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Role of Structured Financial products in managing commodities price volatility

By

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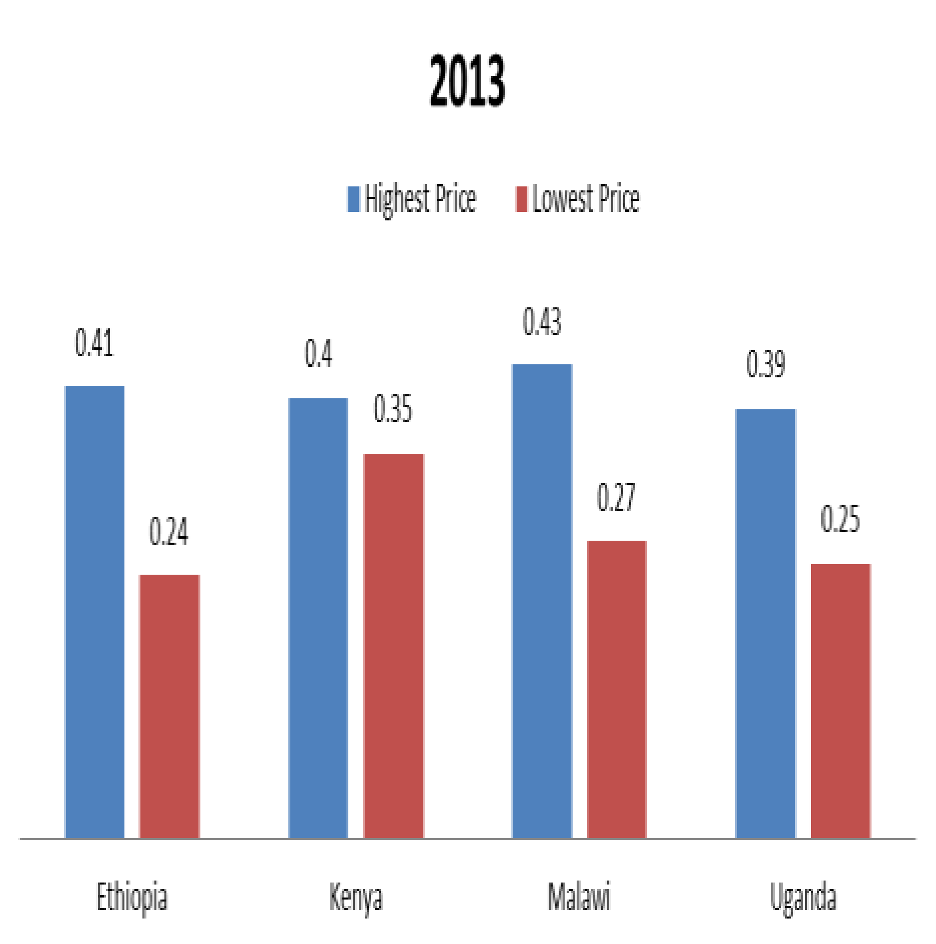
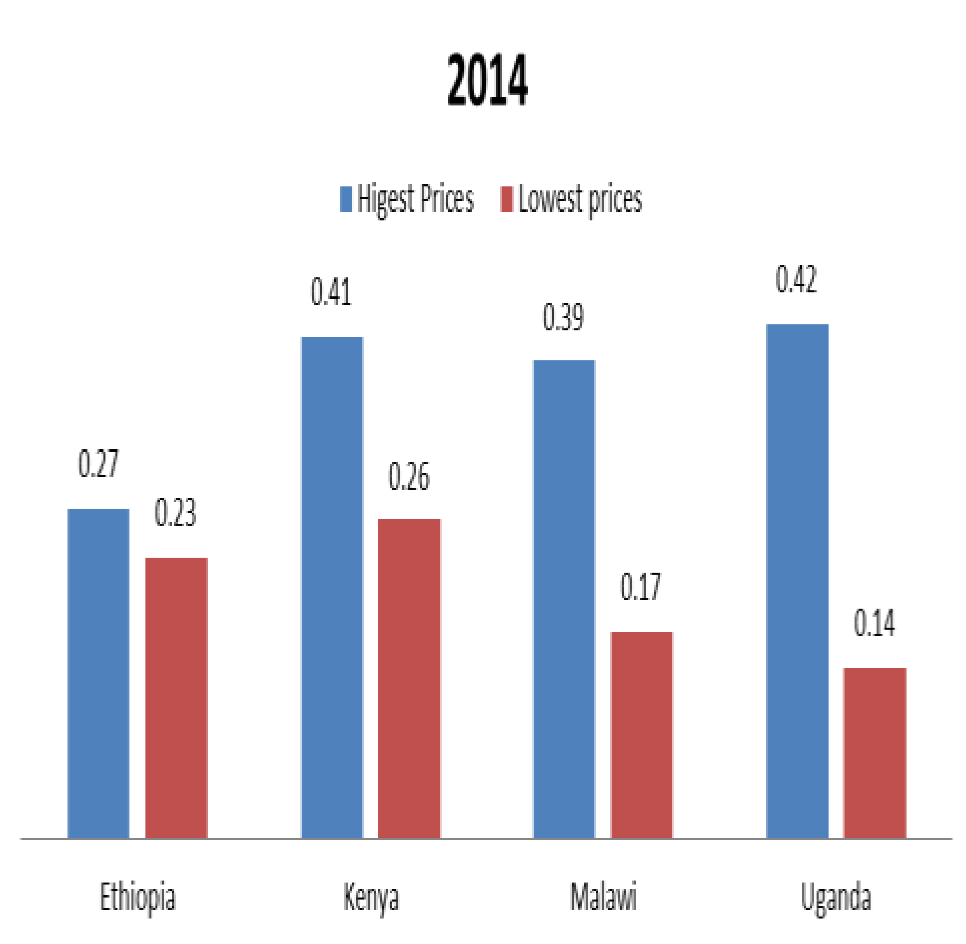
Maize Prices in 4 sub Saharan African Countries





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 ot their produce vis-à-vis 65-70% in the developed economies

Ground Reality in Post Harvest Credit

Lower credibility

Lack of confidence

High risk perception

Lower liquidity & high price for credit

Not seen as an alternative by farmers /Traders

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

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

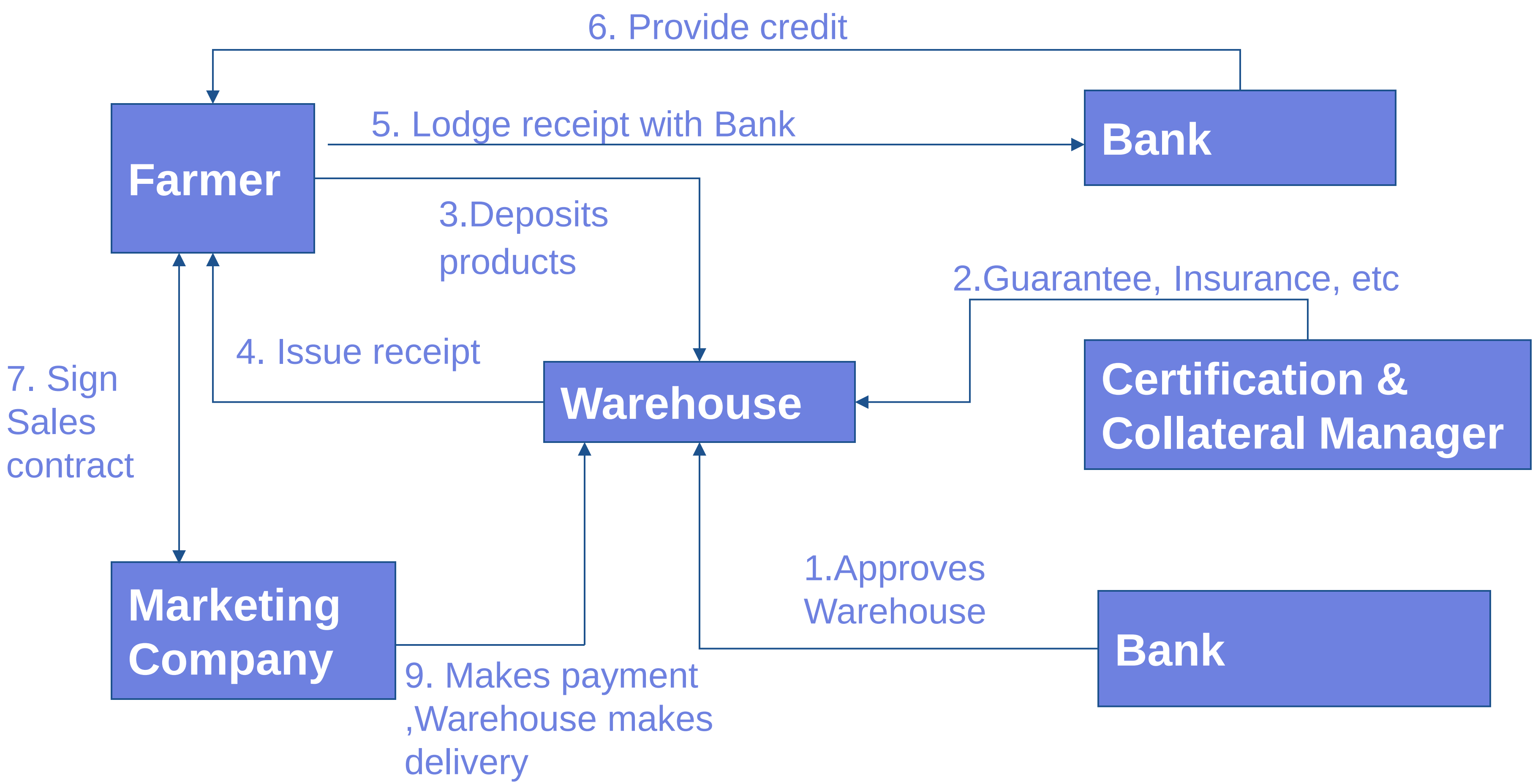
Benefits of the structured financing for Lender

Traditional financing	Structured commodity finance
• Liquidity of the Collateral is low	• More liquid Collateral
• Individual credit risk evaluation & monitoring	• Clearly identified risks of identified class of assets
• Less transaction intensive	• Huge volumes as opportunity scalable across commodities
	• Tight structure => High quality asset

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



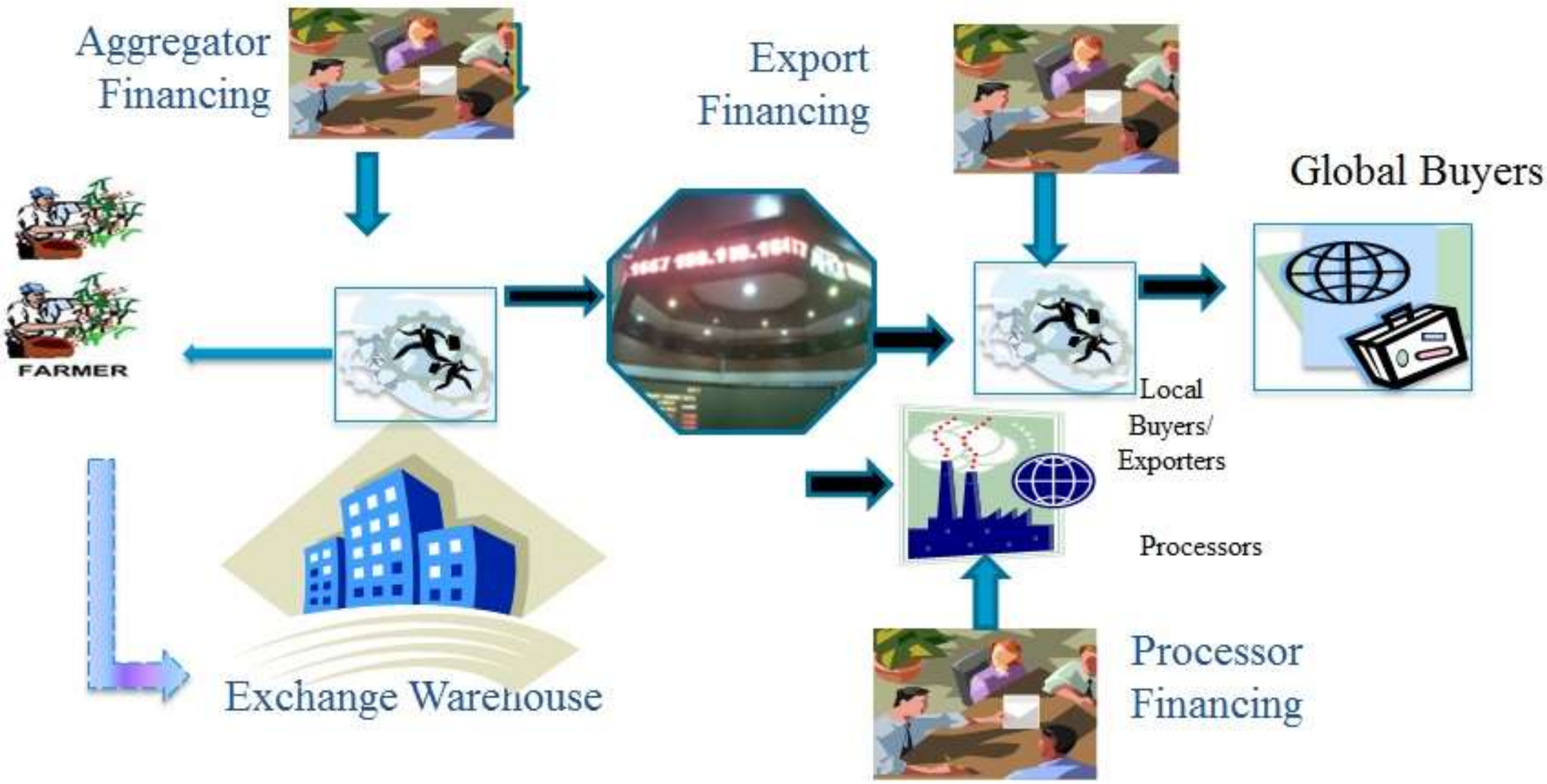
Challenges in developing nations

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

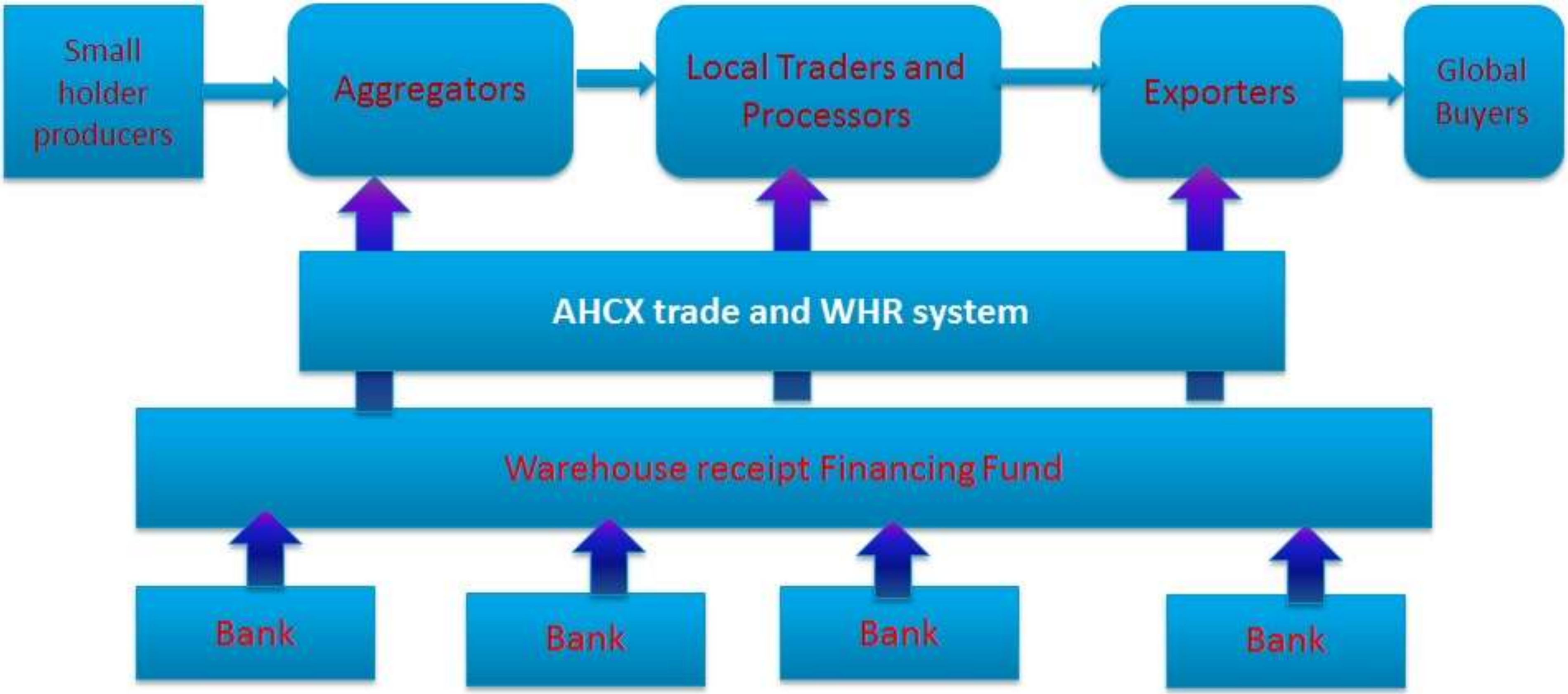
Challenges in developing nations

Risk Management Issues	• Price information • Access to market
Commodity Related issues	• Lack of standardization of grades • Part delivery of goods

The Experiment in Malawi



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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Brain Behind E Africa's First Commodity Exchange

Bharat Kulkarni helped Ethiopia wake up and smell the coffee. Now other African countries are following the lead

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