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TRADE AND DEVELOPMENT BOARD
Commission on Trade in Goods and Services,
and Commodities
Expert Meeting to Examine the Effectiveness and
Usefulness for Commodity-dependent Countries of
New Tools in Commodity Markets: Risk Management
and Collateralized Finance
Geneva, 4-6 May 1998
Agenda item 3

EXAMINATION OF THE EFFECTIVENESS AND USEFULNESS FOR COMMODITY-DEPENDENT COUNTRIES OF NEW TOOLS IN COMMODITY MARKETS: RISK MANAGEMENT AND COLLATERALIZED FINANCE

Agreed recommendations

1. The experts agreed that there was a clear link between exposure to price risks on the one hand, and lower investment and growth, and more income inequality, on the other. They noted also that the savings on interest costs when using commodities as collateral can be considerable. Enhanced use of new tools for commodity risk management and collateralized finance can therefore make a large contribution to development goals, including the reduction of the vulnerability of the world’s poor to the effects of volatile commodity prices.

2. While liberalization of the commodity sector was considered to be, overall, a positive experience, the withdrawal of the government had led to some gaps in the services provided to producers and others active in the commodity sector. In this respect, the Expert Meeting recognized the usefulness of commodity price risk management and warehouse receipt finance; the possibilities for structuring medium- and longer-term finance around commodity collateral; the importance of controls on the misuse of price risk management instruments; government exposure to price risks, and practical solutions; and the potential role of the international community in advocating, pioneering, monitoring and improving the use of commodity price risk

management and financing practices. The experts noted that there are other, related risk factors in commodity trade, including transport risks and documentary risks, and although not discussing these wider issues, the meeting recognized the importance of work on them, and noted the relevance of trade facilitation issues in this regard.

3. The Expert Meeting agreed on the need for a comprehensive approach to enhance the understanding and use of commodity price risk management and collateralized finance. It considered that the best way for taking meaningful action in this regard was through coordination and cooperation not only among international organizations, but also with the private sector (including non-governmental organizations, farmers' associations and all other local stakeholders). Partnerships were seen as a highly effective way to advance work. Therefore, the experts welcomed UNCTAD's initiative in organizing the Lyon Partners for Development Summit, and the decision to include issues of use of modern financial instruments for commodity trade in the Summit's agenda. This was considered a useful way to raise the profile of this work, and obtain the needed political support for meeting policy challenges in this field. Experts expressed their appreciation for the excellent quality of UNCTAD's analytical work in this area and stressed its continuing importance to developing countries and countries in transition.

Addressed to national governments

4. Governments that are directly exposed to commodity price volatility (e.g. through their tax or royalty income) should consider initiating risk management units with a semi-independent role, which would analyse and quantify the government's risk exposure, gather relevant market information, and act on behalf of the government both to cover governmental risks and, if the need exists, to facilitate the protection of some of the private sector players in the country.

5. Governments should undertake to set in place a policy framework conducive to the sound use of modern financial instruments in commodity trade by farmers, traders, processors, financial institutions and investors. In this regard, the following actions are of prime importance: governments need to recognize the importance of having sound legal, regulatory and institutional policies governing commodity trade. If the private sector finds it difficult to access modern financial tools, governments should undertake national reviews of government policies and regulations, if relevant with support from the international community. If these policies and regulations are found to be hindering the proper use of basic as well as modern financial instruments for commodity trade, a programme to modify such policies and regulations should be adopted:

(a) When liberalizing agricultural marketing, governments (as well as international donor agencies) should bear in mind the importance in commodity trade of factors such as quality control, weight verification, information, access to risk management, and institutional arrangements which mitigate counter-party risks; and they should try, when possible, to promote the development of private sector institutions which can fulfil these kinds of functions before radically abolishing existing government entities.

(b) Governments should facilitate (including through the adoption of relevant legal and regulatory provisions) the development of sound, private-sector-based standards for commodity trade, including standard contracts. This requires ensuring that legal decisions, or arbitration awards, can indeed be implemented; and that the legal and regulatory framework in place does not hinder the emergence of the necessary support entities (e.g. independent warehousing companies or inspection companies).

(c) Governments should ensure that price and trade policies are consistent with the use of market-based risk management and finance instruments. Overall, price stabilization is not consistent with the use of these instruments.

6. The experts emphasized the important role that can be played by intermediaries, in particular local banks and farmers' organizations, but also private traders, processors and other stakeholders in the commodity sector, and when necessary, specialized government agencies, in the field of risk management and collateralized finance. They considered that upgrading the skills and capacities of these groups would clearly contribute to development goals. Among other things, the strengthening of local banks would lead to much easier access to modern financial instruments for local traders and farmers' associations; and they recommended a deliberate effort, focusing on developing country banks (including regional banks), in this direction, including the exchange of experience among countries.

7. The Expert Meeting agreed that strong farmers' organizations are desirable, and that efforts to strengthen them should focus on viable organizations. For this purpose, governments and intergovernmental organizations, in consultation and collaboration with such farmers' organizations themselves, should:

(i) facilitate further reflection and debate among farmers' organizations at regional and national levels on risk management and collateralized finance, with the objective of clarifying the position of farmers' organizations, and establishing a detailed plan of action by farmers themselves;

(ii) provide appropriate training and briefing for farmers and farmers' organizations on the new tools in commodity markets;

(iii) design and undertake pilot projects, focusing on the role of farmers' organizations in risk management and collateralized finance, at national and local levels;

(iv) facilitate dialogue and partnership among farmers' organizations and other relevant representative bodies in the private sector for the effective and useful application of risk management instruments and collateralized finance, for the benefit of small farmers.

Addressed to the UNCTAD secretariat, the World Bank and other international organizations

8. The Expert Meeting noted the important role of the World Bank and UNCTAD in providing policy analysis, advice and technical assistance in these areas, and while urging the continuation of the work done so far, recognized that these organizations, as well as others, including the Common Fund for Commodities, international commodity bodies and regional development banks, could play important roles, in close collaboration with each other and complementing the role of private sector players. The possible roles vary from organization to organization, but may include the following:

(a) the role of "honest broker" between the financial entities offering modern financial instruments, and the beneficiaries, to increase confidence in the instruments and their use;

(b) acting as a clearing-house for information on commodity price risk management and structured finance, and ensuring wide distribution of relevant information;

(c) advocacy, awareness-raising, and provision of necessary training and technical assistance, to disseminate information and knowledge about modern financial markets and instruments relevant for the commodity sector, to identify risks, and to design and implement strategies to deal with them. In this light, country-level risk analysis, on a pilot basis or as a systematic part of country trade-review mechanisms, should be considered;

(d) UNCTAD should continue its analytical work in this area, in particular with respect to:

- analysis of factors affecting the level of risk along the transactions chain, and identifying possible implications for work in the World Trade Organization on trade facilitation, and needs for technical assistance;

- analysis of constraints on strengthening the capacity of local banks to develop services in collateralized commodity trade finance and risk management;

- developing the scope for enhancing access to structured finance for the commodities sector by the formulation of sector-specific financing blueprints;

(e) taking other actions to strengthen relevant institutions in developing countries and countries with economies in transition, including emerging commodity exchanges, warehousing companies, and local and regional banks; experts recommended that a workshop on these issues be convened in 18-24 months to exchange experiences of progress of various projects on these issues;

(f) assistance in the development of appropriate risk management and financing instruments which are sufficiently simple in their use, and do not require overly cumbersome financial flows, including the consideration of linking lending to risk management (e.g. commodity-linked loans);

(g) supporting the systematic review of national policies, with the purpose of identifying policies, regulations and practices that hinder or prevent the use of modern financial instruments in commodity trade and credit access;

(h) promoting the exchange of experience and the development of partnerships between countries, markets and international organizations on various issues related to commodity price risk management and collateralized finance, including on the modalities for stimulating the emergence of a sound institutional framework (including warehouses).

9. Given its roles as an international financial institution focused on development, the World Bank Group, as well as the regional development banks, should consider undertaking the following actions:

(i) facilitating commodity risk management transactions;

(ii) facilitating the provision of commodity risk management transactions through local banks;

(iii) examining the possibilities for increased guarantees on risk management and structured finance transactions between developing country entities and providers of these financial instruments.

Addressed to the international community

10. The Expert Meeting urged the international donor community to support country-level efforts to improve the environment for commodity trade, risk management and finance (in particular, the development of appropriate legal and regulatory frameworks), and to support the activities undertaken by the World Bank and UNCTAD, and other organizations, including Common Fund for Commodities, actively involved in this area.

11. The international donor community was also invited to assist in demystifying modern financial instruments for commodity trade, and to consider to what extent such instruments could play a role in their own operations (taking into account also provision of a consistent development assistance package), including support to structural adjustment programmes, and commodity projects.

12. The international community should support national debates on how warehouse receipt finance and other modern financial instruments can be used in commodity-dependent countries.

13. Donor organizations should consider the risk of stifling local initiative, in particular in the provision of collateralized finance, caused by excessive funding in situations where there is insufficient absorption capacity.

14. The international community should coordinate its work in the above areas.