

United Nations Conference on Trade and Development

REPORT OF THE AD HOC EXPERT MEETING ON APPLICATIONS OF STRUCTURED COMMODITY FINANCE TECHNIQUES FOR COMMODITY-DEPENDENT COUNTRIES

Held in Rio de Janeiro, Brazil,
from 19 to 21 May 1999

Executive summary

This paper contains the conclusions and recommendations of a group of experts on structured commodity finance. The experts discussed how structured commodity finance, in particular in the agricultural sector, could contribute to development and help to alleviate poverty, which policies and practices hindered the use of such finance and what measures could enhance that use.

The experts agreed that while structured commodity finance was not a panacea, it could unlock much of the growth potential of commodity production and processing, while enabling the less powerful links in the marketing chain (farmers and small traders) to improve their bargaining power, and developing countries to compete in a global market place. The experts noted the major obstacles to the use of structured commodity financing techniques, and identified measures and actions that could be taken by the private sector, Governments and the international community to overcome such obstacles.

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Introduction

1. Following an expert meeting on “the effectiveness and usefulness for commodity-dependent countries of new tools in commodity markets: risk management and collateralized finance” (held in Geneva from 4 to 6 May 1998),¹ the Secretary-General of UNCTAD convened in May 1999 an ad hoc expert meeting to discuss in more detail the possible applications of structured commodity finance techniques for commodity-dependent countries.
2. The 1998 expert meeting defined structured finance as “a technique whereby certain assets with more or less predictable cash flows can be isolated from the originator and used to mitigate various risks (e.g. transfer of foreign exchange, contract performance and sovereign risk), and thus to secure a credit”. The experts also noted that structured commodity finance includes products such as export receivables-backed financing, inventory financing (also known as warehouse receipt financing), prepayments and more sophisticated instruments such as asset-backed securities, and that overall “this form of finance allows for wider possibilities than other forms of short-term financing, which are normally limited to companies with acceptable credit risk or conditional upon onerous security, and gives access to financing on better terms”.
3. Policy makers are interested in the concept of structured finance. For example, in a keynote speech prepared for the Partners for Development Summit organized by UNCTAD in November 1998 in Lyon, France, Mr. Yoweri Museveni, President of the Republic of Uganda, stated that “the new approach of structured commodity finance must seriously be considered, evaluated and modalities worked out for its utilization”.
4. In line with the orientation of the preparations for UNCTAD X, which will be held in Bangkok, Thailand, in February 1999, the ad hoc expert meeting which took place in May 1999 focused on ways in which structured commodity finance could contribute to enhancing development and alleviating poverty. The experts examined the possible applications of structured commodity finance techniques, particularly in the agricultural sector, discussed which government policies and practices might hinder the use of such techniques and hinder the ability of the poor to draw benefits from their use, and identified positive measures which could be taken by Governments, the private sector and the international community to enhance the use of structured commodity finance techniques for developing the commodity sector, in particular to the benefit of farmers.

¹ See TD/B/COM.1/EM.5/2, “Examination of the effectiveness and usefulness for commodity-dependent countries of new tools in commodity markets: risk management and collateralized finance”, and the report of the expert meeting TD/B/COM.1/EM.5/3.

I. Conclusions of the ad hoc meeting

A. The relevance of structured commodity finance

5. The experts agreed that there is a significant unrealized potential in the commodity sector of most developing countries, with production, processing and marketing opportunities lost because of lack of finance. For example, many producers cannot afford to buy the inputs which would allow them to expand their production, and many are forced by an immediate need for cash to sell their crops directly after harvest, even if they think prices are too low. Processors cannot build up a sufficiently large stock of commodities during and immediately after the harvesting season to use their processing machinery efficiently during the whole year. Traders and warehouse operators are not able to invest in the equipment needed for post-harvest treatment of crops, leading to large crop losses. Exporters need to turn over their working capital as fast as possible, and therefore sell at the earliest possible moment, forgoing the profit opportunities of going further down the marketing chain.

6. Poor access to credit is, in many ways, a symptom rather than the cause of the lack of development of the agricultural sector in most developing countries, and direct provision of credit by Governments or the international donor community is therefore unlikely to set in motion to a sustainable process of economic growth. Such direct credit provision creates dependence on the continuation of support policies, and may even hamper the development of more sustainable financing systems. Structured commodity finance is not a panacea to the problems of development but, contrary to the direct provision of credit, it strengthens private sector institutions rather than undermining them. Providing access to structured finance can therefore unlock much of the growth potential of commodity production and processing. It can make it possible to revive commodity production, increase the flexibility (and therefore bargaining power) of farmers, expand the capacity utilization of processing plants and enable traders to perform better. Structured finance enables banks, traders and other financiers to isolate, to a large extent, funding to the commodity sector from the overall economic and financial problems of a country. In times of crisis, the default rate on structured finance loans remains very low, and in many countries there have been no defaults at all. In contrast, there have been massive defaults on non-structured loans to the commodity sector in the past.

7. While there are many different ways to provide structured finance, experts agreed that the safest way to provide such finance to the agricultural sector is to finance on the basis of goods already produced and in a safe warehouse. This may be the best starting point for banks not yet active in agricultural finance, and it has already been shown to have great potential; in Mexico, for example, the development of proper warehouse receipts for sugar has made it possible to finance most sugar storage in the country through low-cost credit. However, other forms of structured finance should not be dismissed. If there are central collection points (e.g. palm oil processing plants, cotton gins, flower auctions or commodity exchanges dealing in physical commodities), these collection points can be used to structure the transaction. In other cases, it may be possible to provide finance on the basis of a conservative estimate of future production.

8. Experts found that access to structured finance could help countries and entities within these countries to face the challenges of globalization. Among other things, if local banks were able to provide structured finance, local traders could compete on a more equal footing with agents of international enterprises - at present, the large differences in their costs of capital often make it very difficult for local traders to survive.

9. Structured commodity finance will become popular with banks only if there is an active secondary market where the banks that initiate such business can refinance some of their operations. Such secondary markets can be developed at the national level - in this respect, the experts acknowledged the efforts made by a number of commodity exchanges to trade warehouse receipts as credit documents. Experts also noted the existence of special discount (that is, refinancing) windows for trade-related paper at the Federal Reserve of the United States as well as the Bank of England.

10. Although these discount windows were set up to provide liquidity to agricultural finance in these countries, the facilities do not discriminate as to the origin of the paper which is offered for discounting. That is, warehouse receipts issued by Latin American, African or Asian warehousing companies and avalized (guaranteed) by a bank are eligible as are forward contracts issued by farmers and avalized by a bank. These discount windows provide very low-cost refinancing possibilities for credit to the rural sector worldwide, as long as this credit is structured through the issuance of trade-related paper. These facilities are not only low-cost, but also do not require any mandatory reserves or provisioning. In other words, they allow banks to engage in rural credit without tying up their own capital. Experts found it surprising that developing country banks make very little use of these facilities. The main reason for this is probably a lack of familiarity with this relatively simple system. Once banks become aware of the possibilities offered through these discount windows, they can act as a powerful funnel for channeling finance to developing countries' commodity sectors.

B. Structured commodity finance and the poor

11. Structured commodity finance is not a good tool with which to target income transfers to the poor. A structured commodity finance transaction should be self-financing and, thus, sustainable: no public subsidies should go into the transaction. Rather, public support should go to capacity - and institution- building so that banks and others are able to provide and manage structured finance, and farmers, processors and traders are able to use the new instruments on offer. Although it is virtually impossible to target such institutional support exclusively at the poor, structured commodity finance does not discriminate against the poor. Indeed, it enables many farmers and other producers to obtain access to bank credit. Its capacity to reach the poorest, however, is limited when compared to financing mechanisms such as microcredit. On the other hand, structured finance can help farmers obtain pre-finance for their crops, and even obtain medium-term loans, which are weak areas for microfinance. Thus, structured commodity finance supplements microfinance, rather than competing with it. As to its relation to the more traditional government- or donor-subsidized agricultural credit programmes, the experts noted that the experience with such programmes is dismal, and that most have failed to reach all but a small group of relatively rich farmers.

12. Structured commodity finance can be a tool for the inclusion of poor farmers in the development process, but only if deliberate action is taken. In principle, structured finance can give farmers and small local operators more flexibility in their marketing decisions and access to the capital they need to improve their production and operations. However, in practice, the vast majority of farmers are too small to have much direct access to such finance and therefore have to rely on intermediaries. Farmers associations in many countries are weak, and need strengthening. In the absence of strong farmers associations farmers benefits from structured finance instruments will be indirect, through the improved access to finance for traders or processors.

13. However, because of the ways that markets function in many countries, farmers hardly benefit from the improvements in the conditions that traders face. The experts therefore concluded that the reach and usefulness of warehouse receipt finance could be much enhanced by coupling it to a market information or even marketing system. They noted the examples of Brazil and the Philippines, which offer electronic trading networks that enable farmers to sell outside their traditional marketing areas. Such systems merit broad consideration by policy makers worldwide.

14. In some cases, laws and regulations meant to protect the poor (e.g. preventing farmers from giving the land they farm or the house they live in as collateral for a loan) actually lock poor farmers out of the formal credit system, while giving opportunities for richer farmers to exploit the legal loopholes thus created (which in turn undermines the trust of banks in agricultural lending). Laws and regulations that have a negative impact on the ability of banks to engage in agricultural lending need careful scrutiny.

C. Obstacles to the use of structured commodity finance

15. The experts identified the following obstacles to the use of structured commodity finance:

- Inappropriate cultural environment;
- Inappropriate physical trading practices;
- Lack of awareness;
- Lack of training and education;
- Lack of infrastructure;
- Institutional weaknesses;
- Improper government policies; and
- Improper rules and regulations.

16. Experts recognized that a minimum level of integrity is a key condition for successful, broad-based commodity finance. An environment where integrity is not honoured and where it is considered acceptable to abuse public confidence for private gain is not conducive to the development of any economic activity, including structured commodity finance.

17. It is very difficult to use structured commodity finance if there are no clear grading standards, and if there is a lack of properly organized service providers (such as transport companies), a history of poor contract performance, and so on. The physical marketing of commodities must meet certain standards in order for financiers to be comfortable with using commodities as collateral. Self-organization of the commodity sector is a good way to tackle this type of problem. This is true for all the actors involved in commodity production and trade: farmers should organize themselves into associations, as should traders. If an organization bringing together the key players in a given commodity sector is able to put an arbitration mechanism in place, the legal risks of commodity finance can be reduced significantly, making the country a more attractive partner for international trading houses and banks.

18. The experts saw lack of awareness about structured commodity finance as a major problem, and one that had needed be dealt with in order to create client-driven demand for training and education. This lack of awareness applies across the board. It affects developing country banks, which often consider the agricultural sector as so risky that they prefer to forgo their interest earnings than lend their funds for investment in that sector. While this fear is understandable in respect of many of the traditional forms of lending, it does not seem to be justified for structured lending, which has very low

default rates. It also affects Governments, which may maintain policies and regulations that presume that heavy intervention is required to manage credit and input supply to the agricultural sector, and which feel that only the State is able to store the commodities produced. Such government policies prevent the development of more effective private sector initiatives to meet the same needs. Finally, the lack of awareness among potential users of the available instruments reduces demand, and thus the pressure for the system to change. The efforts of UNCTAD, the World Bank and the African Export-Import Bank to create awareness and provide training on structured commodity finance were recognized, but experts noted that those initiatives were still much too limited.

19. Lack of training and education are problems that largely derive from the lack of awareness. If Governments and operators were more aware of the possibilities of structured commodity finance, training and education could be organized, possibly with the support of the international community.

20. The problem of limited commodity financing in many countries is exacerbated by the lack of reliable services such as warehousing, transportation and inspection, which are needed to ensure the integrity (in terms of quality, quantity and value) and timely delivery of the goods to be financed. While the leasing of unutilized or underutilized government facilities to the private sector can often mitigate these problems, in many cases significant investments are required. In a high-interest-rate environment, it is difficult for the local private sector to finance such ventures. To overcome this bottleneck, long-term loans by multilateral finance agencies for trade- or finance-related infrastructure should be more readily available.

21. The experts identified several institutional weaknesses which prevent the wider application of structured financing techniques. Foremost among these is the weakness of the banking sector in most developing countries. The lack of involvement of developing country banks is partly due to their fundamental economic situation: past government policies may as well as a liquidity crisis often brought on by IMF-driven policies may have made it difficult for them to lend at rates close to the international ones. It is also partly a legacy of the past, when government-imposed agricultural lending programmes often proved highly unsuccessful, creating the image of agricultural lending as somehow overly risky for banks.

22. Government policies influence the overall environment for commodity trade and finance. Erratic policies can be very harmful, as can policies which crowd out the private sector from storage and distribution activities, and government-made distortions that make it impossible for the private sector to put into place market-based systems to address the financing needs of the commodity sector.

23. In most developing countries (and contrary to the situation in the countries of the Commonwealth of Independent States and Eastern Europe), the legal environment specific to warehouse receipt finance does not generally provide many difficulties. However, other laws and regulations, as well as practices, create problems. While such problems vary widely from country to country, regulations regarding the ability of borrowers to provide collateral, escrow accounts, export licensing and bankruptcy rules often run counter to the requirements of warehouse receipt finance and related forms of structured commodity finance. In addition, a slow and at times erratic legal process can create a major bottleneck.

II. Recommendations

A. Addressed to the private sector, including farmers' associations and non-governmental organizations

24. The experts recognized the important role that can be played by intermediaries, in particular farmers' associations, traders and processors, in enabling individual farmers to have access to finance. Strong farmers' organizations are desirable, and such organizations merit support in their efforts to learn how to access structured financing tools. Such support should include the facilitation of exchanges of experience on successful applications, the design of pilot projects and training.

25. Private companies, and in particular developing country banks, should improve their awareness of structured financing mechanisms for the commodity sector and invest in the staff recruitment and training required to use such mechanisms. Banks may consider becoming more involved in the operating of commodity warehouses, to support commodity sector financing. Banks should also familiarize themselves with the financing sources that are available in developed markets, such as the special discount windows of the United States' Federal Reserve and the Bank of England.

26. Fair trade organizations and other non-governmental organizations may wish to explore the possibilities of structured commodity finance to refinance products at the moment they are produced, thus enabling them to leverage their risk capital. For this purpose, the discount windows mentioned above could be a useful tool.

B. Addressed to Governments

27. Rather than trying to cope with agricultural financing problems by setting up direct credit and credit guarantee programmes, Governments should focus on measures that make it possible to reduce the risks of private sector lending to agriculture. The Governments' first responsibility is to provide a framework conducive to commodity finance, in terms of policies and in terms of the legal and regulatory framework. If private sector entities, including farmers, find it difficult to access modern financing tools, Governments should undertake national reviews of government policies and regulations, and then take the necessary steps to remedy the problems identified.

28. In terms of the legal and regulatory framework, experts noted that the laws surrounding warehouse receipt finance should be simple and straightforward, since overly complex laws discourage use. As to warehousing law, Governments were encouraged to explicitly recognize field warehousing, and the negotiable character of warehouse receipts. They should also allow warehouse receipts (and related agricultural paper) to be denominated in United States dollars. Governments were also encouraged to facilitate banks' agricultural financing by reducing reserve requirements for warehouse receipts, and by setting up a special discount window in their central bank. Through active encouragement of the operations of banks in this area, they should also allow producers to borrow United States dollars at a fixed premium over the New York Bankers Acceptances market, as long as these borrowers can pledge title documents for exportable crops. For many developing country producers, processors and traders, this would translate into an interest rate equal to the London Interbank Official Rate (LIBOR) plus 3 per cent, or less.

29. While liberalization of the commodity sector was considered to be, overall, a positive experience, Governments need to recognize that private sector mechanisms to replace facilities previously provided by government agencies do not come into existence overnight: they need promotion and nurturing. Temporarily, government agencies using market instruments can allow farmers and others to access structured commodity finance, which may overcome institutional bottlenecks and therefore solve immediate problems. However, in order not to discourage private sector development, such government agencies must have an explicitly temporary mandate.

C. Addressed to the international community

30. Through technical as well as financial assistance, the international community should support the efforts made by the private sector in developing countries as well as by Governments to improve access to structured commodity finance. Given the specificity of the issue and the great similarities between the measures required in various countries, the international community has a particular role to play in the following areas:

- (a) Advocacy and awareness-raising: related activities should encompass decision- and opinion-makers in the public and private sectors;
- (b) Assistance in the development and organization of training programmes;
- (c) Assessment of legal and regulatory conditions, and assistance in their revision if deemed useful;
- (d) Policy analysis, in particular with regard to the impact of current government policies on the development of private sector financing mechanisms, and on possible market-based approaches that could replace costly government programmes;
- (e) Promotion of the exchange of experience and the development of partnerships between countries, markets and international organizations on the various issues related to structured finance;
- (f) Research on the possibilities for new financial tools (such as the creation of international funds which invest in commodity warrants) to enhance finance to the developing countries' commodity sector;
- (g) Exploration of the possibilities for new international schemes (such as sovereign risk insurance facilities for goods in warehouses) which would facilitate the provision of structured commodity finance.

31. The experts noted the important role of the World Bank and UNCTAD in providing policy analysis, advice and technical assistance in those areas, and while urging the continuation and indeed expansion of the work done so far, also noted that other organizations, particularly the international development banks, could and should play a larger role. They urged the international donor community to support country-level efforts to improve the environment for structured commodity finance and to support the activities undertaken by the World Bank and UNCTAD, as well as by other organizations which might become involved in the area. The international donor community was also invited to consider to what extent structured finance instruments could play a role in their own operations, including rural credit programmes and commodity projects.

Annex I

AD HOC EXPERT MEETING ON APPLICATIONS OF STRUCTURED COMMODITY FINANCE TECHNIQUES FOR COMMODITY-DEPENDENT COUNTRIES

Rio de Janeiro, Brazil, 19-21 May 1999

Agenda

Wednesday 19 May

- 9:00 Opening by Rubens Ricupero, Secretary-General of UNCTAD
9:30 Francisco Ourique, Secretary-General of the Brazilian Federation of Coffee Exporters, *The impact on Brazilian coffee growers of lack of access to risk management and structured finance tools*
10:20 Introduction and approval of the agenda

Session I: The relevance of warehouse receipt finance for farmers

- 10:30 Duncan Burnett, Natural Resources Institute, United Kingdom, *The impact of structured commodity finance techniques on market chain participants in export dependent countries*
11:30 Luis Carlos Delanoé, Director, Promexico, Mexico, *Financing small producers in Mexico and Chile*
12:30 Edilson Martins de Alcântara, Manager, Rural Finance, Banco do Brasil, Brazil, *Brazil's experience with the use of campaign finance and warehouse receipt finance for farmers*

Session II: Using structured finance in agriculture: practical aspects

- 14:30 André Soumah, Chairman and Managing Director, ACE Audit, Control & Expertise, Switzerland, *Experiences with the impact of warehouse receipt finance on farmers, small traders and agricultural processors*
15:30 Alfredo F. Lamas, Financial consultant, United States of America, *Commodity financing in Central America*
16.30 Frederick Kawuma, Executive Director, Uganda Coffee Trade Federation, *Competing in a non-level playing field: the impact of limited credit access on farmers and small traders*

Thursday 20 May

Session III: Warehouse receipt finance as a way to empower farmers - the way forward

- 8:30 Raoul Montemayor Quimson, National Business Manager, Federation of Free Farmers Cooperatives, Philippines, *Linking warehouse receipt finance into the agricultural system - the Philippines' experience*

9:10 Discussion on mechanisms, obstacles and ways to go forward

Session IV: Legal and regulatory obstacles to the use of collateralized finance by the poor

11:20 Nicholas Budd, Partner and Head of Commodity and Trade Finance, White & Case, France

Legal and regulatory aspects of collateralized finance for agriculture

12:00 Discussion on policy implications

Session V: Using structured finance to unlock the growth potential of commodity production and processing

14:30 Sergio Barroso, President, Cargill Agricola SA, Brazil, *Structured finance as a tool for development*

15:10 Discussion on finance for agricultural inputs, and finance tools for boosting the capacity utilization of processors

Friday 21 May

Session VI: Structured commodity finance and globalization

8:30 Discussion on finance as part of the supply chain, and the changing role of farmers' associations

Session VII: Comparing structured commodity finance with other forms of rural finance

11:00 Javier Alvarado, Centro Peruano de Estudios Sociales, Peru, *The strengths and weaknesses of structured commodity finance, microfinance and government credits*

11:30 Discussion

12:00 Discussion and adoption of experts' conclusions and recommendations

13:00 Closure of expert meeting

Annex II

ATTENDANCE

Forum on Applications of Structured Commodity Finance Rio De Janeiro, Brazil, 19-21 May 1999

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