L/C to its supplier, backed by a confirmed L/C from the international buyer. With these back-to-back L/C's, the processor or plantation can then obtain a pre-export loan.

c/ In some countries, such as Iran, Syria and Lybia, local law states that only the beneficiary of a standby L/C may release the issuing bank from its obligations; thus, even after years, the beneficiary may fraudulently call on the L/C in his favour, even when the transaction for which it was given had already been performed a long time ago.