Role of Structured Financial products in managing commodities price volatility

By

Dr. Bharat Kulkarni
Director, Stalwart Management Consultancy Services

The views expressed are those of the author and do not necessarily reflect the views of UNCTAD.
Role of Structured Financial products in managing commodities price volatility
Maize Prices in 4 sub Saharan African Countries

**2013**

<table>
<thead>
<tr>
<th>Country</th>
<th>Highest Price</th>
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What is the Reason

- Demand is spread over the year; Supply during harvest season;

- Prices collapse during the harvest period and peak during deficit period

- Leads to poverty - as farmers sell low on harvest and buy at a higher price for consumption
Post harvest liquidity is a major challenge

- Present agro produce marketing system is inefficient & fragmented and does not guide the producers;
- Farmers need money on harvest- Liquidity needs
- Absence of storage infrastructure;
- Cost of borrowing & Banks requirement do not leave viable option for farmers.

Farmers in Sub Saharan realize a very small % value of their produce vis-à-vis 65-70% in the developed economies
Lower credibility

Lack of confidence

Not seen as an alternative by farmers/Traders

High risk perception

Lower liquidity & high price for credit
Challenges for Processors and Exporters

- Huge investment of Working capital in Physical stocks;
- Cost of financing gets added to the Prices.
- Processing margins are reduced.
- Export Financing - barrier to entry;

The challenges offer a opportunity to use Structured financial products
What is Structured Finance

• A process to transfer the risks from parties less able to bear them to those more equipped to bear them.

• Move the risk away from the party which is being financed

• Conversion of Wealth to Capital
  – Plantations, Oil etc
Why Structured Finance

• Issues with the traditional system
  – Risk on Borrower
  – Hence, Borrower needs to be financially sound
  – Even if collateral is accepted- Secondary

• High interest due to higher risk

• New Companies find it challenging
Structured Commodity Finance

• Shifting the primary risk on underlying commodity
• Storage/Control of commodity
  – With neutral party
• Borrower Profile/Financials
  – Secondary comfort
Issues in Structured Commodity Finance

- Warehousing Infrastructure
- Logistics Management
- Quality Assaying
- Insurance
- Exit Options
Benefits of the structured financing for Borrower

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<th>Traditional financing</th>
<th>Structured commodity finance</th>
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<td>• Need of Balance sheet Strength</td>
<td>• Lending is independent of balance sheet strength.</td>
</tr>
<tr>
<td>• The credit risk affects the credit cost</td>
<td>• Standardized commodity risk is lower, hence cheaper</td>
</tr>
<tr>
<td>• Lean on assets tie up the assets as security</td>
<td>• Other assets left free for borrowing</td>
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### Benefits of the structured financing for Lender

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<td>• Liquidity of the Collateral is low</td>
<td>• More liquid Collateral</td>
</tr>
<tr>
<td>• Individual credit risk evaluation &amp; monitoring</td>
<td>• Clearly identified risks of identified class of assets</td>
</tr>
<tr>
<td>• Less transaction intensive</td>
<td>• Huge volumes as opportunity scalable across commodities</td>
</tr>
<tr>
<td></td>
<td>• Tight structure =&gt; High quality asset</td>
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</table>
Warehouse receipt based finance

• Warehouse receipt
  – Title to goods
  – Acts as a collateral against the stocks stored with a credible warehouse
  – In some countries, it is a negotiable instrument
  – Can be used by the farmer as a collateral security to avail institutional finance
  – A very developed system in US, Canada and Australia for financing to farmers
Warehouse receipt based commodity financing: structure

1. Approves Warehouse
2. Guarantee, Insurance, etc
3. Deposits products
4. Issue receipt
5. Lodge receipt with Bank
6. Provide credit
7. Sign Sales contract
9. Makes payment, Warehouse makes delivery

Farmer

Marketing Company

Bank

Warehouse

Certification & Collateral Manager
### Challenges in developing nations

<table>
<thead>
<tr>
<th>Warehouse Facilities</th>
<th>Warehouse Receipts (WR)</th>
<th>Collateral Management Services</th>
</tr>
</thead>
</table>
| • Unreliable performance of warehousemen  
  - fraud & mismanagement  
  • High charges levied to farmers/traders | • Negotiability of warehouse receipts  
  • Non-uniformity of WRs | • Either Absent or too costly,  
  • Even if present, role not understood properly |
Challenges in developing nations

Risk Management Issues
- Price information
- Access to market

Commodity Related issues
- Lack of standardization of grades
- Part delivery of goods
Getting Finance Up the Value chain in Malawi- AHCX initiative
Conclusion

- Banks and Financial institutions have to look beyond the traditional form of inventory finance based on trilateral agreements between a bank, a borrower and a collateral manager.

- In effect, warehouse receipts can play a crucial role into a wide variety of financing schemes. These may not be easy to structure, but often, can be used for sectors which have little or no access to affordable finance.

- Hence, banks and other financiers which develop the relevant skills - quite different from those required for relationship banking or balance sheet finance, and closer to investment banking skills - can reap attractive margins.

- The availability of the finance will allow the market to suck the extra supply and evenly distribute it over the demand period.
Thank You