Securing the frontier supplies

Dealing with most commodities on a physical basis will always have numerous associated risks. The production and movement of these goods in emerging markets can increase these risks dramatically. Storage and distribution are crucial elements in this chain, and this is where collateralized warehouse receipt financing has come in. Trade Finance asks Christian Joerg of SGS to explain the development and uses of this commodity tool.

Christian Joerg at SGS in Geneva

***Trade Finance* (TF):** Warehouse receipt financing is a tool which is increasingly used in developing markets, can you describe how it has come about, and explain the rationale for its growth?

Christian Joerg, head of collateral management services at SGS in Geneva: Warehouse receipt financing is commonly used today in numerous forms and at various stages of the commodity, i.e. during the natural flow of goods from producer to consumer, for example:

- Pre – export financing
- Processing of raw commodities
- Trade, frequently financed through B/L
- Financing of local distribution channels

If an operation is situated in emerging markets with risks potential, or markets with political instability, collateral managers are included into the structure applying their designed risk control techniques.

TF: Why use warehouse receipt financing, what are the advantages of using such a method for the traders?

Joerg: In order to have a competitive advantage, traders progressively extend their services to their clients. Among their traditional functions, they provide for example pre-export financing to their sellers or provide credit to their buyers at the country of destination. Therefore, traders become part of the industrial chain, hence the requirement for external financing. The respective document, the warehouse receipt, gives or should give the necessary control to financiers and traders. The underlying goods are often physically secured by a collateral manager which often facilitates access to trade finance in general.

TF: ... and for the banking community?

Joerg: Banks are increasingly cautious in the way they secure their trade finance transactions. Their operations become increasingly structured with the demand of full protection of the financiers pledge. The transfer of risks to the collateral manager can be one effective tool to guarantee a pledge the financier has on the goods. In my opinion the company issuing a warehouse receipt should be by all means financially viable to do so, i.e. the risks taken should correlate to balance sheets.

TF: What sort of commodities are being worked with in collateral management?

Joerg: Any commodity required to be stored or remain idle for a period of time, the collateral system can be effectively applied. Due to seasonal impact, high valued agricultural commodities stored in developing countries are often financed through warehouse receipts secured by a collateral manager. Recently, collateral management services have been successfully introduced in the energy and ferrous/non-ferrous sectors.

TF: What risks exist in warehouse financing and how are those dealt with?

Joerg: The question of risks is very diverse. The key to success of an operation is to properly identify and analyze risk exposures. By doing this and in conjunction with the concerned parties, risks can be allocated or transferred. Furthermore, the majority of transactions are concluded under English law. However, the impact of the local law in which the transactions takes place should also be carefully examined. In this respect, SGS collateral management services include measures to avoid the occurrence of a risk, limit its severity and reduce its consequences.

TF: What sort of time frame can warehouse financing be used over?

Joerg: In principle, there is no limit to the time frame. However, the inherent vice should be taken into consideration. On the other hand, contracts for coffee and cocoa can be in place for years. However, in such revolving operations located in the plans itself, it is important to have the necessary audit procedures in place. In some particular cases, it is advisable to insist on a 'point zero'.

TF: Why audits?

Joerg: The issuer of a warehouse receipt is accountable for specific risks as the consignee on a receipt has a right of recourse. The company issuing a warehouse receipt therefore has a large responsibility not only towards its clients and banks but also towards its shareholders. Our operations and procedures are ISO 9002 accredited by an external, independent German audit firm, which is one measurement tool to insure the integrity of our operations worldwide. I emphasize external audits are one of several tools to control operations and do not replace internal risk management techniques. The consequences of recent events strengthen this requirement.

TF: We have heard stories of cameras being used to monitor a warehouse stock, only for people to find a camera trained on one pallet of goods and an otherwise empty warehouse. How valid are such stories?

Joerg: I'm afraid those stories are true, the losses to the industry are substantial. A combination of corruption, organized crime, the deficiencies of legal and courts' systems create an environment which can be extremely dangerous. The fact that some commodity prices paid to producers are on record lows can unfortunately further accelerate the problem. When companies need to be sure they should consider firms such as SGS in structuring their trade finance operations.

Zimbabwean raw paprika stored in South Africa waiting for export to Europe

TF: What about in countries where people might see it as being rather dangerous, criminal gangs in the CIS or troubled countries of sub-Saharan Africa, is warehouse receipt financing still possible?

Joerg: Yes, definitely. The key is how such an operation is structured and the reliability of the local operators. Tell me, what value has a warehouse receipt when issued by a company which can not cover its financial obligation or in an environment where companies disappear today and reappear tomorrow under a different name? A warehouse receipt is only as good as the company issuing it, whether this is in sub-Saharan Africa or elsewhere.

TF: How do you insure those risks?

Joerg: Firstly, I must stress that we put all the necessary structures in place in order to eliminate or decrease foreseeable risks. We consider insurance as a risk transfer mechanism only, which neither eliminates nor reduces the occurrence of a loss.

TF: So why should traders and commodity banks be attracted to your collateral management insurance?

Joerg: Our policy has been carefully designed, in consultation with our brokers and underwriters, to provide comprehensive coverage, including, at the option of our clients, war risk on land, and confiscation/expropriation, nationalization and deprivation coverage. Underwriters accept declarations based on our expertise and ability to safeguard the financed goods. It is becoming increasingly difficult, if not impossible in certain circumstances, for our clients to match the cover we can offer as an adjunct to our overall commitment to service.

TF: Following the widely publicized reductions in policy coverage, and increases in rates following the tragic events of September 11, has your collateral management insurance policy been negatively affected?

Joerg: We are pleased to report no cut back in conditions or scope of cover at all. Rates have slightly increased, but only at the lower end of market rises, and well within, we believe, the rate increases being given to our customer base by their own underwriters.

TF: Why is this?

Joerg: The collateral management team is committed to meeting with, and working with, its underwriters. To this end, regular meetings have been held both in London and Geneva, and free access has been given to the external auditors. Due to our vertical management➤

Hot-rolled coil stored in Malaysia

➤structure whereby all contracts are signed by the Geneva office, taking into consideration specific approval procedures, operations worldwide can be effectively controlled. Underwriters have therefore been able to 'buy in' to our way of doing business.

TF: Do you see warehouse receipt financing as a tool to help a developing country climb out of some of its economic problems by assisting the overall export programme?

Joerg: Yes, without any doubt. Let me give you an example of a case study of one operation in Morocco. The cephalopods (octopus/squid) industry is an industry which is extremely capital intensive. Catching, cleaning and processing are labour intensive. Refrigerated warehouses and extended storage periods result in high storage costs, i.e. the pulp is caught during two short seasons and consumed / sold during the entire year. These external factors combined with the elevated value of the pulp itself make it all a valuable commodity. This created several constraints in the past to the local fishing industry. Together with a leading bank in Morocco we have set up a system whereby the pulp is financed as soon as we issue the warehouse receipt for goods arriving at our controlled warehouses. The bank feels confident due to the controls and guarantees given by SGS, and the fishing industry can take advantage of financing the products at an early stage and is therefore not under pressure to sell the goods.

TF: Are there alternatives to warehouse receipt financing?

Joerg: One alternative could be the employment of FIATA Forwarders Certificates of Receipt, which may also include the financing throughout the transport period. FIATA FCR are commonly used in Eastern Europe. However, it has to be noted that FIATA recently prohibited the issuance of all FCR for steel shipments due to increased fraudulent activities in this sector. In some instances, freight forwarder issued a forged FCR without disposing of the actual goods. The buyers who relied on the FIATA FCR and paid for the goods based on this document, were unable to obtain the goods.

TF: Are there any organizations helping to promote warehouse receipt financing as a means to develop agriculture or other resources?

Joerg: Unctad (United Nations Conference on Trade and Development) provides a lot of useful information to companies especially those located in developing countries. They are also actively involved in various projects in order to promote warehouse receipt financing and free trade in general. The EBRD (European Bank for Reconstruction and Development) has also been supporting similar projects in the past. The Natural Resource Institute, a UK based research and consultancy organization, aims also to promote the marketing of primary commodities through improved warehousing and financing structures. The Paris office of Denton Wilde Sapte, an international law firm specialized in structured trade and commodity finance can further assist on the legal side.

TF: What is the future for warehouse receipt financing?

Joerg: Well, warehouse receipt for grains were first recorded in 2400 BC in Mesopotamia and are still being used all over the world. Just compare this with the 'dot.com dot.gone euphoria'. Nevertheless, I believe that correctly used warehouse receipt will continue to be an important document to be used by traders and banks in the future. However, the document alone will not necessarily decide its success. Just as important is a local, sophisticated banking structure along with an efficient, legal and court system. The respective documents may be sent electronically in the future.

TF: The eCertificate or eWarehouse Receipt?

Joerg: Yes, the SGS eCertificate considerably reduces documentation lead-time which implies saving on interest. It further decreases working capital requirements which can be an important factor in our capital intensive industry. In addition, clients using eCertificates, i.e. electronic documents, can process their own information more effectively.

TF: Does the eCertificate comply with international trading practices?

Joerg: Using eCertificates, clients obtain quick settlement of a commercial transaction in compliance with rules of presentation defined by the International Chamber of Commerce called UCP 500 (Uniform Customs and Practices for Documentary Credits 500) and its supplement, the eUCP.

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