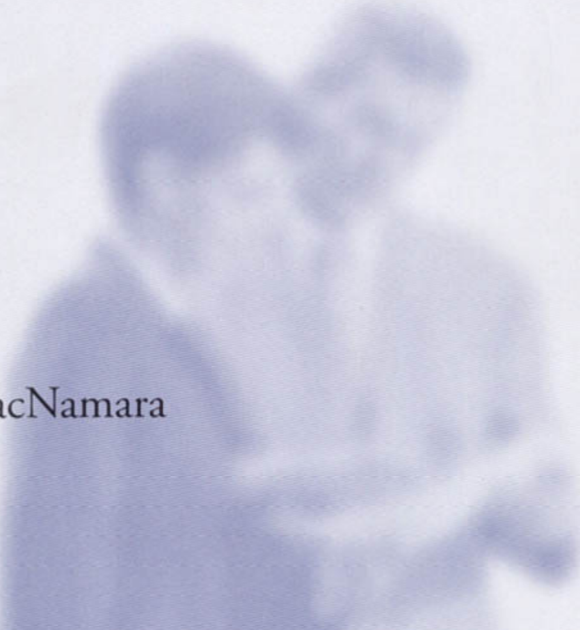
Structured trade and commodity finance in emerging markets

What can go wrong and how to avoid it



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Preface

This book was born from repeated attempts to convince the banks for which I have worked that there is value in risk mitigation techniques in Emerging Market finance. Over the last several years, originally in credit applications, later in strategy papers and strategic reviews, I have had to rationalise so often the basis on which this product is practised that I have been told, proverbially, 'you should write a book'. Specialists in this area of finance have a particularly Cassandra-like existence, because one feels one is forever predicting the future with a depressing degree of accuracy, yet being totally ignored by mainstream banking. This presentiment was particularly extreme in the months leading up to the Russian crisis, when I was told by a senior investment banker at my then bank: 'Why should we bother with your low-yielding structured deals when we can make so much more from our Russian limits by trading GKOs?' GKOs are short-term (up to one year) fixed-rate zero coupon rouble-denominated Russian government debt instruments, heavily traded by foreign banks in 1997–8 on the basis that they had forward contracts with various domestic Russian banks to cover the foreign exchange risk. In practice the crisis meant that not only did the government not pay but that many Russian banks also defaulted on the forward contracts. Everything is relative: the return on assets of this structured trade and commodity finance (STCF) portfolio at the time was over 7%, which rather exceeds the standard targets of corporate banking but doesn't approach the 20% plus enjoyed by the GKO traders right up to the point where they lost their principal.

I use 'return on assets' knowing that the fixed-income trader will quote back RORAC (Return on Risk Adjusted Capital) or RAROC (Risk Adjusted Return on Capital) at me, but none of the risk adjustments they used at the time seemed to tell them they were about to lose their principal, so this seems a somewhat flawed model by which to measure the return. Unfortunately, 12 months later I left, to join another bank, because I still couldn't get the credit committee to approve any of my structured deals. I can't pretend to have predicted the Russian crisis, having been a 'Russian fan' myself, but I can say that all my much-maligned structured deals paid out in full, with all interest and fees, both pre- and post-crisis, and in the end they were not exactly low-yield either. Nevertheless all of us in this line of business are acutely aware that this is a 'minority sport' for most investors and lenders, with the result that the need to convince our various employers of the role this product can play in the product-palette of the institution is a constant theme.

Having got so far, however, we then run into some problematic questions. The obvious question is ‘does the product work?’ While in general and equally obviously, the dedicated specialist would answer in the affirmative, nevertheless there have been a number of reasonably well-publicised cases (some of which I have specifically targeted as case studies) in which the opposite appears to have been true.

There appear to be three stages in the development of consciousness of the STCF product. First is ‘denial’, in which the sceptic points to the typically ‘difficult’ country in which the proposed deal is to take place and says ‘Angola? Surely thou jesteth?’ Next comes ‘Damascene conversion’, at which point the protagonist realises that not only has Angola been steadily borrowing *and repaying* money on an increasingly beneficial basis through structured crude oil prefinance for much of the last two decades, but further, a well-established pool of banks, export credit agencies (ECAs) and even bank regulators (who rather remarkably refrain from insisting on instant provisioning) have been accepting these deals quite happily at relatively modest pricing: there is a liquid and stable market out there for Sonangol performance risk which the bank regulators regard, if not with equanimity, at least without panic. However, as any ex-smoker may recognise: none so zealous as the recent convert. This phase is characterised by intolerance of the infidel, and sometimes overweening faith in the mystery of the structure.

Finally comes deliverance: we arrive at a realistic assessment of what the structure can do for us, and get to use it as a path to salvation, for it is not, to be sure, an end in itself. To have a structure does not miraculously endow us with a Kevlar codpiece nor any more wonderful manifestation; rather it gives us ammunition that helps us fight our way out of difficult situations. Even though we have a ‘structure’ you still have to fight, even pray, and the circumstances (possibly identified by your analysis) will determine whether or not you run out of your structural ammunition before achieving your objective. Different structures achieve different things, and an inadequate or merely inappropriate structure may prove insufficient to deliver all that may be demanded of it in a specific context. In the end, to see what the structure achieves, we have to look in detail at what happens to such structures in practice.

Perhaps it is relevant to this book at this stage to reveal my academic background. I’m afraid to say, in the modern context, that I did not study ‘business’ at university, nor even economics, but rather I was an historian. To be fair, I also studied *inter alia*, medieval money, that is, the history of the development of money in post-Roman-Empire Europe up to early modern times, which perhaps could be described as the original Emerging Market. My point, however, is that the approach here is empirical and driven by experience and analysis of what has been seen to happen: look at what works, and what doesn't work, and learn from it.

In the course of looking at deals done by some major institutions in difficult or challenging circumstances and with the benefit of perfect hindsight, it is perhaps easy to see things rather differently from how they appeared at the time. It is equally plausible that the version or summary of versions used in the case studies may not necessarily be true to the recollections or understandings of observers of, or participants in, those same events. I have tried to be careful not to represent my own opinions as fact, and the facts I represent are from third party sources – individuals concerned or (mainly internet) publicly available sources – with the caveat that these sources often tell conflicting tales of what actually happened. Where I have relied upon my own experience, I have endeavoured to protect commercial confidences.

The journey upon which we embark therefore starts with defining what it is that we mean by 'STCF', the lending rationales that lie behind credit in general and the structured product in particular, leading to the most typical structures seen in the market in recent times. We will then consider the application of such structures in practice, looking at case studies and other horror stories by which we may illustrate what may go wrong, also paying attention to what went right. We will also examine documentation and the common pitfalls of getting first-class loan documentation, which does not describe the structure you are trying to implement. This should, I hope, lead naturally to the conclusions.

In this information age, we have also included an appendix on where to find information. Our difficulty these days is not information deficit, rather information overload. When the publishers asked me to assure them the third party case studies were based on publicly available information, rather than raiding any in-house files, I found this long list of available websites a compelling argument. Finally, aware that not everyone shares the Anglo-Saxon love of acronyms or even my own use of English, I add a short glossary as the second appendix.

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1 Introduction: what is structured trade and commodity finance?

It is customary in books of this nature to set out from the beginning what we mean by the title. Before we can consider what can go wrong in structured trade and commodity finance (STCF), we have to identify what it looks like when it is going right (and there still remain a remarkable number of people in positions of influence who seem to have inordinate difficulty telling the two states apart).

WHAT IT ISN'T

So, to begin with it might be easier to say what we do not mean by STCF. We do not mean forfaiting, which is a very substantial market and topic in its own right, although this usage for 'structured trade finance' appears to have become relatively common in a number of banks and particularly in the New York market. Forfaiting structured trade financiers do structure deals, but generally for distribution rather than for credit enhancement. Both distribution and credit enhancement may be legitimate aims for STCF, but the forfaiter in his purest form endeavours to reduce the transaction to paper, effectively some variety of Promissory (Prom) Note, to evidence the debt, so that he can sell it. This is perfectly laudable, but works best when there are plenty of investors who understand the risks of that particular piece of paper. When investors are scarce, we need to go a step further and into credit enhancement and risk mitigation. Forfaiters may argue that they can also do this and that they can actually 'forfait' pretty much anything, not just Prom Notes. There are certainly areas of overlap. The point remains, however, that the bulk of the forfaiting market consists of trading mainly cross-border trade-related Prom Notes, representing risks for which there is ready investor appetite. I do not intend to cover that here.

Also until relatively recently, in fact before the 1997–9 Emerging Markets crisis, I would have excluded export credit agencies (ECAs) completely from STCF. Again, ECA-backed deals as 'structured trade finance' is primarily an American usage of the nomenclature, but one that is gaining considerable ground in Europe. ECAs are of course the agencies or nominees of OECD (Organisation for Economic Co-operation and Development) governments whose task it is to make export credit available for their national exporters, with the major risks (political and/or commercial, depending on the nature of the cover) underwritten eventually by the taxpayer of the exporter's country. Every OECD country has one of these, and despite rumours to the contrary promulgated by those who will always see greener grass on the other side of the fence, they all operate on broadly similar lines. At least, variations are legion but the basic theme is the same. Bank specialists in ECA finance in the 1980s used to be seen in the same light as pension fund advisers – worthy but dulled by the very high patience threshold required to see a deal through the labyrinthine process of obtaining and maintaining backing for a transaction from what is essentially a government department, for the years it may take to set the whole thing up.

However, much like – for different reasons – those same pension fund advisers in the 1990s, ECA specialists awoke from 'ugly duckling' status to become true banking swans when the Bank for International Settlements (BIS) sponsored new capital adequacy guidelines (also known as the 'Basle rules' or the 'Cooke rules' after the location or the chairman respectively of the committee that drew them up). Among other things, these gave ECA-backed transactions a zero-weighting for capital adequacy purposes to the extent they were backed by an OECD government. This transformed the lending banks' books of ECA assets from the 'low risk, low reward' category into the new bracket of 'low risk, very high return on very small amount of precious equity', to which all lenders, post-Cooke, aspire. These days the ECAs themselves have come a very long way in terms of their perception of risk and the basis on which they are prepared to offer various sorts of cover, to which theme I shall return later.

Lenders are also organised differently these days, and it is increasingly common for STCF departments to form part of a greater ECA lending and structuring division (greater because, unlike most lending departments, export credit lenders can afford to sustain mighty asset books on the basis that very little capital is required to sustain it, typically only what is required to support the uninsured percentage of any deal). As the practice of ECA-backed lending has developed, we are increasingly faced with the 's*tructured* export finance' deal. ECAs are now openly saying 'we are officially off-cover for XYZ country, but if you have a good structure with repayment following a dedicated ring-fenced cashflow coming from XYZ's own exports, then we will consider it'. Where this involves a commodity component, we will consider this. Again, however, the bulk of the ECA-backed export finance market falls into a different category and relies on the OECD exporter having a policy from his respective ECA, who in turn relies on a government, local bank or central bank guarantee from the importing country. Again this is a huge market in its own right, which it is not intended to cover here.

Also excluded in principle here are deals including the multilateral agencies and supranationals (IFC, MIGA, EBRD etc.). While these can end up looking remarkably similar to the average STCF deal, the basic strategy of these institutions is to encourage commercial lenders to make funds available for tenors that normally they would not consider. This naturally leads them more towards Project Finance than STCF, though there are some who would anyway say that, apart from the project financiers' greater willingness to consider local currency revenue flows and startup operations, the only difference between these products in certain industries (e.g. oil) is tenor anyway.

WHAT IT IS

This should leave us with cross-border trade finance in Emerging Markets where the intention is to get repaid by the liquidation of a flow of commodities. At the risk of trying to teach old tricks to experienced readers, I am nevertheless clear that some time needs to be spent here spelling out at least the basics of commodity finance, because there seem to be many strange ideas about what exactly is involved. Frankly it should not be a black art, for the basics are indeed basic. Nevertheless, I must argue that only highly paid specialists are competent enough to know the pitfalls and how to avoid them, and banks and others should be encouraged to pay well for access to this sort of expertise.

COMMODITIES

'Commodities' are the basic generic goods underlying world trade. These are the raw materials used in every country, whose basic specification over the last 150 years has become standardised largely by the workings of a number of commodity exchanges and trade associations, notably in Chicago, London, New York, Paris and (at least for cotton) Liverpool. The commodity exchanges have so standardised the basic contract for some commodities that goods produced in Cuba or Thailand, Russia or the USA can be contractually interchangeable. Oil remains the leading traded commodity, in several senses. Its paramount strategic importance and consequent sheer value dominates any statistical review of the commodity markets, and the oil contracts traded on futures exchanges worldwide are extremely liquid. Hard commodities such as base metals and steel underpin any sort of industry. The London Metal Exchange (LME) was founded in 1877 as the London Metal Market and Exchange Company, and still provides the reference price for 80% of the world's non-ferrous metals trading. Steel, perhaps remarkably, is not exchange-traded, though recently there have been several attempts to launch internet steel exchanges. The weakness of this $200 billion per year market remains the chronically fragmented technical specification of the product and the word 'steel' covers a wide spectrum of metals. 'Soft' commodities, on the other hand, are typically the crop-based commodities like sugar (produced and consumed in every country), coffee, cocoa, grains and cotton. Even today, 65% of all clothes made in the world are cotton-based, while coffee, sugar and cocoa production are the largest employers in the Third World. Stop commodity production and the majority of humanity would be out of work.

Commodities has been something of a dirty word on both sides of the Atlantic in recent decades. Like any other banking/finance market, the commodities markets have had their share of rogues and disasters over the years, and the STCF product like any other must be practised with a certain amount of care. The history of what can go wrong, to which we will eventually come, is littered with people who thought they knew what they were doing.

Many bankers associate commodities with high-risk volatile markets, fraud and losing money. This is rather disingenuous considering that most banks have demonstrated very effectively over recent years that they have absolutely no requirement to be involved in commodities in order to get exposure to high-risk volatile markets, rogue traders, fraud and/or the possibility of losing money.

Sadly, this bad name is not confined to the banking community. The environmental lobby, the 'stop globalisation' campaign and large parts of the political left wing have often associated 'commodities' with exploitation of the Third World. This is sad because the history of the first forty years of post-Second World War cross-border finance was a long catalogue of deals under the broad heading of 'sovereign lending' by which banks threw money at Emerging Market governments, very little of which actually went into anything useful, and most of which went to enrich small ruling elites in those countries. Bankers are now asked to write all this off (perhaps wise, and largely already done) but then give new money to new Emerging Market governments (less wise and rather understandably less popular with lenders) without any sort of collateral, or indeed any tangible improvement on what happened first time round. The 'green' view is also perverse in the sense that with a lot of prefinancing structures, not only are they a lifeline to people in countries otherwise without credit access, but also they may at least ensure that the funds go to someone actually making/growing/mining or refining something, rather than to build some spectacular new outhouse for the presidential palace.

To demonstrate political balance, I should also comment that most of the First World's right wing, together with much of the sophisticated business elite of the modern era, seem altogether to have forgotten what commodities are, and many assume, mistakenly, that they just aren't important any more. In the year of writing, I have been asked by a very senior colleague in the USA why we wanted to use sugar as basis for a financial structure as opposed to say, pepper or indeed washing machines. I have also been asked what we are going to do when the internet consigns commodity trading to the historical dustbin. The consequence is that I also feel bound to justify the role of commodities in the third millennium. Of course, there has been some help in this with recent events. The New Economy first began to falter when the latest dotcom millionaires were replaced on the front page of the *Financial Times* in Spring 2000 by the Western world's old bogeyman, oil producers' organisation OPEC, as the price of crude oil surged to over $30 per barrel, three times the level of just 18 months previously. Some months later the whole of the UK was brought to a standstill, with supermarket shelves empty and schools and factories closed, after just one week's blockade by protesters at the UK oil refineries. It was dramatic proof, if proof were needed, that we still rely on basic commodities – oil for our machines, sugar and grain for our food, metals for our industry and cotton for our clothes – to get through our daily lives, whether we live in London or Lagos.

STRUCTURES

So much for commodities. Where does this leave structures? The Emerging Markets crisis of 1997–9 should have been a boom period for structured trade and commodity finance. In 1996, margins for cross-border risk were on the floor. Mexico in Latin America and the Czech Republic in emerging Europe were leading the way, penetrating OECD membership and achieving new lows for their country-risk pricing in the immediate afterglow of the newly awarded 20% BIS capital weighting (which applies to loans made to OECD banks). This immediately divided Czech and Mexican bank risk pricing by a factor of not quite five (some are always more equal – or equally weighted – than others, even now). I remember sitting at a meeting at a major Spanish bank in Madrid towards the end of 1996 at which we were all asked what we would need to meet our budgets the following year. Colleagues from Europe, the US and Latin America discussed personnel, resources and management organisation. I said what I really needed was a war, preferably in Latin America, to push prices back up. Something like the Falklands War would have been ideal – too small to be a real risk, but with the latent threat of a wider impact. A joke in questionable taste perhaps, though worth it just to correct my colleagues' insistence on referring to 'Las Malvinas'. What we in fact got in 1997 was, from the point of view of the STCF specialist, even better.

The 1997 market meltdown in South Korea and Thailand led to a mass reassessment by lenders and financiers of risk margins, country lines and credit access. This should have been precisely the moment at which lenders took more collateral, beefed up the structures against which they were lending and reined in the tenors of deals. Instead Russia, the 'last Emerging Market' as one analyst at Goldman Sachs used to put it, continued on for another 12 months before the penny finally dropped, or the axe finally fell, depending on your point of view. Certainly there were plenty of 'structured' deals in 1997 and 1998, but increasingly there was the nagging perception that the structures were somehow incomplete. It was rather like the defences of Singapore in 1941, likened by Churchill to a 'battleship without a bottom' for having formidable redoubts but rather unhappily no guns actually facing the direction from which the final assault eventually came. Russian oil major Yukos came to the market in early 1998 with an oil-backed deal that pushed the tenor out and the pricing down just as country limits at lending banks were awash with the latest offering from the biggest and cheapest Russian borrower of them all, Gazprom. Yukos was described by an investment banker at Santander (now the Spanish banking group BSCH) in glowing terms: 'if they were in Argentina, they would be YPF . . .' But the point was that they weren't in Argentina and they certainly weren't YPF (the former state-owned Argentine oil company).

After the Russian crisis broke, lenders found they almost could not give away Russian assets, and the five-year Yukos deal in particular was stigmatised as a deal too far. It was not alone. BP's famous equity commitment to another Russian oil major, Sidanko, accompanied by another longer-tenored oil-backed loan structure, also appeared to be heading for tears and provoked furious wailing and gnashing of teeth among lenders in the months after the Russian crisis, as their credit departments demanded immediate provisioning write-downs or even write-offs. Brazil, the last domino in the Emerging Markets at least to wobble if not actually fall, also saw its share of problem deals, and again there has been disagreement on whether the structures were any help. Lenders to Olvepar and Graincoop may be forgiven for taking a somewhat jaundiced view of the relative merits of the classic Brazilian pre-*pagiemento* structure (see Chapter 4), but the plain fact is that if you don't do it properly, it won't work anyway.

In many banks, the knee-jerk reaction to the Russian crisis was to freeze or simply close down country lines across all Emerging Markets, if indeed they hadn't already done this. In the absence of differentiation between structured deals and any other type of lending, this was throwing out the baby with the bathwater, because it prevented specialists in many of the 'part-time' banks that displayed occasional enthusiasm for structured trade from practising their craft at precisely the moment when it was most valuable, as pricing was at its peak, and those few remaining active lenders could get pretty much whatever they wanted in their structures. Not everyone was paralysed, of course, and some banks and trading houses, perhaps admittedly making a virtue of necessity, not only went on to recoup all their 1998 provisions on markedly smaller asset books in 1999, but also by so doing created a loyalty among the borrower base which has at least survived the first attempts in the new millennium of the investment bankers and part-timers to return to Russia in particular.

Unfortunately, not all the lessons of the Emerging Market crises seem to have been interpreted the same way. Most frustrating is to be told that the structures didn't work any better than unsecured deals, and this idea has hindered the deployment of STCF as a product in many banks and lending parties just when it should have been most appropriate. The problem, of course, is that things can always go wrong with anything, and there is always more to learn. One of the greatest risks for lenders in STCF is to do a few deals, make some good money and then believe that because a deal is 'structured' it has acquired some mystical cloak of invincibility, and that therefore all the STCF team members can now walk on water. It hasn't and they can't. It's a bit like parachute jumping. The first few jumps won't kill you, because you will be exquisitely careful. The 10,000th jump won't kill you, because by then you will have seen pretty much everything and will have the experience and know-how to cope. But in between lies a danger zone where confidence may easily outstrip experience. In a bank or indeed most financing parties, there is the added complication that your jump generally has to be approved and may be supervised by other people who may know less about parachuting than they know about underwater helicopter escape. The task now is to look again at these 'problem' deals and try to establish what the pros and cons of the various structural components are, what they actually protect against and how much use these are in a crisis.

There is good news, of course. Most notable is the recognition from the ECAs that deals with 'difficult' countries, where repayment is guaranteed by a dedicated revenue stream derived from that 'difficult' country's reciprocal export of hard currency-generating commodities, are much more likely to get repaid than the traditional ECA method, which relies on a piece of paper from the probably equally 'difficult' foreign government promising eventually to give the money back when and if it can afford it. This might seem obvious to practitioners of structured trade and commodity finance, but the plain fact is that there still exist, in substantial numbers and right up to the top of the hierarchy in many institutions and enterprises, people who say (and I quote another senior investment banking former colleague) 'why bother with all that commodity stuff when you can get a guarantee?' The simple answer is that the guarantee, even (or, dare we say, especially) from a central bank, may not be worth much, while commodities (subject to certain caveats that themselves we can mitigate, and provided we have perfected our security interest) generally are.

The other good news is that for the vast majority of structured deals throughout the various crises, the structures worked. Or, at least, the deals paid out in full, which may not be quite the same thing. Proving that it was the structure that led to the right result can sometimes be rather like proving that something hasn't happened. If you get repaid on a Cuban countertrade, is it because the structure has worked? Or is it because the Cubans have decided it was your turn to get repaid? Again the sceptics can be harsh in their assessment, but if we compare the track record of Cuban countertrades to the track record of deals relying solely on, say, local bank instruments, clearly there is some advantage in having the structure. Similarly in Russia, lenders in the prefinance market had a much better experience than lenders to either Russian banks or the Russian government. *Investors* as opposed to lenders, as the Yukos story will show, may have seen things differently, but in that particular case there was a failing in the structure that meant that what would work for a bank lender did not suit the capital markets investors. The more developed markets in Latin America present additional difficulties in the commercial exposures that lie beneath the surface, and these are every bit as dangerous as the more visible political rocks above. Nevertheless, it was and is also possible to be a lender in Brazil and survive. Personally, I was able to come through the whole period 1997–9 without loss on any structured deals. Agreed, one should never refute Napoleon's dictum that 'it is insufficient for my generals to be good, they have to be lucky as well . . .', but if we accept that the structures performed well, over the crisis period, and at the present distance from this episode we have seen further satisfactory resolution of some of the erstwhile failures, we should then ask why one deal succeeds and another not.

Africa is a notable absentee from the case studies presented here. This is largely because the African participants seen most commonly in the market – Cocobod, Sonangol, ZCCM and so on – have established such good track records that they survived the whole period almost entirely unscathed, even in terms of pricing. There may be the odd Ugandan coffee prefinance that ran into difficulty, but if so, the banking participants must have kept it very quiet because it is certainly not common knowledge, and has not 'queered the pitch' on the structured market in the way that Yukos, Sidanko, Olvepar and Solo did. The traditional commodity financiers' art of collateral inspection and management is alive and well in Africa, through such companies as ACE, SGS, Cotecna and the various independent international warehouse companies (Cornelder and so on). This is not to say that these companies are not seen in Latin America or elsewhere, but it does seem to be the case that market participants (growers, local buying agents, exporters and traders) accept as normal a more rigorous standard in Africa, which ironically makes this least developed continent one of the safer markets for STCF: you are much more likely to get a copper-bottomed all-embracing structure in Africa than in Latin America, because everyone accepts it.

This is not to say that the annual Cocobod prefinancing is a heavy-duty structure, but then Cocobod has a track record on prefinance that Yukos would die for, and a margin of 35 basis points post-crisis says a lot about the lenders' perception of the risk. Equally, I would not pretend that Africa is the safest place on the planet either, and one may wonder how those who prefinance Zimbabwe tobacco are currently getting on. When I worked for a French trading group in the 1980s, it tended to send people down to Nigeria, on their own, for trips as part of their commercial education, at a time when the first test was to get out of the airport at Lagos. When I came to fill in my expenses, there was a column on the 'expenses claim form' for 'hotels', another for 'taxis', another for 'food and entertainment', and a final one for 'bribes'. French may be the language of diplomacy but *the* French can be brutally frank. Just to avoid leaving Africa out altogether I have included the odd cautionary African tale in the roundup 'Other cautionary tales' in Chapter 5, but these are sadly dated now and there was insufficient information to justify the term 'case study'.

The aim of this work then is to look at the theories and practice of STCF, examine some of the more prominent examples of deals that were deemed either at the time or subsequently to have been 'disappointments', look closely at what can go wrong and suggest what might be done, or at least considered, in the hope that the mistakes of history will not be repeated. In the final analysis, we would not be pursuing the STCF product if we didn't think it worked. There are, however, many sceptics, who point to the deals that have gone obviously or at least superficially wrong; and, on the other hand, there are some newer converts who have yet to undergo the salutary experience of having something go wrong, who might perhaps be said to believe rather too much in the structures. To all of these people, we have to say that STCF is rather like double glazing: anything with two sheets of glass can be called 'double glazing', but it will only work well if it is a quality construction that has been properly installed, and you've covered all the windows. Even then, it will require constant maintenance.

2 Impact of different lending rationales on the prospects of repayment

Banking is not a homogeneous world. Anybody who has spent time in any sort of bank will recognise that there are a multitude of varieties of banker, and each variety will carry with it its own lending rationale and theory of credit analysis. In these days of the primacy of investment banking, we should also perhaps consider the rationale of 'not lending', since increasingly the biggest banks are trying to move away from being seen as lenders in their own right, and prefer to be known as arrangers of financing, who will only invest their own capital as a bridge to raising third party finance from one or other of the capital markets. However, by setting our parameters on the 'Prospects of Repayment', we can at least focus on the narrow criteria of whether the lenders/risk takers are going to get repaid, rather than whether it was a 'good deal' for other purposes. To have mitigated the risk merely by having sold the entire deal to someone else should not really count as a 'structured' deal. Having said all that, if we look at the makeup of the typical bank credit committee, we would normally expect to see bankers from one or more of a fairly limited number of approaches to the lending rationale and thus to bank credit analysis. In this chapter we will consider the four main approaches and their impact on the prospect of repayment. These approaches are:

- Balance-sheet lending
- Cashflow lending
- Asset-backed lending
- Credit-enhanced lending

This should lead us to certain conclusions about what sort of approach or combination of approaches ought to be taken in the context of Emerging Markets borrowers if we intend to get repaid.

BALANCE-SHEET LENDING

How does it work?

The majority of commercial bankers and a fair proportion of all varieties of banker will have been trained in balance-sheet lending. This is the school of credit analysis perfected by Chase in its eponymous (but now independent) credit course, which looks at the relationship between the various components of the balance sheet (as prepared originally under the US accounting standard), to decide to what extent the borrower can sustain his debt burden. It is not the purpose of this book to go into detail on balance-sheet credit analysis, but we need to understand the basics.

First, we have to be clear that this approach depends heavily on the existence of a recognisable accounting standard that is based on the principles of disclosure of corporate information for the benefit of third parties who might want to invest in, lend to or trade with the company in question, enforced by a strong and independent professional body of auditing accountants. Even in the developed world, this seemingly obvious statement can lead to certain challenges. It was only in relatively recent corporate memory that the German accounting standard got anywhere near approaching what the Anglo-Saxons (Britain and the US) had taken for granted for some years. Successive German blue chip companies listed on the New York Stock Exchange (noting that even now, some of the largest German banks are not as yet listed) displayed remarkable discrepancies between profits in Germany and losses according to US GAAP. In large part this was a result of the German use of ‘hidden reserves’, which may be equal to or even greater than the whole market capitalisation of the enterprise, being used to ‘smooth’ the presentation of annual results in the interests of the long-term view. German companies have also (until recent proposed tax changes) faced effective tax penalties for liquidating equity investments, with the result that there has been little incentive to break up the post-war network of cross-shareholdings. Even in the 1990s a German colleague could explain to me that the Anglo-Saxons needed more disclosure because the stock exchange investors (I think ‘gamblers’ was the actual term he used) were just not involved in the companies on whose performance they were ‘betting’. Conversely, a German who invested in a company would typically do so through his bank, whose own position along with the accumulated shareholdings held in trust on behalf of clients would guarantee a place on the company's Supervisory Board. Therefore lenders and investors did not need to see a detailed annual report on the Anglo-Saxon pattern, because they already knew how the company was doing, while those wishing to trade with the company could do so safe in the knowledge that if the company got into real difficulties, it would be bailed out by its bankers.

This approach has only really been modified in recent years as the largest German corporates have outgrown the capital resources available to them domestically and have sought international investment, which has necessarily led them to adopt US GAAP. One might be tempted to remark that if that is the position in Germany, where does this leave us in Brazil or Russia? Even in the Anglo-Saxon corporate environment, the world is full of deals which passed balance-sheet analysis only for the company later to collapse into bankruptcy. This is not unique to Emerging Markets, and this is not even unique to balance-sheet analysis (nor indeed any other school of analysis), but the plain fact is that balance sheets are historical documents rather than exact forecasts of what will happen in future, and in any case just because the auditor accepted a number doesn't mean that the number was correct in the first place.

If we accept, however, the idea that the balance sheet, for all its faults as a tool, nevertheless offers a still useful insight into the operations and condition of the borrower, we then need to look at its components. With apologies to the entire accounting profession, Fig. 2.1 presents a simplified typical balance sheet layout.

At the risk of oversimplifying the multi-billion-dollar accounting industry, the fundamental principle of balance-sheet accounting is that the shareholders' own funds, along with everything they can borrow or take credit from (in the sense of deferring payment for things), that is, the total 'liabilities', sustain the cost of all of the assets of the company, whether these be the fixed assets in the sense of buildings and mines and fixed plant, or the current assets in the sense of inventory and receivables and cash in the bank. Any accountant can tell us it gets a lot more complicated than this, but the aim here is to break the theory down to basics. The general principle of balance-sheet *lending* is then to look at the relationships between certain key components of the balance sheet, to judge whether the balance sheet can sustain current or intended levels of debt. In particular, attention is paid to the relationship between the shareholders' own funds, mainly the equity and reserves/retained profits (the 'net worth' of the company) and its other liabilities, notably the current year portion of all debt. There are a number of popular ratios used by banks. The Quick Ratio, the Gearing and Leverage Ratios, and the Liquidity Ratio all commonly appear in bank credit analysis; for a good explanation, the

Assets	**Liabilities**
Current	*Current*
Cash Debtors Inventory Work in progress Raw materials	Creditors Tax Bank debt – *short-term* – *current portion long-term debt* – *long-term debt*
Fixed assets	Subordinated debt Reserves Equity

Figure 2.1 The balance sheet.

Chase Credit Course is recommended. Overall the Lender would also normally seek to establish that the valuation of the company's assets does not hide some impending iceberg, and that the levels of inventory are not out of proportion to the company's turnover, so that when we move across to the profit and loss (Fig. 2.2), we can see that the company's sales, following on from the full year's operation of the 'Asset Conversion Cycle' (i.e. the conversion from creditor, through raw materials, work in progress, inventory and receivables finally to get cash to pay the creditors again), cover the current year's costs sufficiently well to make a profit at the bottom line.

Sales

Other income

Cost of goods sold
Other operating costs
Interest
Tax
Depreciation
Amortisation
Capital expenditure
Other costs

Bottom line = Profit (hopefully)

Figure 2.2 The profit and loss.

The general idea, then, is that the bottom line should show a profit. Further analysis will strip back these figures to look at cashflow at certain benchmark points, in relation to servicing the debt burden. A commonly sought figure is the EBITDA cover. This looks at 'Earnings Before Interest, Tax, Depreciation and Amortisation' and compares it to (typically) the current debt service requirement.

Monitoring and control of balance-sheet lending then falls to a series of balance sheet-derived Covenants and Undertakings by the Borrower (e.g. Covenants for 'Minimum Net Worth', 'Maximum Total Indebtedness', 'Minimum EBITDA Cover Ratio' and so on) enshrined in the Loan Agreement, monitored through the provision and subsequent analysis of management (typically at best available monthly) and/or audited (typically at best available semi-annually or more usually only annually) financial reports, and by looking at the company's actual performance in repaying its debts.

Of course, it is a gross oversimplification to suggest that balance-sheet lenders only look at the Balance Sheet and Profit and Loss account. Most banks will follow analysis of additional criteria to build an overall picture, broadly as follows:

- *Product/demand/market* – Lenders will look at the basic activity of the company, the future of its market and its ability to sell into that market.
- *Shareholders/management* – Lenders will need to be convinced that both the management and shareholders are trustworthy, competent and have the resources both intellectually and financially to make the business work.
- *Credit access* – The herd instinct is strong among lenders, and most will want comfort that they are not alone in offering credit to the company. Often this is also a big consideration in assessing refinancing risk, if repayment is to be based on the general liquidity of the company. Crucially it is also important in assessing the overall size of the debt burden, and thence the ability of the company to service *all* its debts, and the threat of pejorative action by third party lenders.
- *Profitability* – This is the core of balance-sheet analysis. Lenders will want to see sufficient excess of income to costs at the gross profit level, the operating level, the EBITDA level and typically also on an outright 'net profit' basis. They or the company may choose to make projections of future profitability, but in all cases they will analyse historic profitability and look at trends over time, at least over a three-year period.
- *Cashflow* – Lenders discovered in the 1970s that 'profit' and 'cash' are not necessarily the same thing at all, under any accounting standard, with the result that the Cashflow Statement, that third

plank in the financial reporting of the modern Annual Report, will be the subject of further analysis to determine exactly how much of the ‘profits’ actually make it to cash, and what the timescale is likely to be for the cash available to repay the debt. In terms of the balance-sheet covenants this distinction will typically be caught by the EBITDA cover ratio.

- *Solvency* – This is where the lender will delve deep into the balance-sheet ratios to determine just how much of the asset conversion cycle is cash-generating, and at what point and to what extent the company can rely on its bank debt and its own resources to stay afloat. Here they will apply the Solvency Ratio, Equity Ratio, Liquidity Ratio and so on.

Lenders using this tried-and-tested methodology generally enshrine their credit facility in a ‘loan agreement’ or ‘counter-indemnity’, depending on the circumstances, and see themselves as lending against the whole of the Balance Sheet backed by various Covenants and Undertakings on the part of the Borrower to keep the balance-sheet ratios within certain acceptable parameters. Their repayment strategy is to get to the Balance Sheet first, or at least on equal terms *pari passu* with other creditors, because if they have done their analysis correctly, the Balance Sheet should have sufficient depth to be able to repay at least the lenders and creditors, if not the shareholders. One consequence of this is that balance-sheet lenders tend to move extraordinarily fast once they are convinced that something is wrong at the company, with credit lines immediately withdrawn, credit balances frozen and legal action all taking place more or less immediately.

What doesn’t it cover?

The major failing of this widely practised lending rationale is that it helps us little when the Balance Sheet is bereft of any redeeming virtues (as can be said of many Emerging Market balance sheets). Further it helps us little when the local accounting standard is of the Mickey Mouse variety. As we all know, the balance sheet may also be up to 18 months old, during which time much may come to pass (such as a tripling of the oil price, the halving of the copper price or the rise and fall of several entire governments in Ecuador or Italy). The Balance Sheet offers no protection from indifferent, indolent or even fraudulent accountants or management (as we will see with Solo). The Balance Sheet may yield limited information about the potentially hostile macro-economic or political environment. The absence of an effective civil code renders balance-sheet covenants into so much wishful thinking. *In extremis*, the local civil code may bear no provision at all for the bankruptcy or consequent corporate liquidation of a bad debtor.

The 'Balance-Sheet Lending Rationale' in such circumstances would be to decline the deal. This is not an uncommon occurrence, and indeed there are many circumstances in which the lender should decline to lend, as the safest or indeed the only response. The difficulty with such an approach is that it tends towards lending only to the very best corporates. This initiates a virtuous spiral in the credit department of looking for better and better balance sheets (as most corporate bankers in the Anglo-Saxon recession of the early 1990s will recognise) until the only people to whom the credit department will allow you to lend money are precisely those who don't even want it, much less need it. It may also be fair to say that before this extreme is reached most modern banks find the relatively modest returns of straight lending to good-quality OECD-based borrowers distinctly unappealing unless they can be presented as the cost of entry to some more profitable line of business. However, if the Balance Sheet is insufficient then the typical response, if the Lender still wants to lend, is to look for additional security in some form, which leads us to the other schools of analysis.

CASHFLOW LENDING

How does it work?

This is the school of thought that seeks to identify the cashflows of an enterprise (or country) and then to sit astride those cashflows to get repaid before anybody else (and ideally before any other costs as well). The products of the cashflow lending rationale are:

- Prefinance
- Tolling
- Countertrade
- Future flows securitisations.

To explain cashflow lending as a rationale, we can go back to the Balance Sheet (Fig. 2.3). In the classic Emerging Market borrower, we may plausibly assume that on the liability side of the balance sheet the equity, reserves and subordinated debt were all spent years ago. We can probably assume the level of debt and creditors is high. On the asset side, who knows the value of an oil rig in Siberia or a sugar mill up-country in Brazil? Could we realise the value anyway? So we can probably ignore the fixed assets. At the other end of the scale, we can probably also safely assume the company has no actual cash as such, at least not anywhere where a creditor could get sight of it. The raw materials,

Assets	**Liabilities**
Current	*Current*
Cash Debtors Inventory Work in progress Raw materials	Creditors Tax Bank debt – *short-term* – *current portion long-term debt* – *long-term debt*
Fixed assets	Subordinated debt Reserves Equity

Figure 2.3 The balance sheet (cashflow).

work in progress and inventory will typically be still in the wrong country. What remain really attractive, and what this process of elimination leaves us with, are the Debtors, the Receivables due from companies hopefully of superior credit quality to our Borrower, but yet to be paid. In particular we are interested in the Receivables due to be paid outside the 'wrong' country, ideally somewhere safely in the heartlands of the OECD, so that we can not only lend against cashflow but also against an OECD cashflow from a purchaser or 'offtaker' of the borrower's products who may even be a client of ours. This means that when we go across to the Profit and Loss, we are getting paid out of top-line 'Sales' rather than bottom-line 'Profits' – in fact, on a short-term deal, or a deal in a country with no commercial/civil code or no prospect of the parastatal obligor going into bankruptcy (e.g. state oil-producer Sonangol in Angola), then we really do not care whether the Borrower is profitable or not. What we care about then is:

Performance risk: will the Borrower be both able and willing to continue performing so that the Receivables continue to flow? This is the single biggest issue. If the Borrower can perform, then we are a long way towards repayment. History shows us that Emerging Markets producers carry on 'performing', i.e. doing whatever it is that they do, long after the point where on paper it is uneconomic for them to do so. Often the only thing making them 'uneconomic' is that the country in question simply has the wrong foreign exchange rate. Or it may be that their role in supporting the local infrastructure, as the major employer, or in many parts of the world as provider of the local roads, schools, hospitals *et al*. means that the cost base is simply not matched to the expectations of

Western-style accounting (but it doesn't mean that they are more likely to fail – quite the contrary in fact).

Ability to deliver can be established relatively easily by looking at access to recoverable reserves (ideally backed by independent survey) of the commodity in question, the ratio of reserves to production, the ratio of production to exports, and of exports to the export being financed plus other secured financings (contractual headroom), the condition of any processing plant involved (backed by independent technical reports), access to and dependence on logistical resources, and vulnerability to external threats (such as perhaps hurricanes) all cross-referenced to their track record over time. Some producers are able to demonstrate a statistical base going back decades, which allows for some very sophisticated modelling for sensitivity analysis to establish the parameters of catastrophic events. Thus do we care if a sugar producer is in a hurricane zone, subject also to floods, strikes and occasional outbreaks of bubonic plague, if our statistical base shows that he has never fallen below a given level of production and export over the last fifty years?

Willingness, on the other hand, is a rather more subjective affair, but depends essentially on the track record of the commercial counterparties, the quality and reliability of shareholders and management, the importance of the relationship and the contract with the offtaker to the producer, and the alternatives open to the producer as compared with the penalties the offtaker or lenders/investors may inflict on him if he fails to perform.

Structural risk: will the lender be able to ringfence the cashflow sufficiently that no other creditor can break it open and divert the flow? This is also a major item, because so often it will be an omission by the lender/investors, a structural error or an operational failing resulting in erosion of the structure as originally envisaged that brings the deal down. Assignment of the export contract is a good start, since it generally prevents any third parties from attaching that particular cashflow by subsequent court order, and in theory it allows the lender to step into the shoes of the offtaker, to collect the goods and liquidate the assigned contract themselves. Other structural risks depend on the structure in question, as will become apparent in the case studies. Component parts are as described in Chapter 3 below.

Political risk: will the undoubted political risk which exists in Emerging Markets interfere with the execution of the transaction? The cashflow lending rationale generally has the immediate advantage here that pure offshore cashflow effectively bypasses the central bank and thus eliminates transfer risk. It is not generally the case that countries stop their own exports, though it has happened (see

Chapter 6), and they may certainly want to tax exports. They may also want repatriation or at least registration of export proceeds, though a simple way around this is to structure the deal as a pre-*payment* (thus immediately satisfying rules demanding that export proceeds come back into the country) rather than as a pre-*export* finance. These days it also pays to look out for third country political risks, such as actions by the US Government, which seems to feel it has *carte blanche* to legislate against trade between third parties. The central question, however, is not whether the political risks exist, but whether they will interfere with the cashflow. We have to say overall that the STCF market has survived all manner of political risks very well.

Market risk: will the price volatility of the goods coming out of the 'difficult' country undermine the forecast cashflow? This very probable event is generally easily mitigated. Most effective is a commodity price hedge, to provide a floor – although we then have counterparty risk on the hedge provider, this should not be the hardest part of the analysis, especially if the hedge is direct from a recognised and acceptable exchange, though more usually it will be the bank or the offtaker itself providing the hedge. Most common, however, especially on sub-one-year deals, is a combination of a haircut on the Loan to Value Ratio (if goods are worth 100, we lend 80, so LTV ratio is therefore 80% and overcollateralisation is 125%), giving the lenders a cushion against price erosion (in this case, 25%), and an escalation or 'top-up' clause whereby they can call for additional goods to make up any further shortfall in value.

Payment risk: will the offtaker of the goods be able and willing to pay for them if they turn up? Assuming we have an offtaker incorporated in an OECD jurisdiction, here we are back to balance-sheet analysis and track record. The offtaker, however, plays a very important role in the success of the transaction and should be a credit enhancement (see Sidanko below as a case study compared with Graincoop Eximcoop).

Applying these headings to our case studies, we can see that perhaps surprisingly none of them ran into trouble because of political or market risks, although both were clearly aggravating environmental events. Payment risk should be the least of our worries (although, as we will see, opinions are divided as to how payment risk should be covered). Where the deals ran into trouble was on the performance risk and the structural risk (including inadequate implementation of the structure, and unwillingness actually to use the structure on the part of agent banks).

What doesn't it cover?

The big weakness of this type of 'performance risk' school of analysis is that it fails to address insolvency or liquidation of the Borrower, especially where this is precipitated by third party creditors. Particularly in Latin America, local banks for whom the 'mañana principle' applies for 364 days a year (especially if you want something from them) will suddenly move faster than Superman on a business trip when it comes to nailing a company they think is about to fail. The good news is that this only applies where they have the appropriate civil code. No-one is going to make Cubazucar (in Cuba) or Sonangol (in Angola) or even Sonatrach (in Algeria) bankrupt. In between Cuba at one extreme and Brazil at the other lie countries where there *is* a civil code, but no-one, least of all the local courts, really seems to know how it is meant to work (like Russia), and the bankruptcy process is usually part of the politics between creditors and obligors (and other interested parties).

The analysis also may not cover adequately the unwillingness of the borrower to perform: it is one thing to prove that Cubazucar produces, even in a bad year, a lot of sugar; it is quite another to prove that it will deliver any of that sugar to the offtaker specified by the lender. Similarly, it helps little when that unwillingness is born of fraud (see Solo).

Finally, this analysis may not cover the priority usually enjoyed in most countries by the taxman. Coming myself from a country where we take a fatalistic approach to the inescapability of taxes, I would say the best that can probably be done about this is to quantify before drawdown what the tax position is, try to get the Borrower to keep his tax affairs up to date, and ensure that the borrower is bound to make good to the Lender any shortfall caused by reason of any tax payment.

ASSET-BACKED LENDING

How does it work?

Again this is one of those delightful terms that means different things to different people. For the purposes of lending or investing in Emerging Markets, we can probably say that the types of trade-related structures to which it applies are:

- Stock finance (in the sense of inventory finance)

- Post-Performance Securitisations (e.g. Securitized Export Notes)
- Any sort of documentary credits secured on the underlying goods.

Potentially there is significant overlap between this and the Cashflow Lending Rationale, but the essential 'add-on' here is that we should have access to physical collateral, the liquidation of which can be seen as an additional means of repayment. The rationale and analysis is therefore as for Cashflow Lending, except that we walk slightly further up the Asset Conversion Cycle to take security over the raw materials, work in progress and (most of all) inventory, either in the producing country or (better) offshore. This is generally deemed to be a lower risk than Cashflow Lending, because if the Lender really controls the collateral, it is obviously easier then to realise the cashflow. Uniquely we may even have defence against fraud, though classically fraudsters are equally adept at convincing lenders they have collateral when this is not in fact the case as they are at any other type of misrepresentation. The key issue here then becomes to what extent the Lender has perfected his title to the goods: does he have a watertight ringfence around his physical collateral? He is still exposed to market risk and to political risk to the extent that he has to get the goods out of the country to realise value, but he should have almost completely eliminated performance risk. The trouble generally comes when small details are glossed over, such as the goods being in the Borrower's warehouse (see the Eximcoop case study), which rather erodes the ringfence. Structural and operational risks therefore remain.

A useful additional note is that the 'true sale' of the underlying goods through a special purpose vehicle (SPV) (such as would be seen in a securitisation) will generally have the effect of taking the debt off-balance sheet for the borrower, which may be useful both in countries where they actually care what their balance sheet looks like, and for quasi-sovereign borrowers for whom it is important not to inflate national debt statistics.

What doesn't it cover?

For lenders, this is not an option for banks without a good back office. To manage collateral properly requires significant back and middle office effort on the part of the lender, since the collateral needs to be not only controlled but monitored for value on a daily basis as well. Notwithstanding the development of the electronic warehouse warrant by the London Metals Exchange (LME) most other forms of documentary title, including warehouse receipts, are only available in hard copy, and again these have to be held or processed physically by the Lender.

Equally important is collateral management in the field. It is one thing to have a piece of paper, but quite another to establish whether that is actually backed by goods on the ground, while quality and transport are also variables and risks in their own right. Banks have a tendency to agree that field collateral management is a good and desirable thing, then to balk at the cost of it if this is going to erode their margin. They know they can get the deal through credit without such a component, and if they have done their job properly on the rest of the analysis then the deal should not go wrong, so the additional cost may be seen to outweigh the marginal benefit. Like any other form of insurance, this looks very expensive right up to the point where you have to claim on it, and then it suddenly seems very worthwhile.

Traders for their part tend to believe that they don't need outside collateral management because they will have their own people on the ground anyway. Perfectly true, but often these are locals with sometimes a closer relationship to the producer than any of us would really want; secondly, they do not have professional liability insurance to cover the event that they say something is somewhere or of a specified quality when it is not; and thirdly, while they are probably eminently commercially minded, in the end they represent the offtaker and not the bank. Without good field collateral management, lenders and investors are as susceptible to documentary fraud as anyone else.

Securitisations as a general point are unsuitable for smaller deals, for which read anything below $50 to $75 million. Any structure that involves a credit rating is also potentially vulnerable to a ratings downgrade. This is unlikely to be an immediate downer for borrowers unless they tap the capital markets for their short-term funding as well, but it is likely to be a major disappointment to investors and to a lesser extent banks.

If the creditor is depending heavily on the collateral for ultimate repayment, it may be that the deal is more vulnerable to market movement in the underlying goods than other structures. The risks may look similar, but the existence of physical collateral should not encourage us to push our boundaries too far, for when the need may arise to call for additional collateral to make up for market movement, this will always be at the precise moment when it is hardest for the marginal producers to provide.

CREDIT-ENHANCED LENDING

How does it work?

Most of the structures considered in the case studies below are based on either a cashflow lending or an asset-backed lending rationale, or a combination of the two, with occasional lip service to the old balance sheet school. This is the classic 'STCF' approach. However, there is another lending rationale, one which has changed significantly in recent years, and which now, as the walls between products and categories break down both within banks and the major trading enterprises, offers considerable scope for combination with the other rationales. It is nothing new, however, and has been around for a long time. The credit-enhanced lending rationale is simple: someone else – themselves a good credit – guarantees all or part of the facility. Typical products are:

- ECA-backed loans
- PRI (Private Political Risk Insurance)
- Credit wraps
- Multilateral umbrellas (IFC 'B's, EBRD 'B's, MIGA, etc.)

Traditionally the analysis was simple: did the underlying deal qualify for ECA support? Would the ECA agree to take the risk? Was there any special interest rate on offer? Would the credit committee wear the residual 10% or so uninsured risk given that if the tenor was long enough, most of this might be covered by earnings ('tenor is our friend', as the ECA specialists say). This is probably a gross simplification of the ECA practitioner's art, but until recently there was a strong perception that few people looked at how the ECA was actually going to get repaid. It simply wasn't their job to look. The ECA typically accepted security of (in the old days) a sovereign guarantee or (more recently) a bank guarantee, and everyone else relied on the ECA. When global lenders in the form of IFC came along, and later the EBRD, things got rather more stringent, and the level of due diligence and scrutiny of the projects they covered was in its own way legendary, but still a major plank of the theory was that Western governments had decided it was 'a good thing' to finance certain other countries, they put money into the supranational lenders, and then these entered into deals on the basis of being 'preferred creditors' by the host governments. The good old days.

Nowadays life is rather tougher for the average ECA, which is facing privatisation, outsourcing, hostile auditing and home governments demanding that it makes money at the same time as requiring it backs exports to every country that has ever defaulted, in support of their own political ends. The ECAs are not stupid and should not be taken for granted. They have a constant and critical watch on the Emerging Markets, and possess huge databases of information on what is going on, which information seems to be exchanged on a regular basis through the Berne Union. One outcome of the various crises, as mentioned above, has been renewed interest from the ECAs in countertrade, and indeed in any transaction where there is a clear concept from the beginning as to how the ECA will get repaid in the event of a claim. At the same time we see the EBRD running classic gold bullion and oil prefinances in post-default Russia, based on a mix of cashflow and asset-backed lending to Russian corporates, where pre-default their main enthusiasm seemed to be for Russian banks. On the whole we should applaud these developments, since to a great extent they vindicate what the STCF specialists have been trying to get across for years – that a good structure is not an absolute guarantee of repayment, but it's an awful lot better than no structure at all. If the ECAs have accepted these arguments (and, to be fair, a number of the ECAs were doing business on this basis a long time before the late 1990s crises), then surely one day the top management of banks may accept them too? Some sign that this is coming may be seen in the merger of structured commodity finance/structured trade and commodity finance teams with the structured export finance teams in a number of banks (notably ING Barings, BSCH and at Deutsche Bank).

The other forms of credit enhancement are perhaps less exciting (at least for bankers) in terms of their potential impact, but also valuable. Political risk insurance (PRI) has come a very long way in recent years, as the old scenery of sovereign borrowers has disappeared and the commercial (as opposed to ECA) underwriters have had to come to terms with the idea of taking more and different types of risk. The particular benefit for banks is that often they can persuade their internal controllers, external auditors and regulators, and even credit rating agencies, that this is a direct set-off against the country line in question. This does not absolve them yet – the insurance industry is lobbying the BIS for a reduction to 20% as per other OECD financial institutions – of the 100% capital weighting for the asset, nor does it absolve them from the counterparty risk, but given that country lines for all banks are habitually full, any room that can be engineered by getting another counterparty of good standing to take the country risk has to be a welcome development. This is not a universally accepted treatment by banks, not least because of the potential mismatch between the bank's funded liabilities and the distinctly circumscribed nature of some of the (typically unfunded) insurance policies, but I have to say that the insurance policies are much better than they used to be (from a lender's perspective), and it works, as far as I can tell, for most of the major European banks. As with the ECAs, the insurers like to see a good structure, which helps mitigate the risk they take, and so again the credit enhancement is no longer a replacement for having a good underlying structure, but rather an enhancement that is conditional on the structure.

Insurers will also take credit risk, though this is eschewed by some banks as an invasion of their turf (the suggestion that any of us has 'turf' these days is looking increasingly optimistic, better perhaps to learn how to blend the products of the various disciplines to bake a better – and bigger – cake). However, the 'credit wrap', product of the US monoline insurers for many years, has some particular applications. The monoline insurer makes his money by guaranteeing someone else's risk. They do this because typically they have examined the structure of the credit and satisfied themselves that failure is at least unlikely. Their methodology is not dissimilar to that of the (also US) credit rating agencies, with a focus on the Debt Service Coverage Ratio, overcollateralisation, legal structures and multiple risk mitigants. Where the monolines particularly score over the agencies, though, is that they take the risk themselves and guarantee it to the lender/investor, i.e. they 'credit wrap' the deal. This makes this product very suitable for any structure aimed at distribution into the US capital markets, because the credit wrap provided by the monoline should confer on to the debt instrument issued by the underlying obligor (typically an SPV) the benefit of the monoline's own credit rating, which will not normally be less than AA.

Other advantages of credit enhancements to note: as we've said above, ECA-backed tranches of loans are zero-weighted for BIS capital adequacy purposes. Participation by banks in IFC and EBRD 'B' loans also generally confers exemption from mandatory country risk provisioning in most OECD jurisdictions.

What doesn't it cover?

For most ECAs it doesn't cover 100%. Of course, this is not true across the board, but it is generally the case that both public and private insurers will expect the insured to take at least 10% of the risk. That said, we have recently obtained 100% PRI cover in Argentina and Russia from private insurers, and ECGD has historically been fairly generous in its levels of cover (whatever UK exporters may think). There will generally be 'exclusions' from any insurance policy, often, at least in the first draft, listing absolutely anything that is likely actually to happen. There may be other restrictions – notably for ECAs, the requirement for the deal to comprise an export of goods mainly made in the ECA's home country. There is increasing flexibility being shown here, but eventually one must recognise a certain amount of national interest in the *raison d'être* of the ECA. More often than not, ECA/PRI cover will specifically not cover bankruptcy or commercial risks. Credit wraps are generally more or less unconditional, but then they are much harder to obtain in the first place.

SUMMARY

The purpose of this chapter has been to endeavour to explain where we are coming from in the typical structures used by STCF in Emerging Markets. Clearly, the traditional balance sheet school of analysis as used by Western banks in their OECD homelands is inadequate to the task of allowing lenders and investors to assess whether a proposal in the Emerging Markets is a 'good deal' or not. We should resist, however, the temptation to defenestrate it completely. Balance Sheets remain the major form of financial reporting across the planet, and the Balance Sheet will always tell you something, even if it is only to suggest places to look for more information. Personally, I feel the single most useful thing the Balance Sheet will normally tell us is the level of third party creditors in general and debt in particular. Obviously, as we have said, an update on this information will be required, but a borrower who is already heavily indebted in proportion to his resources is not a good starting point for any structure unless the intention is to refinance all the existing creditors. So, don't ignore the Balance Sheet, but it is probably safe to assume the worst.

Cashflow and Asset-Backed Lending Rationales, on the other hand, are the backbone of the STCF market. Actual individual structures may be stronger or weaker, but this is the basic rationale behind them, that Emerging Market *performance* risk is better than Emerging Market *payment* risk, therefore we should target the performance risk deals. To do this we must take a robust attitude to securing performance. We do this by ringfencing the current assets, as the only worthwhile part of the balance sheet, from the liabilities (especially the third party creditors) by perfecting title to and control over the Receivables, the sales contracts, and ideally to the Inventory as well. Everything has to be controlled and monitored, both at the Agent bank and in the field, and while on the subject of fields, we should say that due diligence is never wasted.

The concept of someone else taking the risk in the transaction is always an attractive one (perhaps depending on price). In the end, however, we have to recognise that the providers of third party credit enhancements, the ECAs, the private insurance market, and to a lesser extent the multilateral lenders, were already moving away from unstructured risks pre-crisis, and no-one wants to be a stuffee. Third party credit enhancement is not a substitute for a good structure. They may yet be *components* of a good structure, and in the end, the sensible approach is perhaps to borrow and blend the principal aspects of each of the above.

3 Typical structures

This is not an attempt to carve in stone the 'true' nature of structured trade and commodity finance deals. The absolute purpose of the structure is to mitigate risk while allowing access to higher reward. To do this *in a changing environment* the principal requirement for the designer of the structure has to be flexibility.

However, that said, experience also counts for a great deal, and common sense alone can demonstrate that there are certain key components that by their nature give the 'structured' deal a superior risk profile to the plain vanilla deal. Offshore cashflow alone strips out a major component of country risk by eliminating any exposure to the solvency (or lack of it) level of the central bank of the 'difficult country'. This has to be better than just lending the money out unsecured. Yet often the RAROC/RORAC treatment employed by banks does not differentiate between these two methods of lending, and banks' credit analysis is too often geared towards capital markets, correspondent banking or corporate banking.

In fairness to the average bank's credit department, it must be said that structured transactions represent a tiny fraction of most banks' asset base and consequently they have not necessarily been able to justify a specific treatment. However, if the aim of RAROC/RORAC is to adjust the measure of return on capital to reflect real risk, then the model should also be adjusted to reflect the impact of risk mitigation, and too often this is lacking. The end result, as seen in Russia, is that banks then go on to allocate resources and capital to products on the basis of a flawed model. RAROC results on GKO investments in Russia were very good, but this doesn't help if you still end up losing your principal.

This section presents a review of the main types of structures encountered in commodity-backed deals (see Fig. 3.1). There are many variations on these themes, but some of the better-trodden paths – prefinance, tolling, countertrade, stock/inventory finance and securitisation – are discussed here, at the end of which attention is drawn to some of the similarities and recurring components.

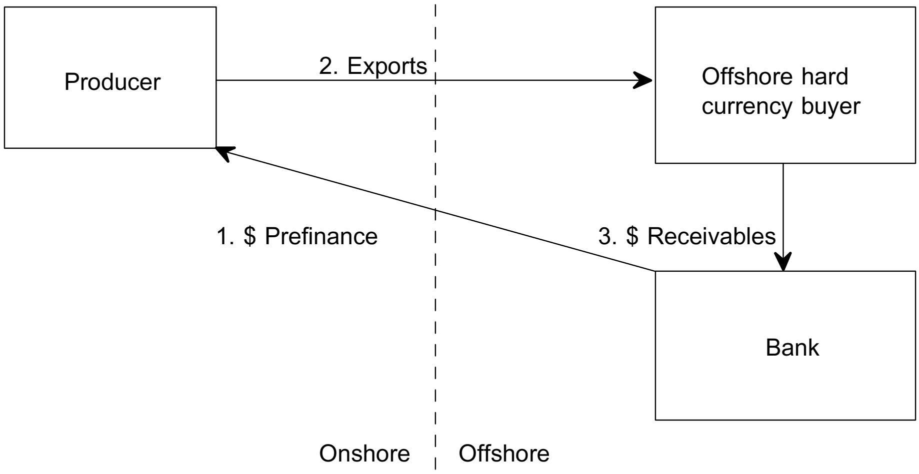

Figure 3.1 Prefinance outline.

PREFINANCE

Variations are so legion that the outline offered is generic only. As a subdivision, 'prepayment' finance means our borrower is the offtaker, 'pre-export' finance means our borrower is the exporter. Risks analysis is essentially the same, but in a very difficult environment prepayment may be preferred as clearly a 'trade advance' from a buyer, rather than pre-export, which has a slightly greater chance of showing up in a moratorium as a 'loan'. The key elements are a performance risk 'onshore' the 'difficult' country, and payment risk 'offshore':

- There are many variations on this theme.
- The structure is driven by having the performance risk onshore (in the difficult country) and the hard currency payment risk offshore, ideally from a good-quality source known to the financing party paying direct into an offshore Collection Account at the Bank.
- The Bank may in fact be two banks, one offshore and one onshore.
- There is substantial refinance market for this type of structure in London and other European financial centres (with third party banks).

TOLLING

Definition

Tolling finance is a credit facility dedicated to financing a very specific spectrum of the asset conversion cycle. It pays for raw materials, is available to the supplier of the raw materials, the refiner itself or the buyer, and is secured on the export receivables generated from the delivery of the refined products thus made possible to the end-buyer (who may or may not be the same entity as the initial supplier).

This is essentially the same as prefinance except that the bank or financing party controls the purpose for which the cash advanced is spent. In some senses this provides a tighter risk profile than straight prefinance for this reason (funds from many prefinancings are commonly syphoned off for reasons totally unrelated to production, such as tax).

However, by definition the performance risk is on the company's ability to process raw materials, inferring a level of technical ability and infrastructure rather above simple mining/agriculture. The bank or financing party therefore will at least need a detailed independent technical report on the company's ability to perform the relevant process, paying particular attention to the likely capacity and remaining life of the plant.

Outline

Figure 3.2 was drawn up for the tolling finance of Peruvian zinc, smelted locally by a refiner unrelated to the mine. It could equally apply to the delivery of crude oil to a refinery for onward-sale of refined oil products onshore (thus incurring local country risk) if the payment risk is deemed acceptable (e.g. covered by a Letter of Credit (L/C) from an acceptable third party bank). Note that:

- Finance may be for supplier, end-user or refinery.
- Tolling entails enhanced control for the bank over use of funds, but means the Bank is effectively financing the refining margin.
- Locks in finance to asset conversion.

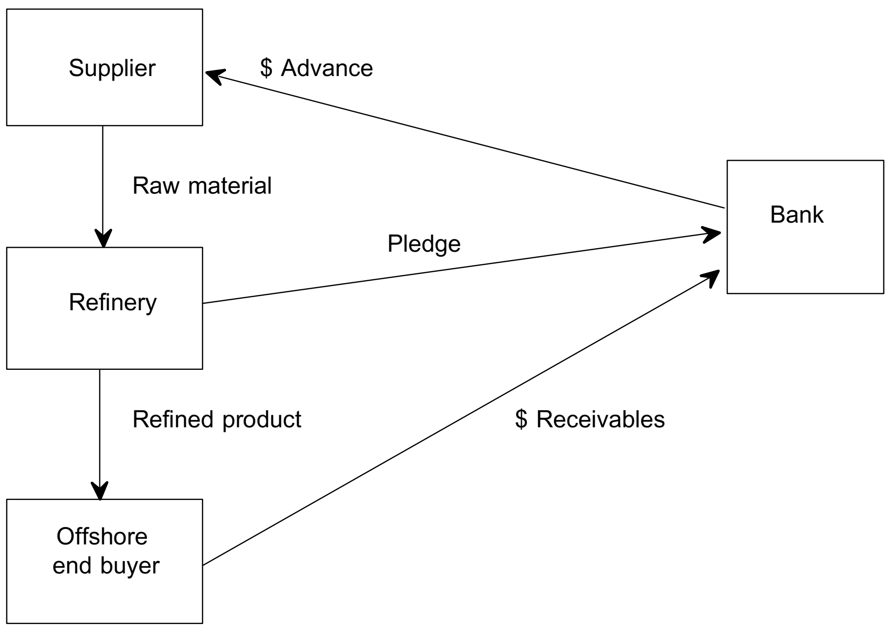

Figure 3.2 Tolling finance.

- End-user and supplier may be the same entity (e.g. Western oil company supplies crude to a West African refinery and takes oil products in payment).
- Essential to assess in detail the technical capacity and outlook for the refinery.

COUNTERTRADE

Definitions

'Countertrade' here is used to cover any structure involving the exchange of goods by way of payment (whether for credit or political constraints) in which the bank or financing party is required to provide finance, either with limited recourse or totally without recourse, between the delivery of goods on one side, and repayment from delivery of goods or from export receivables on the other side.

It is not intended here to examine whether a particular deal should more properly be called an 'offset' than a 'counterpurchase' because these are essentially just variations on the countertrade theme, usually driven by some political requirement for foreign suppliers to buy goods locally to a similar value as they themselves sell.

'Barter' is generally used to denote transactions in which there is no intermediary conversion into cash: a straight swap of one commodity for another.

Again the overall basic risk profile is essentially the same as for prefinance. However there are additional concerns:

- *Structural risk*: in particular, attention has to be paid to the linkage between the various counterparties, especially locally: a breakdown in the linkage between importer and exporter in the 'difficult' country can leave the bank or financing party high and dry. Best is where importer and exporter are either group-related entities (or the same entity) or both state-owned, in which case agreement should be sought from the highest level overseeing both enterprises (agreement with the minister of industry responsible for the import may not help you if you need the minister of agriculture to authorise your export of sugar and the minister of finance to agree to offshore repayment from export proceeds, and it would not be a novelty to discover that such ministers may be colleagues but not friends).
- *Nature of assets*: care should be taken in identifying the assets/goods on offer, since particularly where the local importer and the local exporter are unrelated, or the counterpurchase/offset is driven by a governmental programme for export encouragement, the quality and fungability of goods delivered to redeem the finance may be suspect. The potential for commercial dispute wrecking the frame agreement increases in direct proportion to the number of entities involved in the transaction. Equally there can be additional risks in excluding any interested party from the transaction.
- *Market risk*: depending on how the deal is structured, there is potential exposure to market risk on the price of two commodities instead of just one. The simple way around this is to denominate the facility by value rather than volume (i.e. $ rather than metric tons) for the role of the obligor (whichever counterparty that is) in the deal (e.g. an oil supplier to Cuba getting paid by export receivables from Cuban deliveries of sugar will have a countertrade facility that allows for the delivery of oil up to a pre-specified amount). Subsequent increases in the price of oil merely reduce the volume of oil the supplier can deliver under the facility. Otherwise market risk is as per normal prefinance (i.e. the bank or financing party is only concerned with potential fall in price and hence the value of the commodity stream that is dedicated to his repayment).

Outline

The outline given is from a Cuban sugar/oil countertrade.

Payment risk: in this instance, the oil major supplying the oil took the payment risk on the sugar-buying commodity trader (who was of the same nationality). This gave the financing bank an improved risk profile, since it did not then have to analyse the acceptability of the sugar trader. The alternative would have been to require the sugar trader to pay by L/C, if the sugar trader was an unknown credit or insufficiently strong credit for the financing bank.

Linkage: also of note is that the two Cuban entities were both state-controlled. This meant that linkage between the local importer and local exporter was good, as evidenced by the Central Bank guarantee (in itself perhaps not a particularly 'bankable' instrument, but useful to show unity of Cuban Government purpose). The Cubans also made available a ministerial letter of awareness acknowledging the countertrade.

Third party political risk: a complicating factor in this deal was the existence of a US embargo, now exacerbated by the so-called 'Helms–Burton' law. This is a US law that penalises third party countries (e.g. European) for dealing with the Cubans to the extent that they benefit from assets that were nationalised by the Castro government, and title to which asset is now disputed by US citizens (including Cubans who have subsequently become US citizens).

The value to the Bank of having the European oil company as Obligor (albeit on a limited recourse basis) is that the various agreements and contracts with the Cubans are all in the name of the oil company. Moreover the Bank's interest is paid by the oil major. The Bank therefore is as arm's length as possible from Cuba, is not a lender to Cuba and does not benefit from Cuban sugar production except for repayment of principal. It also ensures a lower profile for the Bank. The Bank's access to the security offered by the documentation is entirely by way of assignment (equally valid).

Note: while the validity of such extra-territorial legislation by the USA has been disputed by (*inter alia*) the EU, Canada, Mexico and all of Latin America, clearly the point remains that third party political risks may still impact upon a deal. In this instance the impact was significantly to reduce the appetite of European banks to join in the financing syndicate.

The sequence is shown in Fig. 3.3, the seven stages being:

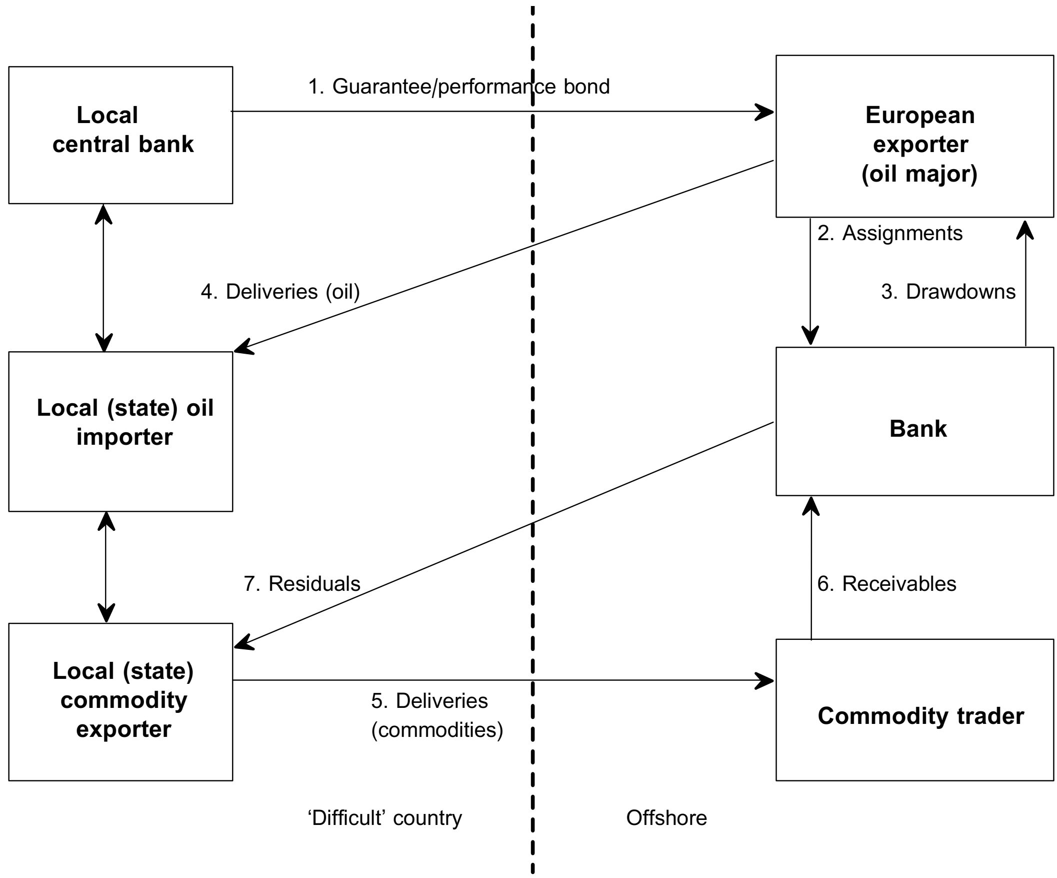

Figure 3.3 Countertrade.

1. Central Bank issues guarantee/performance bond.
2. Oil major assigns all contracts/security to Bank (including rights to benefit if reciprocal commodity contract).
3. Drawdown against oil shipping documents from oil major and oil importer's signed acceptance of the cargoes.
4. Oil delivered.
5. Commodities delivered to Commodity Trader/Offtaker.
6. Receivables flow back from commodity trader to Bank (offshore cashflow).
7. Residual value of commodity receivables after debt service flow back to local exporter.

Note that the transaction is embodied in a general countertrade agreement or quadripartite agreement, and that state ownership provides linkage between local exporter and local importer.

STOCK/INVENTORY FINANCE

Definition

Stock finance is used here to mean the finance of goods in store at some mutually acceptable location. It is assumed that the finance is to be made available only for such period as the goods await on-sale for hard currency. Typically this would mean export unless the goods are already in an acceptable location. The corollary, of course, is that by definition the location of the goods for the time being is onshore in whatever country.

Note that 'stock' here is of course meant in the English sense of 'inventory', rather than the US sense of equities.

The problem for the bank or financing party then is to assess the following:

- Are the goods fungible? (i.e. do they fall into the bank/financing party's preferences established above, to be easily converted to cash?) This is critical if the goods are not presold.
- Are they exportable? (e.g. are the requisite licences, authorisations etc. available?)
- Are they safe where they are? (in theory easily covered by insurance, but you must be sure what this covers, what is excluded, whether the insurance proceeds are payable offshore, who is eligible to make a claim and to whom claims are payable).
- Is there any protection against price volatility during the time the goods are in store?

The key issue, however, is the quality of the warehouse/warehouse company controlling the goods. Otherwise the stock finance is again essentially similar to prefinance, except that the goods have already been produced: they just haven't necessarily been sold yet.

Outline

Figure 3.4 is from the finance of cotton in-store in Argentina. The deal was brought to the bank by an existing offshore trading company, which wanted finance of the goods in-store while it sought a buyer in a nearby export market (Brazil). The trader was of insufficient financial strength on its own to present an acceptable payment risk. The ultimate aim was to sell the goods against a third party Brazilian bank L/C which would be acceptable to the financing bank.

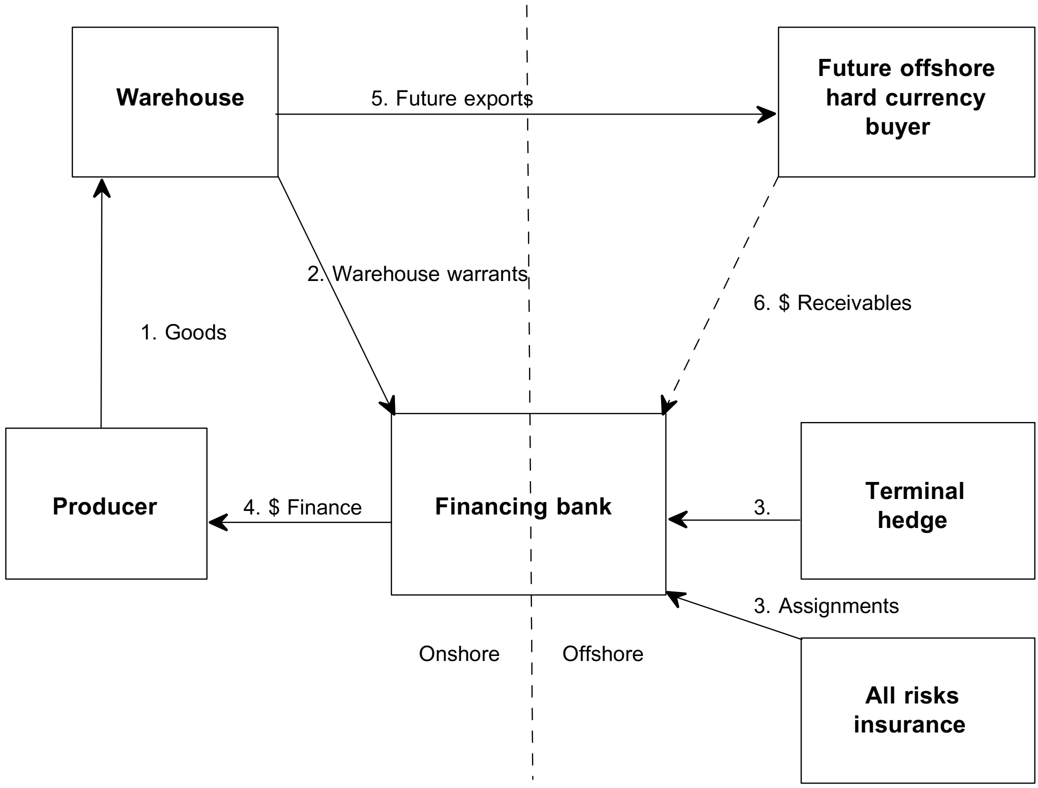

Figure 3.4 Stock finance.

The primary concern was the poor reputation of many of the smaller warehouse companies for allowing 'leakage'. Typically what happens is that the producer lodges the goods in a local, ostensibly independent, warehouse. Warehouse receipts or warrants are issued and lodged with the Bank against finance. The Producer then goes back to the warehouse and persuades or otherwise induces the warehouse company to release the goods without the documents of title. The Bank would then be left with worthless warrants while the warehouse claimed the goods had been 'stolen'. However, by using an independent inspection company, choosing the warehouse with care and taking out insurance against theft and fraud, the Bank or financing party can effectively mitigate the major risk. Note:

- Clearly the security structure has to be in place before the advance is made.
- In the instance cited in Fig. 3.4 the goods in-store were insured with Lloyds of London, specifically against theft and fraud. The Bank was first loss payee, the certificate endorsed in favour of the Bank, and the policies were payable in London.
- There was also a terminal hedge in the form of a 'floor' via a US exchange to provide protection against downward movement in the commodity price. This was to the trading company's

advantage because it wanted to finance 100% of the stock and so did not want to offer the Bank overcollateralisation to cover the market risk.

SECURITISATION

Definition

Securitisations for our purposes are deals in which hard currency receivables from various sources are bundled together into a collateral pool as a security (in the US sense of this word, namely a bond or a Securitized Export Note), which is then sold on to investors. The bond/SEN would normally be rated by one or more of the major credit rating agencies to give the investors a means of comparing the attractions (price vs credit quality) of different deals, and sold either via the Commercial Paper market or as a private placement.

This is primarily a US method of finance, although it is gaining ground in Europe. It relies on having an investor pool driven almost exclusively by credit rating (such as exists on a huge scale in the US) without being too interested in how that rating is actually achieved. The upfront costs of such deals can be high (rating agency fees, investment bank arrangement fees and fees charged on distribution of the bonds), but the marginal costs of finance will generally be lower under stable market conditions.

Compare the pre-crisis Russian Government Bond issue, rated variously around the BB level, which had implicit finance costs of Libor plus 3.25% to 3.5%, to the Russian Government's other sources of finance (in domestic currency it was then paying around 40% short term) or the Russian market benchmark pricing for performance risk deals on top quality exporters (then between Libor plus 5% and Libor plus 7%) secured on offshore receivables. In the pre-crisis froth, STCF deals went down to around 3% over Libor on a 12-month basis, yet the bond market went even further, allowing Sibneft to get a 3% margin for a three-year unsecured bullet. Post-crisis, the corporate bond market disappeared altogether, the government bonds faced 90%-plus write-offs, but STCF deals on good-quality exporters could still be done between Libor +5% and Libor +7%. Further, while some of the STCF deals faced protracted delays because of the very low price of oil, or because of shareholder in-fighting (often not unconnected with the oil price), none of the STCF deals defaulted because of the debt moratorium or subsequent institutional failures. The difficulty becomes not that the securitisation fails to pay out, but rather that the price of the debt instrument (i.e. of the bond or SEN) is driven entirely by (capital) market sentiment.

Post-crisis, all Emerging Market bond values collapsed across the board, while new issues simply were not attempted. The result of all this is that the securitisation route works best in a bull market, but is of limited value (at least in terms of credit access) in times of crisis, especially as compared with other STCF solutions.

Outline

Figure 3.5 is a generic structure: again there are many variations on this theme. Once more we see offshore cashflow. The nature of the beast usually dictates a US legal jurisdiction, which means that the legal documentation will be comprehensive. Higher upfront costs are however usually mitigated by lower outright financing costs and often longer tenors than might be achieved on a (structured) bank loan basis. Note:

- The investment bank putting the deal together may take no risk at all or may underwrite the bond sales. Either way it would normally expect to make more income on fees than on its risk-taking.

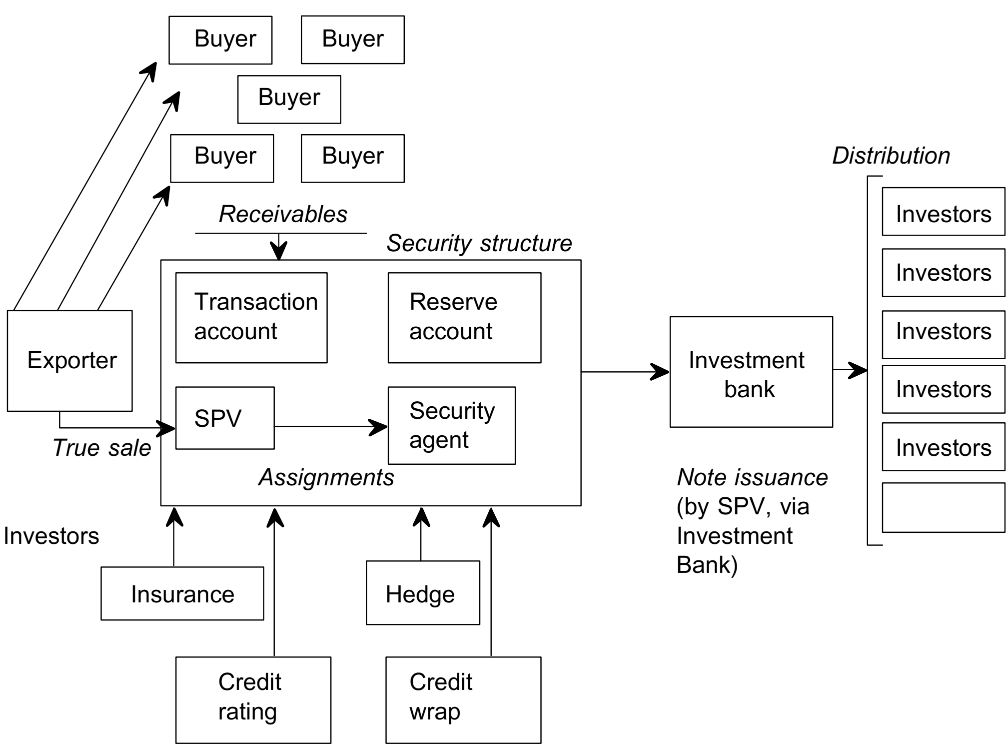

Figure 3.5 Generic securitisation structure.

- Investors may be banks, institutions or retail investors. Typically they will be more driven by the credit rating than by the actual nature of the deal.
- The SPV may be in a tax-advantageous jurisdiction. This may enhance the yield to the Investor, thus allowing the Borrower to achieve lower pricing for the same level of investor attraction.
- The issue may be credit-rated, usually with focus by the rating agency on the Debt Service Coverage Ratio (DSCR), and a detailed financial model in which the structure will be stress-tested against historical and forecast variables.
- The credit rating may be enhanced by a monoline insurer (a highly capitalised, and therefore itself highly rated, insurance company whose sole purpose is to provide credit enhancement). Typically the monoline insurer would make certain of its risk by applying statistical analysis to establish the historic default ratio of the Receivables (hence the value of this structure when there is more than one receivables stream) and eliminate it by overcollateralisation.

For example, a Receivables Pool of made-up Receivables from established customers in a given geographic area of a credit quality may have an historic default ratio of 5% per annum. By overcollateralising by 125% (i.e. 1.25 to 1), the insurer has made certain that it has five times the expected cushion it needs to ensure that default by the credit card holders does not affect the ability of the Receivables Pool to redeem the bond obligations. Of course, the credit rating agency can also assess such probabilities, but the monoline insurer puts capital behind its assessment in the form of a guarantee, and this can make the rating either easier or quicker to achieve, and probably easier to sustain.

SUMMARY

The key elements of the above structures for STCF deals are as follows:

- Offshore cashflow via a dedicated Collection Account pledged to the Agent.
- Performance risk in 'difficult' country/payment risk in OECD country.
- Assignment of the underlying export contract (or contingent assignment), that is, there is real direct access to the producer/exporter rather than disintermediation by a local bank.
- Overcollateralisation of asset value to the loan.
- Escalation mechanism allowing the Bank to call for more collateral if required.
- Collateral must be reasonably liquid (lower liquidity must be matched by higher over-collateralisation).

- Self-liquidating structure (i.e. export goods must have a buyer acceptable to the Bank).
- Strong documentary structures to ringfence legal title to collateral above claims from third party creditors.
- As much credit enhancement of the deal as is commercially viable (noting that, in the last analysis, we do not necessarily want to end up working solely for the insurance companies).

ACCESSORIES

So much for theory. These basic outlines are subject to wide variation to fit the commercial characteristics and legal demands of the various markets to which they are applied. However, armed with the above, it is possible to look at most structured trade/structured commodity deals and see a fair amount of familiar territory. On any of the above, it is possible to enhance further the structure by adding on further 'accessories'. These are considered together because they can apply to any of the above.

Insurance

Apart from the typical 'marine risks' or 'all risks' insurance that we would require to cover any physical collateral (see 'Stock/inventory finance' section above), the most common accessory for STCF structures is third party credit enhancement in the form of some sort of additional insurance cover, particularly private political risk insurance and export credit agency backing. These do not significantly alter the basic mechanics, since the insurance underwriter will also want to be shown how he can expect to get paid out, but typically the insurance market can offer cover for political risks (such as expropriation, currency inconvertibility and contract frustration) and sometimes also for commercial risks. Typically such cover is in the region of 85% to 95% of the whole amount to be financed, but 100% cover is not uncommon. The privately written policies from Lloyds, AIG, Zürich and the rest have come a long way in the last decade and a half, and most insurers will have policies specifically targeting lending banks or lending trading companies. For banks these are particularly useful since they will often mean complete mitigation of country line utilisation: for example, a deal for $10 million in Argentina with 90% political risk insurance in an acceptable format will lead to utilisation of that bank's Argentine country line of only $1 million. The bank still has an asset of $10 million, but it is no longer entirely an Argentine asset.

ECA backing for political risk has the particular attraction, as we say elsewhere, of having a zero weighting for the purposes of capital allocation for banks, and so has become especially beloved by lenders in recent years. ECAs can also offer commercial risk cover. There had been a tendency in former years for the ECAs themselves and ECA specialists in companies and banks alike to consider the main technique of the specialism to be how to perfect the process of successfully making the ECA application so that the ECA would take most if not all of the risk. This has changed significantly since some governments have moved towards at least partial privatisation of the backing they give their ECAs, and most ECAs have focused much more since the 1997–9 crises on how the applicant expects to get paid by his commercial counterparties, rather than simply relying on the ECA to pay out. The result is that the ECA specialists of recent years will now be much more familiar with the types of structures outlined above than was ever previously the case, and indeed some ECAs (notably Coface, Cesce and Sace) have been backing countertrades for many years.

A more recent addition to the armoury is the 'Credit Wrap'. This is the US technique to which we referred in the securitisation outline, whereby a monoline insurer guarantees a structure, thereby giving the structure the credit rating of the monoline insurer, which would typically be expected to be AAA or AA. This is very useful if the aim is to sell into the US capital markets, and all investor markets these days are very 'credit rating-sensitive'. There is a price, however, since the monoline will say, not unreasonably, that since it is taking all of the risks it should get its fair share of the reward.

Collateral management/inspection agencies

In recent years the traditional work of the long-established independent warehouse inspection agencies has increased and has been augmented by the arrival of providers of full-blown collateral management services. These specialist companies literally manage all aspects of movement of the commodity collateral from harvesting (or even initial purchase of seeds) or mining through to the point of delivery to the offtaker. This is especially well established in Africa and is increasingly being seen in parts of Latin America (notably Brazil). The companies are typically covered by professional indemnity insurance and the top ones provide a first-class service. This can be a major enhancement of the structure in terms of preservation of title and access to the commodity while still in the Emerging Market jurisdiction, and addresses the banker's tendency to assume that all goods are the same quality and therefore price. However, use of such companies is not free, and the cost of this service obviously erodes the income on the deal. If the protagonists feel (as is often the case with traders) that they know what they are doing, a lender may face significant opposition to using such a company, and at very least will be told the cost comes out of the lender's margin. It is also unlikely that such collateral micro-management would be tolerated by the very large parastatal producers. However, for deals involving commercial producers, and in particular producers located some distance up country, the use of such a collateral management company can make a lot of sense. Similarly, old-fashioned stock finance, of goods in warehouse, cries out for independent inspection by a reputable company.

Lenders should nevertheless beware of the possibility of fraud with any physical collateral. In 1988 I remember receiving a presentation from a Swiss warehouse and inspection company about its new setup in Lagos, Nigeria, at which I was assured that its warrant from its warehouse there was a 'bankable' document: 'you can take these warrants to any bank and raise finance against them, safe in the knowledge that your goods are in the warehouse as stipulated on the warrant'. Some days later I was in Lagos, and, being a youngish man only recently retired from service in a commando unit of the Royal Marines, I did not think twice about walking from Western House to the nearest bank, to collect something. As I walked down Broad Street in my suit and untanned white skin, I soon realised my mistake in not availing myself of the company driver who had been laid on for my benefit, for the very walls came alive with local people offering to sell me things.

One of the less salacious offers I received was from a Nigerian gentleman who was offering blank certificates from the Swiss company's new warehouse, at the Sterling equivalent of about 50p for a stack of 25 warrants ('just fill them in yourself with whatever you want . . .', and after that the sales spiel was remarkably similar to that of the company itself: 'any bank will give you finance . . .'). I bought the said items and took them back to London, where we invited the Swiss group to elaborate on its presentation. As the executives did so, rather uncharitably we started inspecting the blank warrants. To be fair to the group, this could have happened to anybody, and our own Nigerian warehouse, which we had bought and paid for, when we inspected it turned out not even to have a roof (photos we had been shown were of the warehouse next door).

Acceleration

The outlines above are all essentially short-term structures with the exception of the securitisation. Longer tenors can be achieved on the same basic chassis but with some further tweaking. A common add-on is an acceleration mechanism. The aim is to give the lenders an exit within an accelerated time frame, typically 12 months (see Chapter 5). The advantage is that it allows the lenders to present the deal as more obviously short-term trade, and therefore non-provisionable. At the time of writing this works for all the European banking regulators. This acceleration is achieved either by retaining a larger percentage of the cashflow running through the collection account, or by escalating the export contract on which the transaction is based. For example, a five-year deal may be based on an export cashflow of $100 million per annum. If the amount financed is $80 million, spread over five years, the amortisation schedule will not be too punishing for the Borrower, but the Lender can still take comfort that he could get paid out within a 12-month horizon if necessary. The downside is clearly that the Borrower has committed $500 million of cashflow to get $80 million of debt, but equally under normal circumstances he will only be paying $15 million a year in debt service and the balance of his cashflow, $85 million, runs straight through back to him. It may also be possible to put in subordinated debt based on this $85 million.

Revolvers

As per the straight lending technique, a revolver in an Emerging Market structure is a simple way of achieving a longer tenor when in principle the lenders would prefer to keep their exposure short. A revolver in which the Borrower is able to redraw any amount he repays will not necessarily avoid provisioning unless the availability period for redrawing is less than one year (and some authorities or even internal auditors may require the whole period from first drawdown to last repayment to be one year, though commonly they will accept 12 months per individual drawdown). If the Obligor pays down the Facility to zero before redrawing takes place, however, the question of the tenor of the Facility really depends on how free the Obligor is to redraw or how free the Lenders are to withdraw. Most lenders will have a Material Adverse Change (MAC) clause in the documentation, which says essentially if things go downhill, all bets are off and the obligor cannot redraw. The MAC will then lead to an Event of Default or a Potential Event of Default. The question is often what is the trigger for the MAC. An ‘objective’ MAC will have performance and other criteria that may trigger the MAC, in the absence of which lenders are obliged to allow redrawing. A ‘subjective’ MAC will allow lenders to declare MAC on any grounds they like, from deteriorating market conditions to poor weather, and thus extract themselves from the facility early.

Reserve account

Another accessory for medium-term structures, this entails retaining a cash pool offshore from the drawdown, possibly on a revolving basis. Typically the amount will be equal to one full amortisation repayment of principal plus interest, so that in the event of a delay (and any facility depending on a shipping schedule for repayment can experience a delay) the agent can use the reserve account to keep the facility current, and thus buy time in which to decide what further action to take (such as escalation or acceleration).

Further structural items are considered in Chapter 6.

4 The acid test: do structures work?

INTRODUCTION

Whether it works is of course the real test of the structure. Depending on motivation, a deal may be 'structured' to get round any variety of rules – provisioning rules for banks, balance sheet accounting rules for corporates, country risk limitations set by whatever body has authority to set them, and so on. However, the test for any cross-border trade-related transaction remains: did they get their money back, and did they get it back within a reasonable timescale? A surprising number of people and companies in positions where they really should know better have indeed failed to get their money back, or have been led (one is tempted to say 'panicked') into selling out at a loss, before full repayment is achieved. Obligors are naturally not ignorant of the impact of provisioning rules: they know that a default in August will trigger 95% plus write-offs before the year-end for most creditors, so an offer to repay only 20% in the following year will look remarkably like a profit for many creditors, especially if teams have changed as a result of the original loss. Other transactions, however, have survived remarkably unscathed throughout the crises, and their structures really could be seen to work. In between lay a no man's land of deals which didn't seem to work and received an awfully bad press, only for the stoics who stuck with them to get back their principal plus interest, and indeed penalty interest before the end of the millennium. This next section is dedicated to trying to tell the difference between these three categories.

This chapter consists of a series of case studies. To anyone upset by my analysis of their deal, all I can really say is that it's a personal view, which does not necessarily reflect the views of any of my employers, present or past, one way or the other. I confess I am quite prepared to sympathise – nobody welcomes uninvited criticism. But my criteria, as above, are simple:

- Did they get repaid?
- Did they get repaid on time/within a reasonable horizon?

As a matter of interest, I also discuss whether they got repaid without serious public recrimination and back-biting (what banks now like to call 'reputational risk'), but any other basis (I have actually heard 'we made a bucketful of money on the exit strategy') generally seems to depend on someone else carrying the can for some almighty write-down or write-off, and to the average if cynical outsider seems a little disingenuous.

The case studies have been compiled to illustrate a number of the failings of various structures from publicly available information and market knowledge. Consequently the case studies are overviews of what happened rather than detailed accounts, and they are certainly not intended to be blow-by-blow accounts; rather the aim is to look in general terms at what went wrong, what went right, and why. Great care has been taken to preserve any inside knowledge that may have been available, but in the end, if I didn't name names, the whole exercise would be a lot less interesting and meaningful. In doing so, I hope also to highlight some of the strengths that may be built into trade-related structures and to learn from what people did right as well as wrong.

YUKOS

This is the first of two case studies from the Russian crisis, and to critique the chapter when I first wrote them up, in the interests of discovering whether they made sense to the untrained eye, I showed them to a trainee colleague. He had at this stage been in banking for a couple of years, but was yet some distance from completing his 'Ausbildung', and had been attached to my team in Amsterdam for about one week. However, he was not intimidated at all at the prospect of telling the emperor he had no clothes, and he asked the simple question, 'Why do they need a passport? Don't all Russians have passports?' I was thus reminded that to critique the performance of Russian structured pre-export finance through the 1998–9 crisis, it might be helpful to explain a few things first about how it operated when there was no crisis.

The Russian variety of this species differs from others in that the whole edifice of transfer risk mitigation through use of ringfenced offshore cashflows is compromised by the Russian 'passporting' system. Thanks to a 1996 recommendation from the IMF, Russia imposed a 'passport' system for all exports, which demanded that the exporter get his Russian bank (thus the 'passport bank') to register each export with the Central Bank of Russia. The CBR then demanded that the hard currency proceeds of each export were repatriated to Russia within 90 days of shipment. Further, 50% of these export proceeds were then compulsorily to be exchanged for roubles across the MICEX exchange, before they could be reconverted to dollars and expatriated together with the unconverted 50%, to pay off pre-export finance debt (Fig. 4.1). In theory this was just a series of book transfers across the books of the US dollar clearing bank in New York, and the parties could reduce time delays by

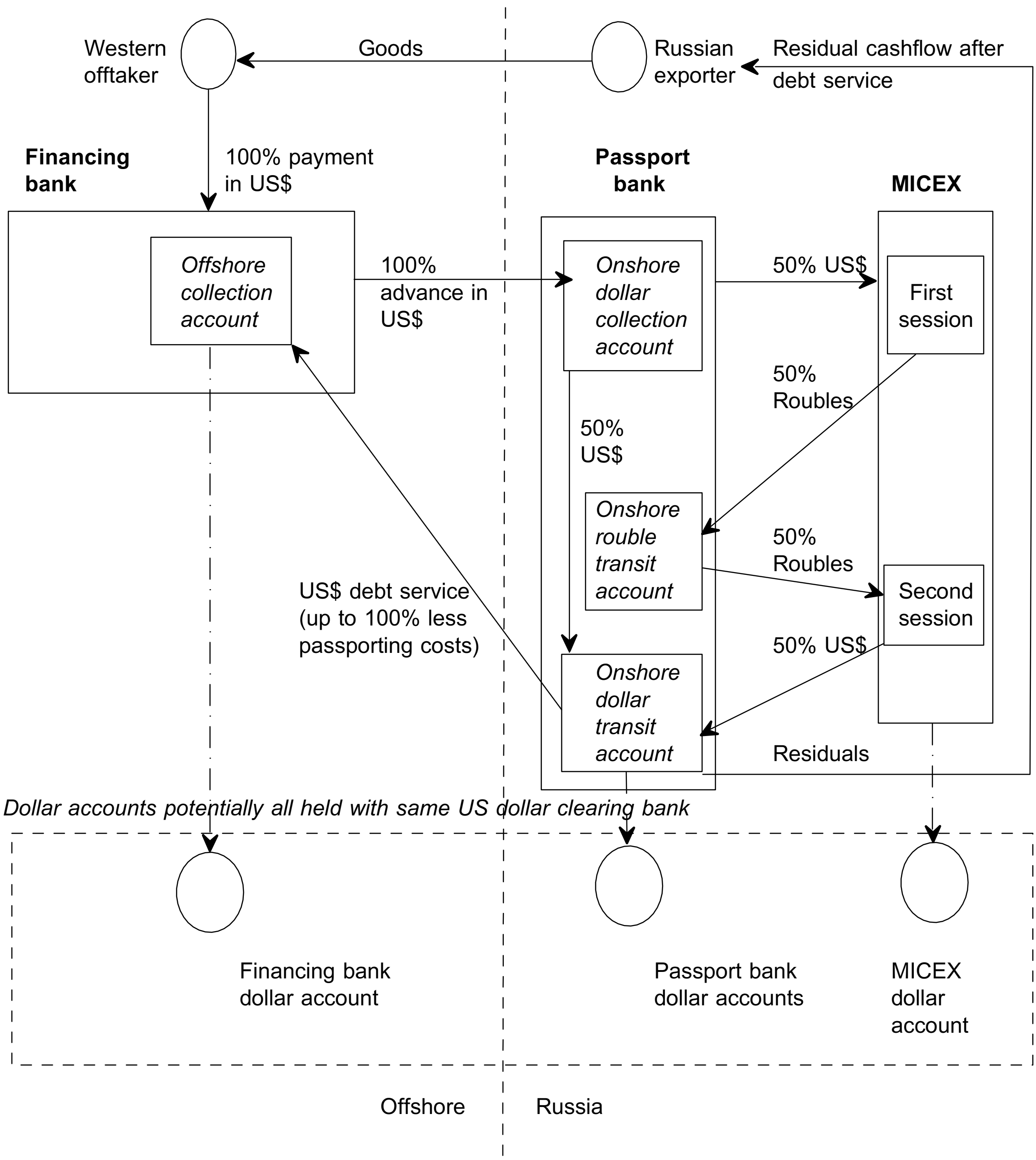

Figure 4.1 The Russian passporting system.

ensuring everyone used the same US clearer, but even so the clearing bank would not process transfers of 'Russian'-domiciled US dollars until it had seen the incoming funds clear, which with the dollar clearing system in New York meant typically at least an overnight delay.

Prepayment (as opposed to pre-export), in the sense of lending to the offtaker so he could prepay for the goods as a trade advance, did not offer a way round these 'passporting' rules, since although a prepayment offered immediate satisfaction of the passport, there was then an equally immediate 20% Russian VAT hit. The result was that even the best structures at that time (and even since the crisis, only RZB with its 'offshore deposit' structures has offered any solution to this challenge) nevertheless entailed at least a daylight/overnight exposure to transfer risk thanks to the passporting system.

An additional rule stated that any foreign loan over 180 days required a licence from the CBR, so a number of structures were executed with a 180-day break point at which the obligor repaid to zero, only to redraw two days later for a further 180 days. Others were structured with an initial 180-day horizon, to be extended beyond that in the event of a CBR licence becoming available. A further complication was that Russian companies could not issue dollar-denominated guarantees without a CBR licence, and typically this would not be forthcoming. They could, however, and regularly did, issue 'commercial suretyships', which were effectively guarantees to perform a contract to deliver goods up to a given value. These suretyships were assignable, meaning that a Russian company in receipt of such suretyships from its operating subsidiaries or from suppliers could assign these to the lending banks. Finally, it was by no means clear whether a Russian producer would be allowed under Russian law to hedge commodity revenues, and at least one Russian court ruled that hedging contracts were gambling, thus not to be tolerated by a corporate entity.

It was widely recognised that, for banks offering pre-export finance in the expectation of having some protection against political risk in general and transfer risk in particular, this system was not ideal. Clearly this affected the thinking of the IMF less, since it is an 'onshore' cashflow lender and it would be better for the IMF for all Russian cashflows to wash through the Central Bank of Russia. Nevertheless prefinance lenders were clearly able to identify their transactions as trade-related through this passporting mechanism (especially so if they had a specific CBR licence), with the result that Russian prefinance in the late 1990s did *not* look like Brazilian prefinance in the early 1980s: there was no way the central bank could claim these were straight foreign loans to corporates independent of any 'trade' (in the sense of 'trade finance') component. The result was that the lenders convinced themselves that there was simply no escaping this mechanism in the Russian structures and that it had to be accepted if one was to continue in this market. In the event the prefinance lenders were proved right, but as is sometimes the case, no-one really knew what was going to happen until it happened.

The deal

In October 1996 Russia was finally awarded an external credit rating by the major credit-rating agencies. The agencies' view, with which (to make my position clear) I remember fully concurring at the time, was that Russia was a slumbering giant whose politics was a mess, whose infrastructure was crumbling, but which was blessed by a technologically educated population and a majority stake in more basic commodities than Margaret Thatcher had handbags, all of which was ripe for privatisation, investment, finance and advisory mandates by Western banks in general and Western investment banks in particular. As a result, 1997 was the year in which the Western banks 'discovered' Russia. Most of all they discovered they could make an awful lot of money applying structures and practices perfected in Latin America (the Russians were wise enough not to let the European banks use the sort of structures they had perfected in Africa), and this seemed eminently plausible when Russia enjoyed a credit rating marginally better than Brazil and on a par with Argentina. This was to be 'the last great Emerging Market'.

The start of the Asian crisis began to cream off some of the froth towards the end of the year, but no-one experienced in Russia really saw any connection in 1997 between the rating agencies' failure to predict the South Korean collapse, and the ability of a Russian oil major to perform its obligations. The result was that prices came down, tenors went out and structures became thinner, if indeed there was a structure at all. In May and June 1997, Siberian oil major Sibneft was still offering well-structured, one-year, monthly-amortising pre-export finance based on crude oil receivables from Elf and Exxon (these were not difficult deals to sell, and performed excellently). By August the same year, with some help from US investment bank Salomons, Sibneft was able to issue a three-year bullet repayment, unsecured corporate bond, based on pure balance-sheet risk, bearing more or less the same pricing. We received a call from Sibneft, who, one has to say, are a class act, saying very politely 'thank you very much for your support in the past, but we see the future lying in capital markets funding and we won't be offering pre-export finance or similar collateral in the future'. Under the circumstances it could hardly be blamed.

By the end of the year, Gazprom, mightiest of the Russian monoliths, broke all records, first with a

\$2.5 billion structured medium-term syndication, and then with a \$3 billion structure, run by Crédit Lyonnais and Dresdner Bank, which was to be the cheapest Russian deal ever (although I concede it was a perfectly good structure that matched well Credit Lyonnais' understanding of the commercial requirements and realities with Dresdner's more formal eye for what would be required to produce a structure that would be non-provisionable for most bank lenders). It was backed by gas receivables from France and Finland, enjoying a tenor (seven years) only exceeded in Russia by other Gazprom deals. Gazprom's previous offerings had all been massively oversubscribed. For this new deal there was heavy fighting over the underwriting mandate, largely from banks late to enter the Russian bonanza, and more than once we heard 'this will be a statement of our commitment to the Russian market'. Co-underwriters committing \$300 million (a huge amount in the context of the average country line for an Emerging Market country) were even scaled back to \$175 million. The hard part was that the bank market to whom they expected to sell were either already in the huge underwriting group, or still preferred one-year oil-backed structured risk at 3% plus, to seven-year gas-backed structured risk (with two years' grace) at 1.75% (Gazprom or no Gazprom), or were finding that post-Asia, Emerging Market country lines were not what they were. The result was severe indigestion that overhung the market for the next several months (one could even say 'ever since').

It was against this background that Goldman Sachs and Merrill Lynch decided to get in on what the commercial banks had been doing for some time. In Yukos they identified another Russian oil 'major' of mighty reserves, if rather more challenged production and distinctly 15-watt financial management. Yukos was the world's fourth largest oil company by proven reserves. Teamed up with an experienced STCF team at commercial bank Crédit Lyonnais, which delivered the underlying security structure, the US investment bankers saw the potential to match the traditional oil prefinance structure as a product to the Goldman Sachs/Merrill Lynch distribution machine for selling syndications, and thereby to distribute in a way that would make the efforts of the commercial banks look amateurish by comparison. To be fair, they had a point. In many of the commercial banks (Crédit Lyonnais included), distribution of the structured deals was an amateur affair, conducted between specialists many of whom had known each other for years. Few had set up specialist distribution channels because it was so rare to find a distribution specialist who really understood the structures (UBS and KBC – staffed by the ex-UBS STF team – springing to mind as notable exceptions). Crédit Lyonnais itself managed to agent and syndicate entire Russian structured pre-export finances with loan documentation lacking any agency clauses. Paribas Genève, the Swiss-incorporated subsidiary of the French 'oil' bank, managed to conclude over a hundred Russian deals (according to it) before an audit pointed out that there was no Russian–Swiss double taxation treaty, so it was liable to withholding tax. It was, then, in the autumn of 1997, faced with the embarrassing task of contacting banks in deals where Paribas Genève had been a direct lender, including deals already repaid, to see if they would agree to retrospective amendment of the documentation so that Paribas Genève could be re-presented as an indirect participant. So it was perhaps understandable that Goldmans and Merrills might have thought they had something to bring to the party. Unfortunately, all did not go entirely according to plan.

The basic structure was sound and essentially as practised very successfully by Crédit Lyonnais and other commercial banks on the one-year deals: a pre-export finance loan to Yukos, secured on an assignment of REBCO crude oil export contracts with Total and Elf (meaning Total and Elf receivables), backed up by a commercial suretyship (a guarantee to deliver goods) from the Yukos operating units (i.e. from the oil-producing units themselves, to avoid holding company risk and in lieu of any ability under Russian law at that time to offer US dollar guarantees). There was the usual Escalation clause, calling for more oil to be delivered under the oil contract if the dollar value of the oil fell below the amortisation schedule. A Condition Precedent before initial drawdown also required sight by the agent of the Grafika – the famous Transneft (Russian state oil pipeline operator) schedule that sets out the oil pipeline allocations and destinations for the Russian oil exporters three months in advance. This was a useful detail, because it was commonly held by Western banks that the sheer weight of bureaucracy within Transneft, and the difficulty of producing the Grafika in the first place, meant that once a delivery was enshrined in the Grafika it was virtually certain to happen if only because it would be too difficult to change. This ensured at least three months' 'forward vision' for lenders.

What went wrong?

There were, however, a number of difficulties, which lay mainly in the overall parameters of the deal. Just before Christmas 1997, the arrangers started to warm up the larger market players. This is never the best time to launch a deal. Anybody with any real influence is typically already on holiday. For the workers/specialists, most know also that it is probably too late to influence the bonus decisions (September/October is a much better time – it prompts the hierarchy to think about what they will miss if their specialists move on to other banks), so there is little point spoiling Christmas by working flat out on something which won't be decided upon until mid-January anyway. It was clear, however, that the deal was already set in stone and that the 'warming up' was a euphemism for a hard sell rather than an attempt to sound opinion.

Goldman, Merrills and Crédit Lyonnais were looking for 'co-arrangers'. 'Co-arranger' under normal circumstances is quite a good role for banks. By the time a deal is being co-arranged, it has got past the initial phase of flirting between borrower and lender, and therefore is much more likely to go through (primary originators will tell you the mortality rate of enquiries for structured loans in difficult markets is similar to that of British fighter pilots on the Western Front in 1916 facing the Red Baron: only a small fraction of deals actually make it through to drawdown). The ' co-arranger' slot offers superior fees to the simple participant, but also offers the opportunity to sell down, and thereby further enhance returns by the ratchet effect of retained 'skimmed' fees on a reduced principal. Customarily it also offers at least a modicum of influence over the shape of the final loan documentation. However, in this case it proved a tough sell. There were several reasons.

For one thing, many players in the Russian market were simply full. Many of the legion of one-year Russian deals completed in 1997 were still on the books, if not already amortising. Worse, the Gazprom hangover was huge, and even if booked in different areas to the STF/STCF teams looking at Yukos, its effect on soaking up country line capacity was the same. The short answer from Crédit was 'sell some Gazprom and you can do some Yukos'. Sadly, this was virtually impossible because at that price Gazprom could not be sold; the teams (typically, different teams within the lending banks) holding Gazprom were not yet ready to sell at a loss, and prior to the Russian moratorium could not yet be forced even to contemplate such an eventuality.

For another thing, the global environment was deteriorating fast. Asia was going from bad to worse. After the shocks of South Korea and Thailand, the dominoes of Malaysia and Indonesia went clattering down, the Brazilian currency was beginning to look shaky and the speculation was rising that Russia could not be far down the list to follow these unfortunate precedents.

An outside event (but sadly typical of Yukos) was an attempt to merge Yukos with Sibneft in the first quarter of 1998, which would have produced a truly huge oil company with the largest reserves in the world. This in the end fell down because of personality conflict between the two sides, but lenders could be forgiven for deciding to wait and see what would eventually happen.

Then there was the nature of the deal itself. It is one thing to say the underlying structure was sound. This is not the same thing at all as saying it was a 'good deal'. Yukos was known as a chaotic entity. It 'changed management more often than they changed their underwear' said the manager of trade finance at one well-known Western oil major. It had had a number of stabs at raising pre-export finance earlier in 1997, and although the underwriting groups had been put in place, not all the deals had gone through. Personally I got credit approval (quite an achievement within any bank for Russian deals) three times to be co-arranger in a Yukos deal in 1997, and each time the deal fell through. The result was that Yukos did not necessarily enjoy the goodwill among Western lenders experienced by some other Russian oil companies.

The tenor, under the circumstances, was aggressive. In September 1997 the market expectation was that in future, to maintain pricing, lenders would have to look at three- to five-year structures, rather than the simple one-year deal. However, the global environment changed in the last quarter, and by the time the arrangers were making soundings for Yukos, there was a feeling that three years would have been a better 'next step' than five. The amount, at $800 million, was going to be a real test, especially post-Gazprom. Given that the average hold for the final participating banks which would hold the deal to maturity would normally be between $5 and $15 million, then clearly the arrangers were either predicating the whole structure on a huge number of banks coming in (60-plus, even allowing for substantial holds by the top tier) or they were gambling on selling big chunks to co-arrangers and leaving them holding the baby (i.e. another Gazprom scenario).

Finally, there was the pricing. The tinge of regret that may have been felt by commercial banks that the investment banks were muscling in on the pre-export finance market (as they had muscled in on syndicated loans and so much else that was profitable for commercial banks in the late 1990s) turned to resentment that the real rewards of the deal were clearly to be inequitably shared. For much of the 1990s the participants in this market had been an incestuous group, with the same names turning up again and again, and much 'reciprocal business' in the sense of banks going into each other's deals. The 'club' deal was alive and well. It was expected that the lead bank or banks should get extra fees for the extra work and in some cases additional risk that they undertook, but the usual convention was that this should not be extortionate (or if it was, then at least it should not be blatant and the 'stuffer' should at a minimum be reasonably polite to the 'stuffee'). Margin, however, was passed on in full to those finally taking the risk (margin was for risk, fees were for work). This was already breaking down in 1997 when one Dutch bank (ING Barings) blatantly skimmed margin on a Russian structured deal for which the original pricing had already been advertised in Moscow. For some reason it seemed to think that the banks covering Moscow from London never visited the place. When Yukos launched at a margin of 3% per annum for a five-year deal, the suspicion (rightly or wrongly) was strong that the investment bankers were assuming they could get the commercial bank market to swallow the pricing for five years they had previously accepted for just one-year deals.

The result was that the arrangers were obliged to withdraw, and repackaged the deal in February

1998. They said they had had a 'Market Change' clause in their mandate agreement with Yukos, which allowed them to revamp the price and relaunch the deal better to suit the new market conditions. The result was still a five-year deal, but for $500 million, and with pricing increased to Libor plus 5% per annum. Of course, had they done this from the start, this might have looked like an attractive proposition. Unfortunately, the move had attracted considerable attention from the press, specialist and otherwise, with the result that credit managers and the upper echelons of bank hierarchies who, under normal circumstances, might not have known their REBCO from their Grafika, suddenly were all experts on the well-known fact that 'Yukos' was a bad deal. Post-Gazprom, of course, they were also experts in the idea that 'Co-Arranger' in a deal with a superior level of 'arrangers' could sometimes be a nasty euphemism for 'Glorified Stuffee'.

Of course, this did not defeat the investment bankers. They restructured the package for distribution, turning what had been a glorified syndicated loan into a $250 million fixed rate bond, a $100 million floating rate bond and a $150 million syndicated credit. The bonds finally were issued in May 1998, and were sold primarily to US investors through the Merrill/Goldman networks.

On 17 August 1998 in a well-documented move, Russia suspended the Rouble-denominated Russian Government securities market in GKOs and OFZs, introduced a substantially wider band for the official 'crawling peg' exchange rate for the Rouble against the Dollar, and declared a 90-day Moratorium on foreign debt. Exactly what classes of debt were included in the Moratorium took a few days to establish. After an agonising wait, the pre-export finance structures were specifically excluded from the Moratorium and, unless obligors had other problems, continued to repay. This was a major test for the structured trade product, and on the whole it survived extremely well. It was a particular relief to most of us because up to that point none of us had been altogether confident about how the famous passporting system would behave in the event of a general moratorium. It was therefore more with a sense of relief than of vindication that we found that, despite the Moratorium, the passporting system had not been used as a mechanism to trap export proceeds on more than an overnight basis. Certainly there were obligors who tried to take advantage of the chaos to get out of obligations, and Russian banks defaulted en masse (with the noble exceptions of Alfa Bank and Gazprom Bank), which was certainly a blow to structured deals if the prefinance 'passport' was held in a Russian bank, but if the obligor had to export, creditors got repaid.

Of course, for most exporters the attendant devaluation was a positive boon, as their costs were cut at a stroke. Nevertheless, the universal reaction from Western lenders was to pull all credit lines, freeze further credits and look to see how they could get out of existing ones. It is fair to say that the new Yukos bondholders were not best pleased at this unfortunate turn of events, and there was a certain period of high volume trading during which the bonds changed hands more than once, as fixed income prices tanked. Lenders and investors in the Yukos deal, having faced some opprobrium in the first place for going into what was widely known as a 'bad deal', now faced the market knowledge that they were 'long and wrong' of one of the very few commercial medium-term exposures in the market. While few observers really expected much to go wrong with Gazprom's medium-term debt, market watchers had few grounds to be so optimistic over Yukos. Worse, however, was to come.

As the Asian crisis began to bite in 1997–8, one little-noticed effect at the time was a steady downward trend of commodity prices. Asia is a huge consumer of commodities of all types, and as Asian development blossomed in the 1970s and 1980s this market became a large component of the global balance of supply and demand. Remove that demand while maintaining supply, and the obvious corollary was not far behind. Oil prices in particular suffered. As Brent fell to the $10 per barrel (bbl) level, REBCO was trading at a discount of $1–1.50/bbl. This, against the high fixed cost base of the average Russian oil field, made all Russian oil producers on paper unprofitable. This would have been serious had Russian accounts had much meaningful basis, but in practice and as discussed elsewhere, they effectively created their own exchange rate with Rouble costs and Dollar income. However on the typical structured pre-export finance (including the Yukos deal) this meant that the original tonnages committed to repayment were now of insufficient value to meet the amortisation schedule.

The agent therefore invoked the Escalation clause in the oil contract and the loan documentation, and called for more oil. Yukos, of course, agreed (it had no choice) and complied. However, there was a structural problem. The Transneft pipeline has a fixed capacity. As we have seen, that capacity is allocated in the famous Grafika schedule, three months in advance. This means, however, that if the lender calls for more oil, and we take it for granted that all existing oil is already fully committed, he can only reasonably expect to get it starting in three months' time. Escalation in a pipeline environment inevitably means delay. Where the Gazprom transactions (also 'pipeline' deals) were structured to include Reserve Accounts (additional reserves of cash held by the agent on accounts pledged to cover at least one debt service instalment in the event of short-term problems – a common component of medium-term structures), there was no such reserve on the Yukos deal. This would not in itself be a problem if the lenders agreed to wait the additional three months. However, the Yukos deal had not been distributed only to lenders but also to 'investors'. In the US capital markets, things can be rather straightforward. The obligor either pays on the due date or he is in default. Yukos found itself on the front page of the international press in 'technical default'. It did not fail in its obligations to deliver oil. However, it was unable to make the debt payment exactly on time. This stigma has stayed with Yukos ever since and only recently shows any sign of abating.

At the creditors' meetings two things became clear. One was that whatever the banks agreed, they could do nothing without the agreement of the investors. Second was that the much-vaunted US investment banks' distribution machine had one particular failing: it did not track the changes of hands as investors sold out. The result was that there was an immediate problem simply to identify the investors. And then when they did turn up, each one was armed (one is tempted in the context to say 'to the teeth') with American lawyers.

In the market there were also rumours that Yukos had taken advantage of the situation to ask for a lot more time than an extra three months: it was already demonised for being in technical default, and the common view at the time was that oil prices could stay at these levels for years. The details of the negotiations are not public knowledge. However, in the end, Yukos was back on track with all debt repayments by late 1999, helped substantially by the recovery in the oil price. This was not luck in an oil-backed structure, but the nature of the beast in that the whole concept is entirely based on the premise that the oil flow will become cashflow. However, Yukos continued to attract the fear and loathing of lenders and investors because of the widespread idea that it defaulted on its deal, which common knowledge said had not been a good deal in the first place. Nevertheless, the French oil offtakers Total and Elf say there was absolutely no problem with the oil contract and that Yukos delivered everything it was asked to deliver on time. The nature of the oil contract was stable, it was the price that varied and consequently with it went the cashflow. Low prices led to delayed repayment. Subsequent high prices led to repayment well before the original schedule.

Post mortem

So, what do learn from this? For one thing, the initial market soundings could have been a lot less aggressive. If the aim is to find out what pricing/tenor parameters the market will bear, this can be done very informally between people who have probably worked together from their respective institutions for years. Every specialist likes to feel his expertise is being respected and his view sought. It is a different matter to hit these same specialists with a *fait accompli*, which goes through too many parameters at the same time (too big, too far, too cheap – in the event, far too cheap). Even worse for the specialists was to get offered the deal from one of the 'smile and dial' brigade from a big syndications unit: they may be very professional syndicators, but if they don't know whether the oil contract is assigned or not, or why a lender might want that, it does not inspire confidence with the prospective participating bank. One of the things that became clear early on was that the arrangers had failed to bring with them those institutions which regularly put up large amounts for this type of structure, and this perception quickly snowballed so that many of those institutions which regularly put up *small* amounts for this type of structure also declined.

The failed Yukos–Sibneft merger from the arranger's point of view could have been seen as pure bad luck, but was symptomatic of the rapidly shifting strategy that characterised Yukos throughout 1997 and 1998. Of course, had it gone through, the arrangers might have had a much better deal on their hands, with the mighty Yukos oil reserves matched to the formidable Sibneft finance team (which on top of the already astute Russian–Americans who had shaped the company through the previous year, now included some of the ex-Salomons team). When this was not to be, the arrangers fell back on the US capital markets. This route has been something of a holy grail for the distributors of structured trade and commodity finance deals for some time, yet few have accessed it altogether successfully, and the Yukos transaction was to be no exception to this observation. To sell such a deal to investors who expect timely repayment without explaining (or perhaps without realising) the possibility of automatic delay if escalation was invoked, was to invite an immediate declaration of default the moment the oil price fell through the loan-to-value 'cushion'. They advanced 80% of the anticipated value of the oil contract on day 1 (bearing in mind that commodity contracts are denominated by volume – tons or barrels of oil – rather than by value). Once the oil price fell below 80% of where it had been on day 1, the oil contract needed to 'escalate' to deliver the same value. This could only be done at the earliest in three months' time, because of the nature of the Transneft pipeline schedule. A simple mitigant, of course, as mentioned earlier, would have been to include one repayment instalment in a reserve account, funded from the initial drawdown and to be controlled by the agent, but it may have been that Yukos did not accept such a condition.

Another feature reasonably commonly seen now in medium-term commodity-backed deals is a commodity price hedge, specifically a floor, which could have supported a minimum level of repayments. That is not to say this would have been accepted by Yukos in 1998–9. This can be a tough sell to the obligor, who will often see it as an excuse for the lender to make more money out of a risk he is going to take anyway (one way or the other), just via a different department. Like any insurance, hedges look very expensive to the commodity producer when all the forecasts are saying (as they often do) that price variation over the next several months is going to be plus or minus 10% of where it is now. They have been common on the Sonangol oil structures in Angola since the early 1990s (when UBS made millions out of providing them to support its own structured prefinance, and

Sonangol later saved millions when the price eventually fell below their floors), but in 1997–8 they were a very difficult sell in Russia, and, as said, a number of Russian courts were on record as seeing 'hedging' as 'gambling'.

It was then an operational failure that the US investment banks did not track the various changes of title to the bonds. Of course, for unregistered securities or bearer instruments this would not be normal anyway, and the arrangers might be forgiven for feeling that they should not have had to do this, but in such a structure the fact that the creditors could not even identify each other made concerted creditor action very difficult.

Finally, did they get their money back? Well, in this instance this is quite a hard question. Yukos certainly paid all the money back, eventually, but this is not the same thing. US investors in fixed income instruments tend to invest in relative value, and buy a bond at a certain price. If, because they subsequently want to get out of Russian investments, they sell out, and at the same time as everybody else is dropping Emerging Market bonds like hot potatoes, it is likely to have been at a loss. For anyone selling the Yukos paper in late 1998 or early 1999, the loss is likely to have been substantial. For those who stayed with it (for example, some of the participants in the syndicated loan, which should not have been provisionable for bank purposes), they would have recovered the value in full. The underlying structure was in the end proven to be sound. What really mattered was how it was sold.

SIDANKO

The deal

This is another Russian crisis story, and another Russian oil company prefinance, so for background see 'Yukos' above first. Everybody knew Yukos to be incapable of moving in a straight line if their lives depended on it, but what was different about Sidanko was that it was commonly perceived to be doing everything right, and the Western banks loved Sidanko for it. The major shareholder was the Interros group, vehicle of oligarch Vladimir Potanin.

The oligarchs were a mixed and disparate group of leading Russian businessmen whose claim to fame was that between them, their banks, their cash-cow businesses, and their media empires, they got Boris Yeltsin re-elected in 1996 against seemingly impossible odds. Deeply unpopular for having presided over a 50%-plus fall in GDP, Yeltsin was politically dead in 1995, and not just because he needed a quintuple bypass. The Communist party was easily the most popular bloc in the Russian Parliament, and it seemed more than probable that a candidate from this bloc would emerge as the new president in 1996. It is fair to say that this prospect caused a degree of disquiet among those who had done best from post-Communist rule. The result was an intensive media campaign backed up by an oligarch-bankrolled crisis-management programme to fire-fight the worst problems standing between Yeltsin and his second term. Arrears of wages and pensions were suddenly made up, distribution of food and other goods temporarily achieved a level not seen for some time, and, rather incredibly, the man who had been incapable of getting off the plane at Shannon Airport to meet the Irish premier successfully persuaded the Russian electorate to return him for a further term.

The price to be paid, however, was the perpetuation of the oligarchs' business interests and the expansion of their empires through the fledgling Russian privatisation process. A major feature of this process was the infamous 'loans for shares scheme', the creation of Vladimir Potanin, which entailed oligarchs' banks lending to the government against security of shares in state-owned enterprises. When the state was unable to redeem the loans, the shares fell to the lenders, which were to a man, banks or vehicles owned by the so-called oligarchs themselves. Foreign bidders were excluded from this 'privatisation'. Bids came largely from the *upolnomochenye* or 'authorised' banks, that is, banks authorised to hold government funds and cashflows. Suspicion was deep that the oligarchs were using government money to fund this asset stripping of the state.

However, there were oligarchs and there were oligarchs. Yukos fell to Khordakovsky, a media baron of limited oil expertise, who went on to appoint a series of managers to Yukos none of whom rivalled his understanding of oil. Yet Khordakovsky was seen in a largely neutral light by the Western banks: few above the level of the front-office Russian specialists had heard of Khordakovsky, and in 1997–8 there was none of the contempt and hatred that was to come later. Siberian oil major Sibneft (along, effectively with national airline Aeroflot), on the other hand, fell to Boris Berezovsky, possibly most 'political' of the oligarchs. Berezovsky was the sort of figure who would be the one name apart from Yeltsin himself of whom the members of the average Western bank credit committee might have heard, but for all the wrong reasons. There was, and still is, a wholly unjustifiable level of antipathy in the West towards Berezovsky, fuelled by ill-informed articles in the *Moscow Times*, recirculated by the *Financial Times* and others who ought to know better. Aeroflot was widely reported to have been money-laundering $200 million of its overflight receivables by directing them through an offshore vehicle in Switzerland, FORUS, in 1998–9. In fact all it was doing was repaying a $200 million loan made by a group of Western banks and trading companies via FORUS to Aeroflot in late 1997.

Having been a lender to a number of Berezovsky companies through the crisis period, all I can say was that in the business dealings of these companies with the Western banks, they conducted themselves admirably. One might have wished, as a Western lender, that the Berezovsky empire had extended rather further to more of the Russian banks, which were soon to default on everybody from the Western lenders to the Russian small depositors. Mr Berezovsky may have played a rather over-active role in recent Russian politics for some tastes, but there can be no faulting the quality of the management teams he put in place in his companies, teams that, on the face of it at least, were left to get on with things and which could boast levels of corporate disclosure that would put to shame many enterprises in some of the more secretive Western jurisdictions such as Germany and Switzerland.

If Khordakovsky was neither loved nor hated, and Berezovsky was deemed a pariah, Vladimir Potanin, on the other hand, was the absolute darling of the Western investors, and in particular he was the darling of the Western investment bankers. They loved the way he was as young as they were. They loved the way he ruled an empire of Rockefeller proportions while still in his early thirties. He spoke English. He dressed Italian. He walked American. His primary vehicle was Unexim Bank, most favoured of the Russian banks, and Unexim made a fortune on borrowing at the finest rates achieved by Russian banks from their Western lenders, then investing the money in trading in GKOs. Potanin's spoils from the privatisation binge were oil major Sidanko and nickel goliath Norilsk. Norilsk sits on a deposit comprising 35% of the world's nickel reserves, and produces up to 50% of the world's palladium, a metal that has leapt to greatness in the last decade on the back of its major use as the principal element in automotive catalytic converters. Investment at Norilsk in the 1990s was so low that when the roof of one of the main buildings fell in owing to the weight of snow, workers simply pulled canvas over the hole and carried on working, with outside temperatures of 40 degrees below. This was the proverbial cash-cow, but the sexier prize was Sidanko. This was a true oil major, the sixth largest in Russia by production, among the top twenty in the world by reserves. Potanin put up a loan of 9 billion Roubles through Unexim, secured against the State's shareholding in Sidanko. When the state couldn't repay, in 1996, the rules said the shares should be auctioned to the highest bidder. The auction was run by Unexim Bank, which also by sheer good fortune made the winning bid. Potanin took control of Sidanko.

There was also a lot of foreign interest. When BP subsequently came in with $400 million to take a 10% equity stake (which meant, incidentally, that Potanin had already covered his acquisition costs by a factor of over four times), and famously parachuted three top BP executives into the key (as we all supposed at the time) boardroom posts of finance, operations and exploration, Sidanko looked like the pick of the bunch in the crowded field of Russian oil majors.

In 1997 Sidanko tapped the Western bank STCF market for 12-month prefinance, along the much-trodden path followed by the other Russian oil companies. This deal was if anything better than many of the rival propositions in that, for once, the offtaker (BP) played a prominent role in helping the deal get established and, best of all from the credit perspective, had not only equity in the producer but also what we all thought was 'management control'. The deal, led by Greenwich NatWest in the days of NatWest's ill-fated attempt to be an investment bank, followed the well-established formula for such deals, was a great success in syndication, and it ran like clockwork. However it was not the only thing Sidanko had been up to.

One of the harder things to do even now with Russian companies is to establish exactly what they have on their balance sheets. This difficulty is not just at the level of counting the fixed assets – how many oil wells, operational or otherwise, do they possess? – it also extends to what stakes they have in other companies and even what percentage they own of the actual operating units that are deemed to make up the company as a whole. Often a shareholding as low as 25% can control 50.1% of the voting rights, or shareholders with ostensibly minority holdings may have control over substantial further voting rights in trust on behalf of passive shareholders (like the State Property Fund) or through their own proxies (often incorporated in Cyprus or Switzerland). Actual control is a difficult thing to track. The Russian oil majors hold myriad shareholdings in the various Russian oil production assets and, in the mid-1990s, control of these changed hands a number of times, not always by mutual agreement. Sidanko as part of Potanin's empire had not been slow to grab what it could in the Russian oil bonanza, and one asset in particular was to prove controversial.

Chernogorneft was an oil production unit comprising one half of the giant Samotlor field, and was a substantial plank in the Sidanko organogram as a vertically integrated oil company. There was, however, a powerful school of thought that disputed whether it belonged to Sidanko at all. At an earlier stage it had belonged to NizhnevartovskNefteGas (NNG), the one substantial Russian oil company blacklisted by many of the Western banks over its handling of an unfortunate Dresdner Bank facility for an affiliated Isle of Man company in 1995. This facility was drawn down by the obligor in the Isle of Man. However, as part of an internal company dispute (the Isle of Man company was no Special Purpose Vehicle, but rather a semi-independent entity with substantial third party interests), the funds never reached NNG, with the result that NNG delivered no oil. With the deal unravelling fast, the unit on the Isle of Man, rumour control had it, was at the receiving end of an offer it couldn't refuse, and used the money to prefinance aluminium instead. The loan was repaid, though not exactly as envisaged by the Dresdner credit committee. Rumours as to what exactly had happened were legion, but the Western banking market moved on, while making a mental note to ensure that in future deals funds got through to the oil-producer in Russia, and another mental note not to deal with NNG again. When Sidanko lightened NNG's load by forcibly acquiring Chernogorneft, there were few tears shed by observers. By this time the NNG management had fallen into disarray, while the clean-cut Potanin was everybody's hero. However, when NNG's management was finally ousted, and the company acquired by the Alfa Group to become the

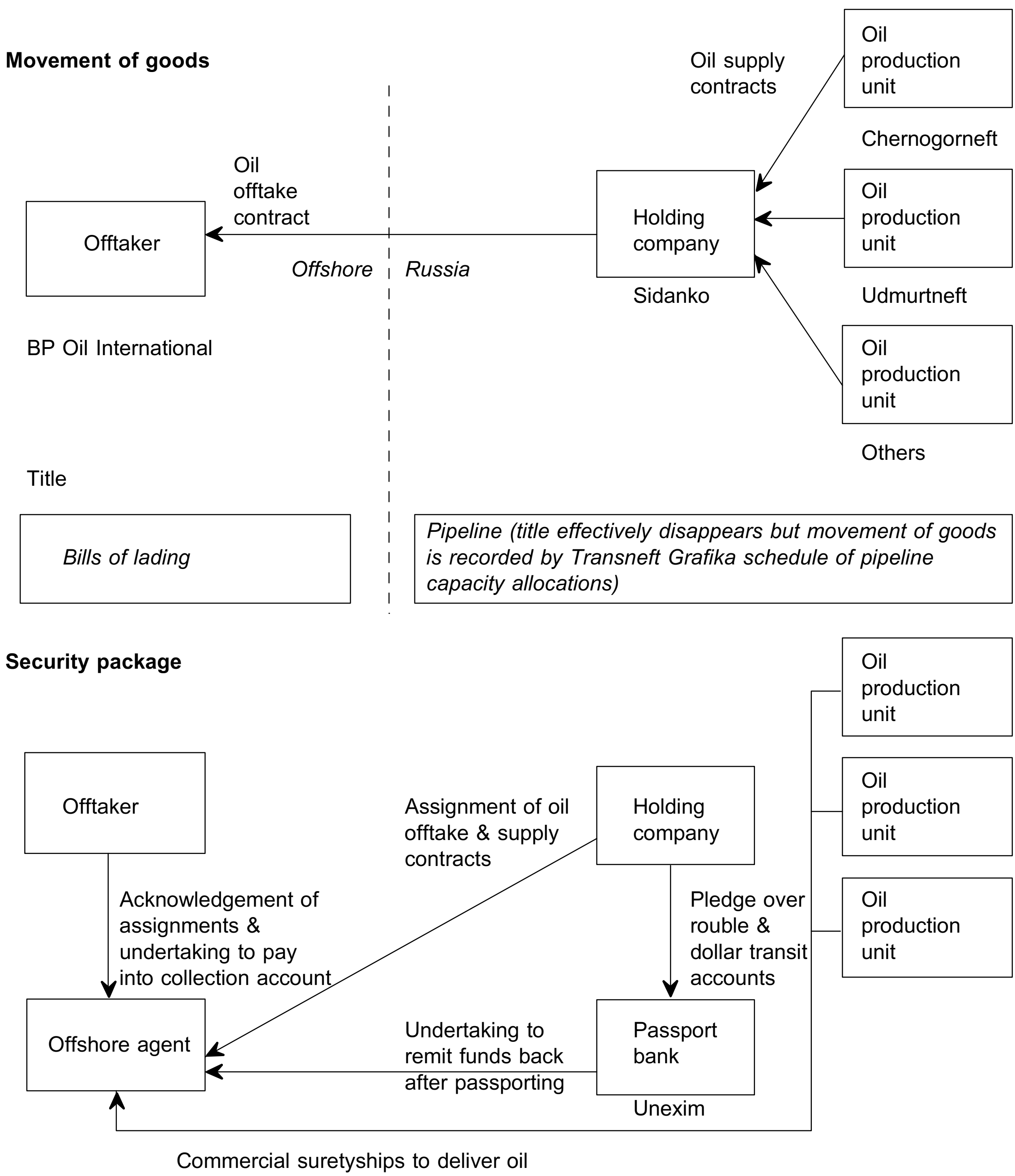

Figure 4.2 BP/Sidanko pre-export finance.

engine room of the Tyumen Oil Company (TNK), one of the attractions for the investors was a rather good-looking claim to Chernogorneft, to complement the other half of Samotlor to which NNG had managed to cling.

Following the success of the 12-month deal, in later 1997 Sidanko, BP and its Western banks began to look for medium-term finance (Fig. 4.2). We all agreed in the market at the time this was the logical next step, and there was no faulting either the strategy or the rationale behind it. BP did not need another cash-cow, what it wanted was access to Russian reserves, which were considerably greater in terms of years of Reserves to Production (R/P ratio) than those of the average Western oil major. While BP's then R/P ratio was a mere 10 years, and the Western industry average 14 years, the R/P of Sidanko, depending on who you believe, was anywhere between 24 years and 100 years. BP had a medium-term plan, and wanted the term of the finance to match the term of the plan. In practical terms, in 1997–8 for a Russian oil company, the best it was going to get was five years. The deal followed the same basic structure as the one-year Russian oil deals, but drawn out to this tenor. The passport bank was Unexim, group-related to Sidanko. Note that:

- Figure 4.2 is to a certain extent generic in nature, since the exact terms were disclosed only to the commercial counterparties.
- Pledges under Russian Law apply to property rather than assets, are generally not embraced with much confidence by lenders, and come under the category of 'nice to have' rather than really 'bankable'.

Unlike the Yukos deal, the arrangers had a very clear idea of what they were about, and most of them wanted to lock in and hold on to the relatively high pricing of medium-term Russian oil prefinance while they still could: even with the Russian oil industry's standard 3% margin for one year, seen throughout 1997 (and down from the 5% to 7% seen in 1995), this was still higher than the margin paid by Sonangol in Angola at the same time for its three year pre-finance deals despite the fact that the Angolans were in the middle of a 25-year-long civil war. There was a strong feeling among Western specialists that it would not be long before the STCF practitioners would kiss the Russian oil majors goodbye as the Russians went en masse across to the US capital markets along the path pioneered by Sibneft. There was the odd drop-out from the 12-month Sidanko deal, notably Deutsche Bank, which was reasonably close to BP and closer still to Russia, and unexpectedly declined the deal. I would love to report this was the result of clear-cut analytical forecasting and due diligence by Deutsche, but frankly it seems to have been based on the gut feeling in certain quarters that it was not yet ready for five years for a commercial Russian oil company (although it had already done eight years for Gazprom). On the whole, however, the deal was well supported by the

BP relationship banks, and the lenders for the most part were of the type of banks who understood these types of deals, and would sit them out to final maturity rather than seek only to sell them down.

It looked like a good deal, and it attracted a good bank group. Greenwich NatWest, Dresdner and Bayerische Hypotheken- und Wechsel-Bank underwrote the deal, and by the time it closed successfully in May 1998 the $175 million pre-export financing had a tenor of four and a half years. The margin, at 4.75%, was slightly inside the revised Yukos deal, but not significantly so, and generally it was accepted that with its BP and Potanin connections, Sidanko was a better risk anyway. It also helped that there had been no messing around with the price, and the banks entering the deal were able to feel happy that they had got 'a good deal'. The only hint that Sidanko might not have controlled quite as much of its balance sheet assets as it was leading everyone to believe was that, in the countdown to drawdown, as so often happens under pressure of time, a relatively large number of the 'conditions precedent' of the original term sheet were waived to become 'conditions subsequent'. This included a number of the conditions relating to the subsidiaries.

What went wrong?

Unfortunately, the gut feeling of the managers at Deutsche was not altogether wrong. When the Russian debt Moratorium hit, the first thing to happen was that the financial components of Potanin's Interros empire imploded spectacularly. Having made a killing on GKO trading for two years, Unexim Bank suddenly found it had enormous debts on one side of its balance sheet and effectively valueless assets on the other. Potanin's true colours started to show through. The Western and Russian creditors and investors alike were all promptly ditched. What decent assets there were in Unexim were stripped out and reincorporated in a new vehicle in St Petersburg. A half-hearted attempt by the Russian government to bail out key commercial banks of 'social importance' led to transfers from State-owned Sberbank washing straight through Unexim and out to allegedly group-related entities in Switzerland. The Sidanko deal continued, exempted along with the other prefinances from the Moratorium, but it was not to remain unaffected for long.

The oil price decline of 1998 and early 1999 did no favours to any of the oil-backed structures, but as discussed elsewhere, the real effect was only a matter of timing. If the oil price was really low, it was simply going to take longer to pay off the loan. The lenders were all experienced people (and institutions) and an oil price-driven delay alone would have been acceptable. What the lenders perhaps appreciated less well, as indeed most of us tend to gloss over in our analysis, was that in

Russia in particular there are significant dollar-denominated production and transportation costs that still have to be covered if oil is to be exported, whatever the level of the international oil price. In Russia, these difficult-to-avoid costs included regional and federal taxes, of which it was hardest to avoid the regional taxes since the Russian exporters were and are constrained to support large swathes of their local infrastructure thanks to the historical legacy of integrated industries maintaining their own roads, schools, hospitals and power generation, and the geographical imperative of the often remote areas in which they are so frequently located. The federal taxman generally was less often seen, but had more teeth since he could effectively do anything. Also important were the Transneft charges for access to the pipeline, set and payable in dollars, and an absolute priority payment if future access to the pipeline system was to be maintained.

Further, in a system of operating units and holding companies, the Russian majors had to pay their own subsidiaries for the crude oil. At $20 per barrel, these costs were manageable and prefinance worked fine. When the international price for Brent crude hit $10 per barrel, Rebco was achieving only $8.5 per barrel, and the dollar costs alone of the crude were only just being covered. Debt service therefore relied on using unencumbered barrels to subsidise the cashflow on the encumbered barrels. Yukos just about managed to maintain its debt service thanks to non-payment of wages, deferral of federal taxes and delaying payments to suppliers who could wait, but this route was harder to contemplate for a management team from BP, and cash was getting decidedly tight.

Sidanko had made the first few oil shipments as per schedule, and there was approximately $40 million from the resultant cashflow held by NatWest in London as the offshore agent. The small matter of the now-bankrupt Unexim Bank holding the passport for the deal meant that NatWest was unwilling to remit these funds to Russia for passporting, but on the other hand failure to passport would put Sidanko in trouble with the Russian authorities. In retrospect it was perhaps not the best idea to have a pure Russian bank as passport, but at the time everyone had seen Unexim as pick of the bunch, and Sidanko (and Potanin) had insisted. However, the matter was resolved by moving the passport to the Russian-incorporated subsidiary of Austrian bank RZB, which had a good relationship with most of the Western oil companies and banks, and which could be relied upon to play by the rules. The funds were passported and Sidanko continued to deliver. This operation meant that most of the time the lenders had at least $20 to 40 million of the $175 million they had advanced either in oil or in cash outside Russia.

Where Sidanko fell into more serious trouble was on the vexed question of Chernogorneft. The Alfa Group came through the Russian crisis rather well, both financially and reputationally. Lacking its own oligarch, it had always been squeezed out of the feeding frenzy in the GKO market by the oligarchs, with the result that its eponymous group bank was not seriously damaged by the meltdown. None of the Alfa Group companies used the Moratorium as an excuse to avoid their debts, and two years later were all still trading. This was its moment to press its claim against Sidanko to regain Chernogorneft for the now Alfa controlled oil producer TNK. It did this by the simple expedient of buying up Chernogorneft Rouble-denominated debt in the Russian domestic market. With Potanin strapped for cash as his bank collapsed and the oil price tanked, Chernogorneft was late in paying its rouble debt and TNK was able to sue Chernogorneft for bankruptcy.

It was more or less at this point that BP discovered that the much-vaunted ‘management control’ of Sidanko, which had featured so prominently in so many bank credit applications, was rather more ethereal than either it or anybody else had really bargained for. History does not record exactly what was going on inside Sidanko, but suffice to say that the company’s Russian majority was entirely capable of functioning quite happily in more or less complete disregard of the wishes of the three parachutists.

The ‘conditions subsequent’ were fast becoming ‘conditions impossible’, and the lenders found that the operating subsidiaries of Sidanko were not properly integrated into the holding company structure. The ‘commercial suretyships’, which the operating units were supposed to issue themselves to the lenders to guarantee delivery of goods to the lenders, were now found either not to be in the right form or not to be there at all. The lenders had exposed themselves to ‘holding company risk’ – the risk of lenders to a holding company being subordinated to direct creditors of the subsidiary operating companies in a group – because their claim is only through the equity stake of the holding company. This was a particular embarrassment for the STCF specialists at the lenders since the perils of holding company risk are taught on day 2 of the ‘junior banker’s introduction to basic credit analysis’ course, and should not, in theory at least, have caught out these experienced people. To be fair, this is precisely the sort of point that appears in the typical legal opinion on loan documentation as a disclaimer on page 6 of 17 pages of disclaimers to the two-paragraph opinion: the lawyers and the bankers alike will generally take at face value the statements, assertions, declarations, undertakings and covenants of the borrower, without enquiring further. If the borrower says he controls a subsidiary, and on paper he appears to have a controlling share of the voting rights, most lenders will be forgiven for believing him when he says the subsidiary’s suretyship will be available shortly after drawdown.

The difficulty was that without this key operating asset (Chernogorneft), the gross production of

Sidanko was cut by about 40%. On top of the oil price collapse this put the company in a perilous position. BP was forced to write off approximately 40% of its equity investment, and the lenders under the 4.5-year facility were in the invidious position of having to explain to their auditors and regulators why they should not take the same approach to a loan which was now looking like a seriously impaired asset in most books. The oil contract assigned to the facility was still performing, and the agent was able to maintain the offshore cash 'cushion', but funds sent to the passport bank were then allowed to remain with Sidanko to pay its tax, Transneft charges and 'subsidiary' crude oil suppliers. Potanin himself then put another subsidiary production unit, Urdamut, and Sidanko itself into bankruptcy as a defensive measure. The Sidanko medium-term prefinancing was not looking very pretty.

Bankruptcy remains something of an arcane process in Russia, where the penetration of Western corporate values and accounting ideas is still rather less than skin deep and the courts' attitude to the commercial code is more often than not the triumph of form over intent. Nevertheless it is possible, and if the creditor is himself a Russian entity, plausible, for such a creditor to force an auction of the bankrupt's assets, and to have the inside track to purchase or otherwise acquire these assets from the bankruptcy court. Unexim was debarred from its shareholding in Sidanko but title passed to Interros, Potanin's overall holding company. By May 1999, however, Sidanko itself was declared bankrupt by the Russian court and the lenders' position was looking decidedly difficult. The lenders and BP were not helped that Westdeutscheslandesbank (West LB), a participant in the deal, sold part of its stake to another Cyprus-based entity widely suspected to be a front for TNK. The Cyprus investors then proceeded to block any move by the lenders that required unanimity.

As the oil price climbed in 1999, the financial pressure began to come off the Russian oil companies, but Sidanko was still trapped in bankruptcy. TNK bid $176 million to buy Chernogorneft in a bankruptcy auction, and took the asset in November 1999, which did not go down too well with the Western shareholders. They retaliated by lobbying hard, and successfully, in Washington to block a US Exim loan to TNK which would have given TNK ten-year money at ECA rates, for upgrading its oilfield production. However, one thing to emerge from this action was a realisation for the first time at BP that Alfa/TNK were not necessarily the villains of the piece at Chernogorneft, and that perhaps they were both victims of Mr Potanin. By January 2000 BP had compromised with TNK over the Sidanko affair, with the result that the bankruptcy of Sidanko was lifted as creditors agreed a restructuring of a total of $460 million of debt. At this stage the lenders of the 'structured' deal appeared no better off than any other creditors. The same month a settlement was announced by which Sidanko's shareholders approved a 37.7% increase in the share capital, after which the BP (now BPAmoco) holding remained 10%, TNK emerged with a '25% plus one share' stake, while the holdings of Interros and Kantupan Holdings (a Cyprus-based investor widely believed to represent other Western shareholders) were diluted proportionately. Both BPAmoco and TNK now had blocking stakes, but under this settlement Chernogorneft was returned once more to Sidanko.

What of the structured \$175 million pre-export finance? With oil prices now at a level where this could be represented by a mere handful of cargoes, the loan was repaid two years early, in the summer of 2000. Sidanko paid cash. Did the structure work? Well, the lenders got repaid in full, and clearly the oil price recovery played its part in the eventual ease of that repayment, but it is perhaps an overstatement to say that the lenders' repayment had anything to do with the structure: in the end they got repaid out of the general liquidity of the borrower, just as the bankruptcy of the borrower had thwarted repayment. The structure that they had served them sufficiently well in the face of the Russian Moratorium itself: their problems were not directly caused by actions of the Russian State, and this was not failure from our normal great fear, political risk. Rather it was a combination of *commercial* problems that coalesced to render the structure ineffective.

Post mortem

What lessons can be learned from this? For one thing, the structure was severely stress-tested, and in other circumstances it might have survived rather better. To have a general moratorium, followed by a commodity price collapse, followed by the effective bankruptcy of the major shareholding group, including the onshore agent bank, followed by a hostile third party claiming and succeeding in carving out a production asset worth 40% of turnover, would be something of a test for any expert's best structure. It is difficult for anybody to claim 'I told you so' to a list of disasters of this length – not that this stopped certain colleagues in 1999. The structure was designed to cope with a moratorium and a price collapse. The bankruptcy of the major shareholder should not have mattered, and although having a group bank as passport bank was with hindsight an error, it was not an irretrievable one. Where the thing unravelled was in what happened after that (and in a sense, before that). There was a failure in the due diligence on the corporate structure, and in the enforcement of the conditions that had been agreed, which would have locked in independent obligations on the part of the operating units. The banks (and perhaps also BP) were to discover to their cost that Sidanko, as a holding company, did not exercise the control for which one might have wished over the entities that were nominally at least its operating 'subsidiaries'. Had a legally valid, binding and enforceable commercial suretyship been in place from Chernogorneft, it might not have mattered whether Chernogorneft belonged to Sidanko or to TNK. The problem, as the group splintered into its various bankruptcy actions, was that the lenders were unable to get to the additional oil that was meant to repay them. The lenders had simply not perfected title to their collateral.

What of the other 60% of the production? As we have seen, the oil contract itself did perform, but the problem was that with the very low oil price and the stubbornly high production and transit costs, there was absolutely nothing left for debt service. Even in bankruptcy, an oil producer protected from its creditors does not stop producing and exporting oil, and most credit analysts would accept that oil contracts with the big oil majors are generally a priority item on which producers default at their peril. Unfortunately, the involvement of BP as an equity investor in the producer worked against the structure here. BP as manager of Sidanko was not able to defer certain items, as the Russian companies were. Also it was an 'interested party', so under another quirk of the Russian legal system its votes did not count towards the Board resolutions of either Sidanko or the subsidiaries when it came to trying to get matters resolved and the debt serviced. Sidanko was left trapped with the costs of exporting the oil barely covered by the export price, no additional oil available or forthcoming and therefore no free cashflow from which to cover the debts.

Other structural weaknesses? The major obvious one is the lack of a commodity price floor for a medium-term deal. There is no doubt that the oil price collapse in early 1999 made life very difficult for everybody, and this could have been avoided by this relatively straightforward measure. However, as discussed above, a hedge pledged to the structure is usually a very tough sell to the average borrower, and all the banks here felt lucky to have got into such an otherwise well-structured deal with such good counterparties, against increasing competition from the US investment banks. It might be said that to have an oil price hedge when the borrower is being torn apart by creditors is akin to having a state-of-the-art fire-extinguishing system on board the *Titanic*, but blessed with our infallible hindsight we could also observe that the borrower might have been better able to preserve itself against these other creditors had it had some protection from the outright collapse in price of its product. Other Russian oil companies (notably TNK) have managed to get their oil exports hedged by using the group-related offshore trader (which so many Russian exporters now possess) to do the hedging for them (so not upsetting the Russian courts). This is not to say, however, that they would accept pledging such a hedge to a prefinance facility.

As we say elsewhere, structures only work if they are properly set up and properly enforced. In this case the structure the lending banks had on the term sheet and in their credit analysis was rather more than the structure they actually had in place at drawdown. Their willingness to concede conditions precedent and their lack of attention to the corporate structure of the borrower meant they were rendered unable to enforce their structure, certainly unable to rely on getting the oil to get repaid, and thus fell into a number of straight credit pitfalls recognisable to any bank credit analyst of plain vanilla corporate loans: they had holding company risk, they had a shareholder who had a known record of sharp practices and who would betray them, they had a balance sheet lending-style exposure to third party creditors, and in 1999, thanks to a rock-bottom oil price and hostile third party action, they had a bankrupt borrower bereft of liquidity. Hindsight, as we have said, is a wonderful thing.

What did the lenders do right? Well, as it happens, quite a lot. For one thing, they might have made a mistake about Potanin but they had chosen the right partner in BP. A 'good' deal sponsor is worth a dozen borrower's covenants. BP's equity role may have been a tactical handicap, but the eventual solution to the lender's problems came because BP cut a deal to serve its own purposes but which also led to repayment for the banks. This may surprise some people, but when the chips are down, not all deal sponsors (by which I normally mean the Western offtakers of the goods produced in the Emerging Market) look after their banks. Some cannot afford to; for others, it is sufficient that they save their own positions. Those that do look after their banks are generally known as 'good' deal sponsors (at least by banks!), and this is something which should be recognised and encouraged speaking as a banker. The role of BP as offtaker for the transaction was one of the original attractions of the deal and, as described in our product review, the offtaker should generally be a credit enhancement rather than an additional challenge. In this instance, the presence of BP in the deal was very much a credit enhancement and remained so to the end.

Secondly, the lenders stuck with it. Anyone who sold out in late 1998 or 1999, as banks are increasingly wont to do, would have been lucky to see more than a few cents on the dollar. Defaulted Unexim debt briefly made it to 20 cents on the dollar after some discovered that certain Russian entities, rumoured to be fronting for Potanin, were buying Unexim paper, but generally if you saw more than 7 cents on the dollar you would be doing pretty well. By holding on to their deal, the lenders in the end saw full recovery of principal and interest. The moral of this story is 'don't panic'.

Thirdly, the lenders worked at the deal, together with the offtaker, to get a solution. In the end, even the best structure is about ammunition, of either the carrot or stick variety. How many carrots can you offer the people whom you need to achieve repayment? How big is your stick (and if it breaks, do you have a spare one)? It was said that Dresdner and NatWest worked quite hard towards the eventual settlement, and most of the rest at least didn't get in the way. Only West LB was seen to be obstructive, but then West LB was also a house bank to TNK and clearly had broader interests than the other lenders.

So, can we say the structure passed the acid test? The verdict has to be negative, but it didn't work because vital parts of the originally intended structure were simply not there. There are both villains and mistakes in this story, but even so, in view of the eventual outcome, it is hard to say that the original premise of the deal was not a good one: a good deal flawed in execution, ruined by misrepresentation and redeemed by one of its credit enhancements.

SOLO INDUSTRIES

The deal

A short case study this time (in fact two of them), since the structure under these circumstances is a little academic. Solo Industries Ltd was a Dubai-based metal-basher that claimed a track record of production of non-ferrous metals and alloys dating back to the 1920s. According to its website (the home page of which was still accessible at the time of writing) it occupied 140,000 square feet near Sharjah and produced 33,000 tons of metal (mainly aluminium in various forms) from nine smelting circuits. By the 1990s Solo was an offshoot of the Indian group Hamco, with an 18-year track record built originally on the import/export trade between the Persian Gulf and India. The owner of Solo was the educated and articulate Madev Patel, whose father owned Hamco.

Solo generally sold to its clients and to the group in India against letters of credit (L/Cs), of which Solo was the beneficiary. Many of these L/Cs were deferred payment, meaning that Solo had granted the buyer of their goods credit. Given that the L/C issuing banks were in the main first-class international banks, such as Citibank, ABN Amro, Barclays and so on, the main type of facility enjoyed by Solo was for discounting these L/Cs without recourse (i.e. forfaiting them) on a 'borrowing base' basis (i.e. pooling incoming L/Cs to provide a 'borrowing base', against which value funds would be advanced), to provide immediate cash ahead of the individual L/Cs actually becoming due and payable. It is not generally deemed to be a high-risk transaction to discount Citibank or ABN Amro L/Cs, and so Solo was popular with banks seeking this business.

Standard Bank of London Ltd put up a 3 years 4 month medium-term tin prepayment finance loan in September 1997 for Solo Industries Ltd, 100% guaranteed by Hamco Mining and Smelting Co. Ltd of India (Fig. 4.3). The actual producer of the tin ingots was Drayva Industrial Chemicals Ltd, whose performance risk was 50% covered by a Canara Bank (of India) performance guarantee. Canara Bank is a modestly-sized but well-known Indian bank, and many of the Western lenders would have found such a guarantee a useful part of the structure. Nevertheless the cashflow was offshore, and lenders were told they could look at the Indian country risk on a performance basis only, if they wanted to disregard the Canara guarantee. A number of banks will give a structured deal a lower country line impact to reflect the additional risk mitigation, so it may have been the intention of Standard Bank only to have a 50% performance guarantee (as opposed to a 100% guarantee) so as not to present a purely Indian payment risk. Equally, it could just have been a matter of pricing.

The metal was to be of LME specification, meaning that it was good liquid collateral which the lenders should not find too difficult to dispose of should they need so to do. Structurally the tin contract was to deliver regular monthly shipments of 200 mt each, which should not have been a challenging amount, leading to straight-line amortisation over 36 months from February 1998. The tin contract was assigned to the facility, the goods were insured and the facility agent was named as First Loss Payee. The eventual offtaker was Sogem, the physical trading company then related to Belgium's Union Minière, and group-related to LME ring-dealer Sogemin. This was and is a good address, again well known to the lenders and so an acceptable payment risk. Sogem was due to pay for the metal into a dedicated offshore collection account that was pledged to the facility agent. The whole facility was in the name of Solo, fully guaranteed by its Indian parent Hamco. The structure looked good,

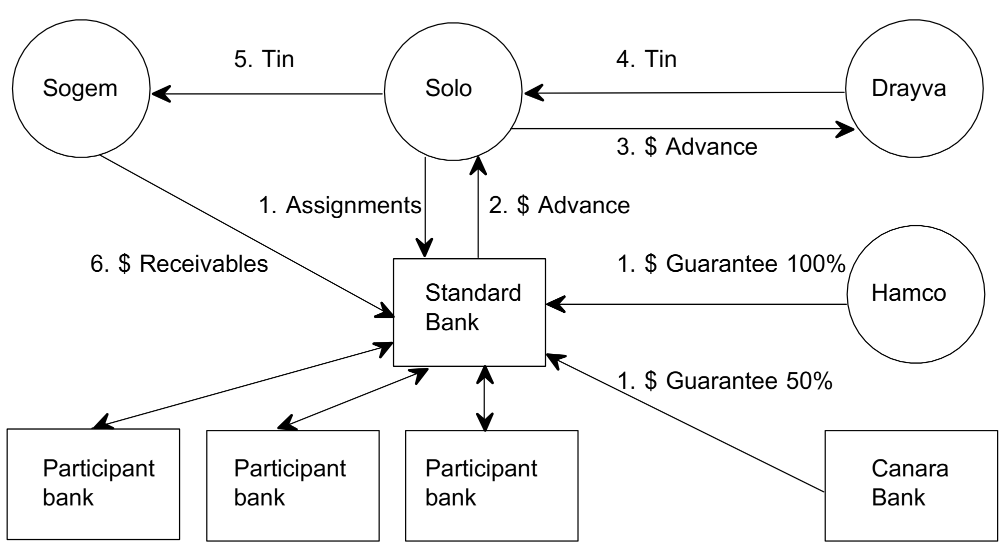

Figure 4.3 Standard Bank/Solo prefinance.

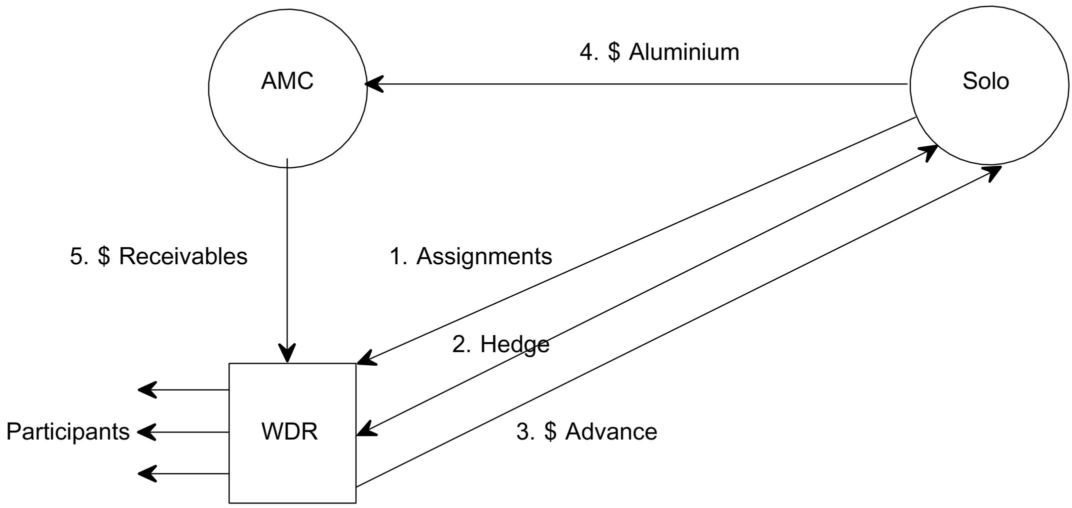

Figure 4.4 WDR/Solo prefinance.

pricing was rather on the thin side, but not wildly out of touch with typical Indian pricing at that time, and the whole facility drew late in 1997 at $20 million.

Not long after, Warburg Dillon Read (WDR – the former Swiss Bank Corp) beat off stiff competition for the mandate to put up a three-year preshipment finance facility backed by aluminium alloy contracts with Amalgamated Metal Corp. (AMC), the metal trading company then part of Germany's Preussag (Fig. 4.4). Again, AMC is a respectable trading company whose only involvement in the transaction was that it was contractually bound to buy the goods if they turned up, and those contracts were assigned by Solo to the agent bank on behalf of the lenders. Another useful feature of the structure was a floor option provided by WDR to hedge the export value of the aluminium alloy. Again the risk analysis looked good. The payment risk was on AMC and therefore acceptable to the agent bank and lenders. The commodity price risk was taken care of by the floor option. Again, the export contract was assigned and the Agent's Collection Account pledged.

On paper the performance risk, this time on Solo itself, looked sound. Solo had a certificate for ISO 9002, the international quality standard. It was an associate member of the LME, which is generally a well-regulated exchange known for the stringency of its inspections of the so-called 'LME warehouses' (which in fact belong to various third party warehouse companies), where the physical metal to be delivered on to the market is stored. LME membership, even at 'associate' level, confers a certain respectability and says 'this is an established player in the metals market'. Solo was a reasonably well-known name from its discounting/forfaiting facilities, and from the Standard Bank-structured deal, so there was a sense in which Solo and its associated companies were getting a good name in this market. The balance sheet, such as it was (for there were no consolidated group figures), showed gearing to be a little high, but lenders would know that most of this debt was backed by incoming L/Cs and so the debt could be deemed 'self-liquidating'.

Looking at both these deals at the time, and having regularly worked with both Standard Bank and the former Swiss Bank Corp (before it became WDR), both of whom knew exactly how to structure this type of deal, the only thing wrong with either of them really, as presented on paper in the London market, was that the pricing was below the 'Petrobras' hurdle. This is the argument that says why do a full metal jacket structured trade transaction with the Mother of All Documentation, a significant operational burden and not insignificant risk, for a Gulf metal-basher whom we don't know, when at the same time you could get almost twice the price on plain vanilla import finance for Petrobras? Yes, Petrobras' import deals have no structure beyond good documentary evidence of the import shipment, but a clearly identifiable import is a great help in a moratorium, a Petrobras Payment Undertaking is a better credit than a dozen Solos, and such a deal was a lot less work if you had the credit lines available. Obviously Petrobras pricing waxes and wanes with the fortunes of the Emerging Markets in general and of Brazil in particular, but as a rule of thumb it is not a bad threshold. Nevertheless there are many who will go into a well-structured deal whatever the price, in the interests of a balanced and diverse portfolio (how else does Ghana's annual Cocobod prefinancing get away with pricing at the bottom end of ridiculously cheap?).

The Solo deals were billed as the first medium-term financing for a private commercial borrower in the UAE. WDR, like Standard Bank before it, was an experienced house for structured deals, and the WDR deal also sold well (bearing in mind few institutions have large lines for Dubai), closing at \$18 million, with several banks participating with amounts in the \$1 to \$5 million bracket. All Solo had to do was perform.

What went wrong?

The problem was that Solo didn't perform. It was using the funds to keep aloft a merry-go-round of debt, mostly on the back of discounting L/Cs which would never be drawn. Hardly anything was ever shipped. As L/C's fell away unutilised, they would be replaced with new ones to preserve the borrowing base, but the whole edifice was built on a shifting sand of fictitious imports and exports. In the summer of 1998 Canara Bank began to smell a rat and pulled its guarantee to Standard Bank. In August and September 1998 the London-based banks were really too tied up with the Russian crisis to worry about Solo, but by the time the music stopped, and Mr Patel had fled in May 1999, he left behind him a $300 million shortfall in Dubai and between $600 and $700 million in India. The litigation, particularly concerning which L/Cs are payable and which are not, continues to the time of writing.

Rather incredibly, lenders have subsequently discovered that this huge mountain of debt, including all the L/C-backed facilities, was achieved on a turnover that in reality was no more than $20 million. Creditors are now claiming that 85% to 90% of transactions were simply fictitious. Lenders say they were discouraged from proper due diligence, but of course in most facilities everyone relies on the agent, and the agent often relies on what he gets in writing. The page of disclaimers at the start of every information memorandum, and the tens of pages of disclaimers at the end of every legal opinion you will ever read, are not there for nothing. As we have seen, there were no consolidated accounts for the various parts of the empire, and now the reason why was becoming clear. Representations made to auditors and creditors alike created an impression that allegedly was far removed from the brutal reality. The true level of debt and the cross-commitments with India were simply denied. The merry-go-round had come badly unstuck.

Post mortem

What do we learn from this? There was little wrong with the structures *per se*. There was no failure through political risk. The deals fell down purely and simply because of fraud. One is tempted to observe that the type of performance risk structures we use to mitigate the nastier country risks perhaps lull us into a false sense of security about the commercial risks that remain, but remain they do, and they will rise up and bite the unwary creditor who ignores them. If you are going to do a performance risk deal, you need to be absolutely certain that the obligor has the ability, and in many cases the will, to perform. Further, you need to be sure that his ability to perform is not threatened by the overall level of debt.

What could have been done about the fraud? Fraud is often in the eye of the beholder. In similar circumstances I have sat with various fraud experts all of whom have told me ‘oh yes I could see straight away from the Bills of Lading/Inspection Certificates/Phytosanitary Certificate/Colour of the Moon etc. that this was a fraudulent transaction . . .’ All I can say, having served my time processing shipping documents, is that I have a lot of sympathy for those who look at documents and are led to accept them at their face value (as, it seems, does the International Chamber of Commerce from the way the 'Uniform Customs and Practices' are drafted to absolve banks dealing with transport documents from doing any more than looking to see if, on their face, they 'appear genuine'). Lenders were not given a clear picture by Solo and were actively discouraged from trying to establish one. A good third party technical report from an independent specialist company on the mine/plant/smelter/mill is always a help, but I am also inclined always to go to have a look at what we are financing, to make up my own mind, and I budget for travel on that basis. I do not possess the skills to go into an aluminium smelter or mine and know exactly what they are doing, but there is often a world of difference between what one hears in a bank's offices in London and what one might see and hear on the ground in Sharjah, and it concentrates the mind. Of course, most of us would also expect the Agent to have done the on-the-ground inspection, and even so the Agent may be misled. The moral of the story has to be simply 'beware fraud'.

OLVEPAR

This is one of two Brazilian case studies, each of which illustrates different perils that may not be entirely covered by the typical structure applied to this market. Again Brazil has its own market norms, and it might help to outline these before considering the transactions in detail.

Brazilian prepayment finance has become a reasonably well-trodden path in recent years, and the sheer size of this commodity-exporting giant means that there are large numbers of such deals in the market at any one time. One Brazilian commercial sugar exporter (Copersucar) alone produces more sugar than the whole of Cuba. Brazil is a big country with some very big trade flows. The major difference between Brazil and say, Russia, is that the Brazilian commodity exporters are more often than not family-owned enterprises or co-operatives or family concerns that have been operating under a civil law commercial code for many years. It is entirely possible for these companies to go bankrupt within a reasonably short time horizon, unlike the parastatal producers of other countries, and in many ways unlike the oligarch-dominated Russian producers for whom bankruptcy still seems to be little more than an extension of politics by other means. With monotonous regularity, Brazilian producers, without actually going bankrupt, seek protection from their lenders and creditors with help from the Brazilian courts, and it is fair to say that a big foreign bank in a Brazilian court will enjoy less sympathy than a big local employer.

The most common Brazilian deals seen in the European markets are the soft commodity prefinances, made by banks and the large international trading companies, making a prepayment for future

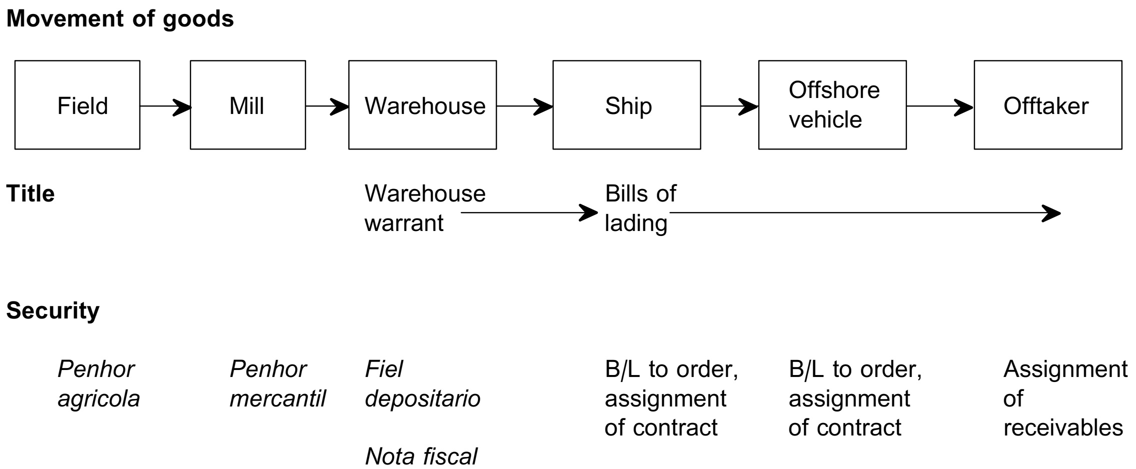

Figure 4.5 The typical Brazilian pre-*pagiemento* deal.

exports (Fig. 4.5). The security package sounds formidable. The producer grants a *penhor mercantil* or a *penhor mercantil y agricola* (an agricultural pledge) over goods typically still growing in the field (possibly even over the seeds supplied to the growers). This is supported by a *fiel depositario* (a sort of personal guarantee that goods are in a warehouse), typically backed up by signing over the warehouse warrant ('warrant' may actually be a strong word for what you are actually getting from the warehouse company, many of which are group-related to the producer, and this document should not be seen in the same light as the eponymous item found in Rotterdam, Hamburg or Le Havre) to the lender. The producer and his shareholders (and in these cynical times, usually also their spouses) are required to counterguarantee the company promissory notes evidencing the principal and the interest, or else provide their separate personal guarantee. Finally, the producer assigns the export contract to the financing, and allows the cashflow to be routed through an offshore collection account.

Typically, the producer also wants it routed through its offshore group-related trading company, which will be incorporated somewhere in the Netherlands Antilles, to make the transaction as tax-efficient as possible (Fig 4.6). The pledges and assignments are all registered with both the Brazilian Central Bank and the local commercial register, and allegedly infringement of, for example, the *fiel depositario* (i.e. guaranteeing the goods are in the warehouse when they are not) is a criminal offence punishable by jail. In theory the whole production chain, from seed through field, warehouse, bill of lading and finally cash can be attached, secured and ringfenced to protect the creditor (being either the lender or the offtaker).

Goods are insured throughout, typically naming lending bank/lending offtaker as First-Loss Payee

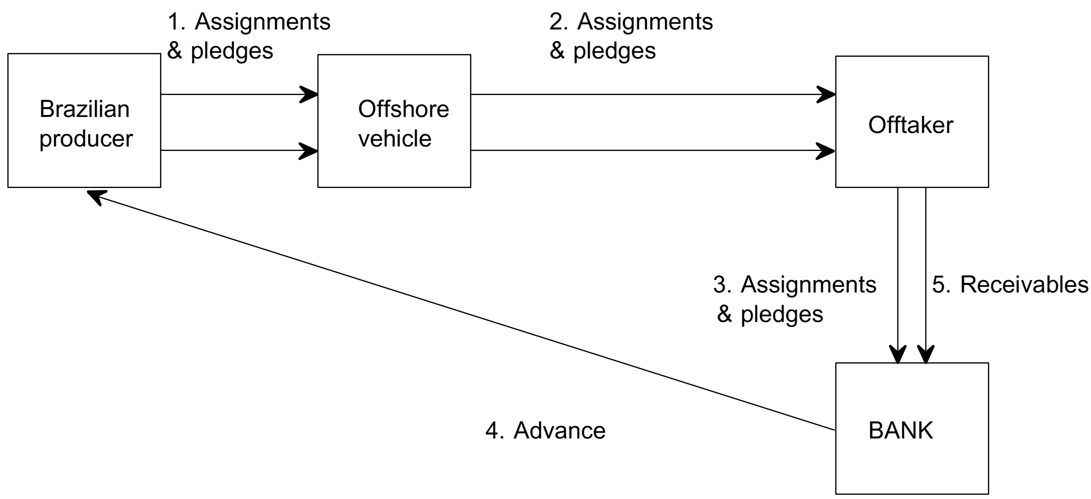

Figure 4.6 Financial structure of the typical Brazilian pre-*pagiemento* deal.

(less typically, but desirably, the insurance certificate is endorsed to the order of the lending bank/ lending offtaker).

The Brazilians will usually ask for drawdown to be made to the offshore vehicle, in, for example, Aruba. This is generally resisted by lenders, who want to be able to prove to the Central Bank that the funds actually entered Brazil.

The deals

The first Brazilian case study is Oleos Vegetais do Parana SA ('Olvepar'), a medium-sized soya producer founded in the 1970s and based in Central-South Brazil. Three deals involving Olvepar are of interest. Olvepar was in the London market looking for prefinance in the second half of 1997 at the same time as the ill-fated Ovetril, which offered virtually the same prefinance structure but rather inexplicably wanted the money some months before it was due to pay for anything (first rule of soft commodity prefinance: if the purpose is crop finance – as opposed to a medium-term requirement – find out when the season is and when producers normally need to borrow). Ovetril indeed got its deal, drew down and used the money to buy Brazilian Government bonds, which were then paying a spectacularly high rate of interest thanks to the global credit squeeze that arose towards the end of that year. Sadly, both the bond and currency markets turned against Ovetril, and it made substantial losses before it could actually use the money to prefinance the crop (a story which will also sound familiar to creditors of Tatneft, the Russian oil company, or indeed creditors of pretty much any Russian bank in 1998).

Olvepar, by contrast, came across as refreshingly naive in its approach. Olvepar was controlled by the Crestani and Consoli families. The headquarters was in Curitiba, but the group had operations spread over four Brazilian states, which gave it some geographic protection from crop risks. The principal activity was processing soya for export, so although the group also grew a little of its own soya, most was simply bought in from farmers, who would typically be bound to Olvepar by the latter supplying the seeds from which the crop was to be grown. Olvepar handled about 1 million mt of soya beans a year, into processed soybean, soybean meal, soybean pellets, soybean oil and other derivatives. Olvepar had an offshore trading company subsidiary, Conny Holding AVV, which was 100% owned and controlled, incorporated in Curaçao, and it routed all its export contracts through Conny. This was not a great challenge because in practice Conny could be ringfenced from the cashflow, and the contracts were back-to-back in everything except price. For the lenders, cashflow would come direct from the final offtaker.

Initially Olvepar did not have a dedicated offtaker in mind. It had been selling for some time to Louis Dreyfus, Andre, Cargill and Glencore but none of these seems to have provided prefinance, or if they did, by the end of 1997 Olvepar wanted to try its own hand at obtaining offshore finance. It went to and was financed by Banco Santander, London, which gained credit approval in October 1997 for a prepayment structure with an initial grace period to be followed by amortisation from April to the following October, for $9 million. The start of the harvest was February, while the export season runs April through to November/December depending on the product. The forward price curve of soya was negative, so the loan to value (LTV) ratio was set relatively low at 65%. Santander asked Glencore Grains in Rotterdam to act as offtaker, as a high-quality payment risk for whom it had established credit appetite, and as a very experienced hand in Brazilian (and other) prefinance. This was not a Glencore deal, and Glencore took no risk share, but from the bank's perspective its presence in the deal was a plus. To help identify the transaction cashflow, the deal was structured on a red-claused Letter of Credit basis, not because it was felt necessary to make Glencore pay by L/C, but because Glencore's turnover was huge and this was a very small deal from its point of view: the L/C route was an easy way to identify such a small deal in among all Glencore's automated payments, so that the cashflow would come back through the collection account.

The structure included all that one could ask for in Brazil, including *penhor mercantil*, shareholders' guarantee on the promissory notes, shareholders' personal liability for the *fiel depositario*, collateral over soya in warehouse from day 1 and throughout the harvest period (allegedly from stocks) followed by control and pledge over the goods right up to the point where Glencore was due to pay for them. The Olvepar offshore unit Conny was indeed ringfenced, and the bank issued a back-to-back L/C from Conny to Olvepar, so that Conny could be the beneficiary of the Glencore red clause, and in turn Olvepar could receive an identical advance from Conny. This allowed the bank to ensure that drawdown was made direct into Brazil. When the shipments came in the opposite direction, shipping documents were to be provided to the bank in the name of Olvepar, which would them accept them on behalf of Conny; then the bank would add the Conny invoice to Glencore (from a presupplied stack of blanks) to present to Glencore in Rotterdam.

What went wrong?

Olvepar was a very co-operative borrower from the lenders' point of view, and contested very little of the facility documentation, which was consequently robust (drawn up by Lovell White Durrant). To some extent this seemed to be a result of the finance manager's complete inability to speak or read English, which might be deemed a handicap when signing English Law/English language documentation. Santander as a rule liked to distribute at least part of any asset, and the deal was offered on a 50/50 basis to Société Générale in Paris. The colleague there gained credit approval but withdrew because he didn't like the documentation, which he felt was 'too strong' in favour of the lenders. These must be unique grounds on which to reject a structured deal, but *c'est la vie*. The deal was at the same time offered to Erste Bank in London, another experienced player in this market, and one favoured by arranging banks because typically it does not seek to run deals itself, but it does know what it is doing and will contribute to the overall process. Erste Bank signed up, and the deal was on as a two-bank club.

However, the achievement of the Conditions Precedent took considerable time and did not inspire confidence. It was not a question of Olvepar not signing everything put in front of it: it agreed to everything demanded. To be precise, it didn't sign it all at the first attempt. The loan documentation was prepared in London, then put together with the Brazilian components and the whole thing sent to Curitiba. There Olvepar turned round the complete package of hard copy loan documentation and sent it back from Brazil to London, having only signed part of it, with the result that it had to be returned again to Brazil and the signatories brought down to the coast to sign the remainder, before returning it again to Europe (an exercise that cost three weeks). Other Conditions Precedent took even longer. The idea that Olvepar was going to pledge soya, in-store, from day 1 turned out not to be the case. Olvepar agreed the documentation with the lawyers confirming the presence of the soya and pledging it over to the agent. It was not, however, able to supply warehouse warrants or even receipts. When challenged, it replied that of course there wasn't any soya *yet*, because the harvest had only just begun, but as soon as there was some, of course it would go into the warehouse and be pledged to the agent, no problem. However, all was not lost. It is generally not customary anyway to have inventory ahead of the harvest (so this was not a major condition for the lenders) and so close to the delivery schedule – the lenders in the end were looking at less than one month before the soya would be flowing anyway. The facility documentation was signed by December 1997, but it was not until late February 1998 that all the conditions precedent were finally in place, and early March before drawdown could be achieved. In practice the first shipment was due within three weeks of the drawdown.

There was a further problem, though, when it came to the first shipment. Right on cue, Olvepar contacted the agent to tell it that the first shipment had been loaded and that the shipping documents had been sent to the bank. Some days later, the documents had still not arrived, and neither the agent nor the offtaker had any idea where the documents were. It was established that in fact the documents had been sent to 'the bank' in São Paulo rather than London. More days passed as Santander do Brasil was turned upside down. Still no shipping documents. The subsequent telephone call to Olvepar went something like this:

Agent: 'Exactly which bank did you send the shipping documents to?'
Olvepar: 'Oh, we sent them to ABN Amro São Paulo.'
Agent: 'Why did you do that?'
Olvepar: 'Well, we always send them to ABN Amro, they're our bank!'

It was with a certain amount of relief at Santander that it was established that the goods had not also been pledged to ABN Amro and that Olvepar could retrieve the documents from the Dutch, who had been wondering no doubt exactly what they were expected to do with them. The documents were duly retrieved and thereafter things ran rather better. Santander kept up local inspections and visits from the London office to make its presence felt. The price of soya declined during the course of 1998. Santander's middle office calculated that more soya would need to be delivered to maintain the collateral levels (as allowed under the facility documentation), and in the meantime it started to retain higher percentages of individual cargoes to make the amortisations (the 65% LTV giving it quite a cushion). There was no argument about the increase from Olvepar, but the price eventually stabilised so that the LTV cushion was sufficient to achieve repayment.

In the end the facility ran well and was repaid exactly on time in October 1998. The experience from the lenders' point of view was that perhaps Olvepar was a bit too naive for this type of product, and that the limited capacity available to take Brazilian risk might be better deployed on more robust counterparties. The Emerging Markets crisis was also beginning to bite deep at this stage, and there was widespread fear that, after Russia, Brazil would be next. The 'Petrobras hurdle' (see the Solo case study) was over 4% p.a. for 12-month risk, where the first Olvepar facility had seen a margin of 1.75% p.a. less than 12 months earlier. Finally, the local colleagues of Banco Santander Brasil could see the direction in which soya crushing margins were going, and they declined to support any further deals for soya exporters. The result was that Santander London did not renew the facility.

Société Générale, however, took a more robust view of the protection offered to lenders by such structures in a crisis, and continued to write business. Eventually it put up its own two-year deal for Olvepar from its New York office, seeking to build on the previous year's one-year deal. The new facility drew in early 1999. Again it had the classic Brazilian pre-*pagiemento* structure based on offtake contracts with Andre, the large Swiss trading group, and Tradigrain, another Swiss trading group. They were looking at a time horizon which would take them through two crop cycles. There is nothing necessarily wrong with this. Although it is often held that soft commodities should only be prefinanced one crop at a time, in practice most soft commodities undergo at least some processing or milling in the country of origin. This gives rise to a capital expenditure requirement that should be financed on a longer-term basis. Olvepar's immediate difficulty was that it was investing in additional soybean oil refinery capacity (Olvepar Aliementos), but was having to finance this medium-term capex investment on a short-term basis. Société Générale offered it two years' finance (at least better than one), but only for $20 million. The rest was financed from short-term local debt raised in Brazil (principally from Banco do Brasil, Banco Itau and HSBC Brasil).

In August 1999, with the pressure now easing off Brazil, Andre came up with its own deal. It initially proposed an $80 million/15 month syndicated facility for Olvepar based on its offtake contract with Conny, guaranteed by Olvepar, and sounded out banks on this basis in September. In the manner of many of the very large international traders these days, the arranger was to be Andre itself, in the person of its in-house structured trade finance unit. It had Crédit Agricole Indosuez, New York, lined up as agent bank and co-arranger. Again these were both experienced addresses, and the proposal looked very good on paper. Perhaps Andre had a similar experience to Santander when dealing with Olvepar, for this was to be very much a full metal jacket structure, with mortgages over assets, pledges over the crop and, over goods in warehouse, and control over all movement in between. The structure had multiple collateral, multiple risk mitigants and specialist collateral management company Audit Control & Expertise (ACE) of Geneva controlling the movement and quality of goods throughout. This was to be one of ACE's first contracts outside Africa, where this group had most of its business, and it is probably the case that ACE's brand of micro-collateral management of commodity collateral came as something of a shock to the Brazilians.

The Facility soon shrank to $68 million, but finally the Full Metal Jacket structure including field management was looking unobtainable as Olvepar failed to co-operate with the demands of ACE. However, ACE was not in a strong position, since the entity in the driving seat for the deal was not the Bank, which might have been expected to have taken the conservative view, but rather the Offtaker, which wanted a commercial solution. Rather than back the detailed demands of ACE, Andre, like Santander before it, decided to focus on the commercially attainable, to drop the deal down to $36 million, and to fund on the basis of the mortgages over fixed assets and the assignments of contract. Again, there is nothing specifically wrong with that, but the difference was that drawdown at $36 million was still substantially in excess of Olvepar's actual working capital need (estimated at the time at $1.2 million per month), it was now drawn down some months prior to first shipment, and with ACE now distanced from the collateral management, either Andre or Crédit Agricole Indosuez would have needed to step up monitoring, which may not have been planned earlier.

At the same time the shareholders in Olvepar had come to the conclusion that their long-standing, non-English-speaking, financial management was not really up to the task of representing the interests of the company in the face of the increasingly stringent demands of the foreign lenders. The foreign money was cheaper than the local variety, but there was a price to be paid in the wholesale commitment of all the group's (and shareholders') assets and resources to the financing. The result was that the former finance manager was replaced by a new man recruited from Cargill, who brought with him a new team drawn from the market. Foreign lenders saw this as a broadly positive move which promised greater professionalism in the execution of the prefinance structures. Local lenders, however, were appalled and saw the move as a sure sign something was deeply wrong within Olvepar. A new audit of the group from new, more stringent, auditors was instigated: opinion is divided on whether this was the idea of the new management or at the insistence of the local banks. Either way, gone were the cosy relationships of the previous financial management with their auditors and bankers. Instead, here was a financial management with no interest in defending the practices of the past, but no friends either to protect them from the inevitable fallout.

And fallout there indeed was. Andre, Crédit Agricole Indosuez and ACE found the new management even more obstructive than the previous incumbents had been chaotic. The good news was that there were some deliveries from March 2000, and the facility began to amortise. However, the new auditors set substantial new provisions in the balance sheet. Added to this was the increased burden of short-term unsecured debt matched with a medium-term capital investment programme. Worse, low soya product prices meant that crushing margins were actually negative, and Olvepar had allegedly been 'buying performance' from the market (i.e. buying soya products from the market and delivering these against its contracts, instead of crushing and processing the raw soybeans themselves), at least until it ran out of cash. The farmers who grew the soya were supplying on credit terms, and had not been paid. Under such circumstances collateral over warehouse stocks was illusory, for the farmers would have a claim to the stocks that would look good in front of a Brazilian court. At this stage the local banks took fright and pulled their credit lines because of the looming liquidity squeeze. The company was forced to go into the Brazilian equivalent of Chapter 11. Andre's facility still had about \$7.5 million outstanding, while the Société Générale deal, now in its second year, was looking decidedly unwell.

Post mortem

Olvepar has been held up in the Brazilian market as an example of the classic pre-*pagiemento* structure not being much help in an insolvency. Let's look at exactly what happened across these three deals. The first point to be made is that one of the principal attractions of the pre-*pagiemento* structure is that it is designed to mitigate Brazilian *country* risk. Brazil is a country that, off and on over the last twenty years, has defaulted on its international debts outright, suspended hard currency transfers, frozen and seized all hard currency accounts held by Brazilian companies and individuals, and seen more local currency devaluations than Michael Schumacher has seen grands prix. In the case of Olvepar, however, it continued to export and to pay their creditors throughout the 1998–9 global Emerging Markets crises, including the Brazilian devaluation of January 1999, and including also a period of decline in the price of its commodity product. Whatever else happened, Olvepar's failure was *not* due to the undoubted political risks that existed, which appear to have been successfully mitigated by the structures applied. So far so good.

The next question is to look at the performance risk. At what point did Olvepar cease to perform? Clearly, the answer is that it ceased to perform when the third party (local) creditors pushed it into insolvency by pulling the local credit lines. This clearly is a balance-sheet risk. We have to conclude from this that, *if* the borrower exists and functions in a market with a developed commercial code that allows for creditors to demand bankruptcy, and *if* the borrower depends on a level of short-term local debt to keep the asset conversion cycle going that it cannot repay if the debt is all called at once, *then* to do justice to the credit analysis of the structure we must include traditional balance-sheet analysis of the borrower along with the rest of the structural analysis and the focus on the performance risk. The difficulty here is that balance-sheet analysis of Olvepar prior to the final audit would not have helped us, as indeed it obviously did not help any of the Brazilian banks that used it as the basis on which to advance their local lines of credit. What it should have told us at least was the extent of the local debts and the level of dependence on locally available short-term finance.

In September/October 1997, Santander and Erste conducted both structural and balance-sheet analysis, and concluded that Olvepar was safe from third party creditors at least for the lifetime of their deal, before going on to take collateral over the asset conversion cycle of Olvepar to ensure repayment from the top-line sales before any other costs. By the time of the Société Générale deal 12 months later, things were rather different. By late 1999, of course, had the Andre deal gone through at $80 million or even $68 million, Olvepar might well have been able to ignore the local banks and rely on the cheaper offshore finance for everything (albeit more burdensome operationally). Equally, had the Andre/Crédit Agricole Indosuez deal gone through in its original format, the lenders should have been able to rely on their very heavy-duty structure and monitoring mechanisms to ensure they remained collateralised at all times. However, also by late 1999, the financial condition of Olvepar had clearly deteriorated through the combination of the medium-term capex burden and the low/negative crushing margins, which at least Santander Brasil was able to observe locally and report back to its colleagues in London. Olvepar's liquidity crunch is evidenced by the unpaid farmers.

The uncharitable observer might comment that the original management prevented both Santander and Andre from looking at effective field collateral, though both were offered (and accepted) other security. Although under other circumstances the new financial management might have been taken as a plus, in practice it was little help to creditors except in that the audit that it at least allowed in the end appears to have shown a more accurate picture of the company's condition. Société Générale may not have been in a position to predict any of this when it analysed their deal over Christmas the previous year, but the nature of the beast is that, when we operate in a country where we fear the country risk, we are probably also right to fear the commercial risks therein and so should endeavour to structure for this also. The idea of the classic pre-*pagiemento* structure is that although the lender does take performance risk, often a pre-harvest performance risk, nevertheless he should be more or less secured by his lattice of mortgages, pledges, assignments and guarantees throughout the lifetime of his exposure. As this is being written, both Andre and Société Générale are endeavouring to establish whether this is indeed the case, and are negotiating for the rest of their money back.

The difficulty with the concept of collateralised lending in Brazil is the question of to what extent the collateral structure is realisable by creditors (especially by foreign creditors). Possession seems to be a key component. If the creditor can take possession of commodity stocks in a warehouse and execute the export, then he is in the best position. The difficulty here is that the 'warrant' should grant control but the warehouse is often borrower-owned and borrower-operated, with the result that creditors may simply be denied access. Possession would then need to be achieved through the Brazilian court, which may not be a fast process. Also, as we have seen, the farmers may have a convincing case for a prior claim if they can show they were not paid in the first place. Realisation of other forms of collateral also requires court action. The shareholders' guarantees or avals fall down on the point that the Brazilian court will often take into account what the shareholder says he needs to keep the company (or perhaps another of his companies) going, and thus both paying tax and giving employment to many working Brazilians. Or he may simply plead that he has no money anyway. Realisation of the *penhors* is a longer process still and eventually becomes embroiled with all the other claims made on the company. At this stage the lender will discover that his claim is effectively subordinated to those of both the state (the taxman) and the employees (for wages and compensation).

This is not to say that the collateral package is worthless, because the structure does afford multiple points of pressure on the owners of the company – they will not want to plead they have no money if they can really avoid it, because they will presumably intend to remain commercially active in Brazil for years to come (unless the drawdown was really huge) and will see the current difficulty as merely a passing episode of unpleasantness. Their aim will therefore simply be to defer so long as possible (in fact, indefinitely, if at all possible) the ugly day on which they have finally to repay the foreign creditors. It may be that we malign unjustly the Crestanis and the Consolis, who may be suffering only temporary embarrassment, but these are general observations about the market in Brazil drawn from experience. Truly effective collateral management may be a solution, but as we saw, the collateral manager was in the end brushed aside by the very people who should have most wanted him to fulfil his role. At very least we should be suspicious when the borrower does not co-operate with the collateral manager, in case this presages the subsequent discovery that the collateral is not there after all.

So, where does this leave us with Olvepar and its pre-*pagiementos*? Well, Olvepar continue to make modest deliveries using soybean for which it had already paid, and it may be that it can rebuild some of the business and emerge from its liquidity crisis. This does seem a slightly optimistic target, while foreign lenders are unlikely to reappear for Olvepar while Société Générale and Andre are still looking for their repayment. At the very least it would seem that a name-change was in order (using that well-known technique pioneered by the British nuclear power industry, which after a major nuclear contamination scandal simply renamed the offending power station from 'Windscale' to 'Sellafield' and then carried on as before). However, there does at least seem to be some cashflow, and that being the case, the foreign creditors are in with a chance. There are also various fixed assets, and clearly there is some hope from the Brazilian courts, if only to put pressure on the shareholders. This is back to the 'bargaining chip' theory of structured trade finance noted in the Cuban case study, that at very least the structure should afford the creditor as many bargaining chips as possible for when he sits at the negotiating table where what happens next will be decided.

Where did Société Générale go wrong? Why did it get caught while Santander got away with it and Andre got back the larger part of its advance? One hesitates to criticise Société Générale because it is a very experienced bank in this market, employing some top-class specialists, and it has real depth in its teams: it is not a one-man band, but rather a full-blown 'one-stop shop' for any kind of trade-related structure. We cannot throw stones at Société Générale's analysis, because the performance criteria for a \$20 million deal were certainly there, and to the limited extent that Brazilian balance sheets say anything, the Olvepar balance sheet at the end of 1998 would not have looked as bad as it would have done many months later after the last audit. However, the key misconception seems to have been at the end of Santander's 1998 deal. The banks involved in that deal got to the end feeling they had probably tested the parameters of Olvepar about as far as they really wanted to go at that point. The outside world, on the other hand, may be forgiven for having thought at that same moment that Olvepar had passed the 'one-season deal' test, and was now perhaps ready for something more challenging. Olvepar was a good counterparty, but within fairly narrow limits. In the end, it is not, and never was, a major entity. A one-season deal done in early 1999 would have repaid, but would probably not have been renewed. Olvepar did not have the track record over time to go beyond one season. It was simply not 'up' to a two-year deal, in the same sense that it was not up to an \$80 million deal, as Andre and its bankers found when they tried to put it in place, mercifully before they were committed to seeing it through.

To establish whether or not this is the case requires more than either structural analysis adding up the various pledges, or balance-sheet analysis trying to make sense of the Brazilian accounting standard. Rather, it requires the lender to look at the whole picture of how the company functions, its overall performance (in this case measured also by the crushing margins) and its relationships with shareholders, offtakers, banks and any other entity or group of entities vital to its proper operation. At Olvepar this equation did not stack up strongly enough to get beyond the one-season horizon, and this was a problem for a group implementing a medium-term investment programme. The new management came in too late to fix this, and its attempts to sort things out precipitated a rapid exit by the local banks, which all seemed to follow the American maxim that ‘he who runs first is most likely to get clean away …’.

This does not, however, invalidate the Brazilian structure, rather it qualifies the ‘single lending rationale’ approach. Just as we said it is insufficient in balance-sheet analysis to look only at the balance sheet without considering other factors like management, shareholders and the market environment for the product, so with asset-based or cashflow lending it is insufficient merely to think one has collateral, so all other considerations are void. What might have been really interesting from the professional interest point of view would have been to see what happened to the Andre/ACE ‘super structure’ had it been in place at the time of the Chapter 11 filing. Similar positions in Mexico and Africa have led to the secured creditors (at least, those who had really perfected their security) indeed getting repaid ahead of other creditors. Let us hope that Société Générale and Andre also eventually fall into that category in Brazil.

For the record, I continue to do Brazilian soft commodity prefinance, even for medium-term deals, but only with the top-tier exporters who have a strong track record over time combined with long-standing offshore offtakers (and we continue to look at both the balance-sheet and the performance risk criteria). I would also note that at the time of writing we do not enjoy with the Brazilian case studies quite the same distance we have from the Russian crisis, so it is more difficult to see whether the final outcome is a satisfactory one for lenders. Subsequent to writing the above, I have learned that ACE was indeed successful in Brazil in establishing that where goods were placed in its custody as the field warehouse company, and the custody was publicised, even though ACE was leasing the warehouse from Olvepar and it was located at Olvepar’s premises, its warehouseman’s lien over the goods was recognised by the local court. Possession of the goods should not merely be ‘technical’ but should reflect full operational and legal control, exercise of which must be ‘continuous, exclusive and notorious’. Clearly, full perfection of the security requires rather stricter procedures than most of us will have normally seen in the Brazilian context.

GRAINCOOP

This is the second Brazilian case study, and the overall environment and structure for prepayment finance is the same as for Olvepar. As with the other case studies, the information is gathered from publicly available information and interviews of people involved. The analysis is my own.

The deal

Graincoop Trading AVV was the Aruba-registered offshore vehicle of the Eximcoop group of co-operatives in Brazil, which in its day was a top five player among the Brazilian soya exporters. Eximcoop as an entity was based in Orlandia and was the export vehicle of a group of seven Brazilian soya mills, the largest of which was Carol, owned and managed by the Junqueira family, also known for its involvement in Crystalsev, the large Brazilian sugar group. Other significant shareholders were Corol and Coopersul. In the summer of 1998 Standard Bank London Ltd brought a pretty much standard Brazilian soya prefinance to market, with Graincoop as the borrower of record, for $15 million for one year. The intention was to pay (advance) in July, the money to be used to purchase fertiliser (then in relatively short supply in Orlandia) and seeds for delivery to local farmers, who would then deliver their crops to the seven co-operatives, who would process the soya and then deliver to Eximcoop, on to Graincoop and thence to the final offtakers, so that the banks could be repaid the following year from the offshore export proceeds of processed soybean, QED.

There was no single dedicated offtaker, rather a panel of seven to ten offtakers all of whom were well-known names, including Japanese trading house Itochu, which were each individually acceptable to the lenders. Two downsides of this seemingly minor detail were that when it came to the crunch, the banks were to have no help from offtakers in collecting ‘their’ soya, and the contracts assigned to the financing were not critical to anybody concerned other than the banks – they were easily replaced with other contracts outside the financing.

However, otherwise the facility looked good from a structural point of view. The banks liked the idea of the purpose of the facility being locked into the working capital cycle of the production of soya. This was not quite a barter or a tolling, but there was a strong feeling that the money was being used as the banks would have wished, to ensure good production (this was no Ovetril). Further, although the documentation specified the ‘market standard’ 80% LTV ratio/125% overcollateralisation for outstandings to value of soya, in practice if the advance to buy seeds and fertiliser was ‘x’, then the collateral level pledged by the co-operatives was more like '3x'. The co-operatives also seemed to have good logistics, with several silos available to them at the mills, a good truck fleet and a five-year lease on a large silo in the name of Eximcoop at the port. These silos were to produce and sign over warrants to the Agent once processed soybean was available, and this collateral should not have been released without a corresponding invoice to the offtaker presented via the Agent, followed by a swap of the warrant for bills of lading. The management of Eximcoop was well known to several of the lenders, as were some of the shareholders (notably Carol). They were deemed to be reasonable people who ran the business carefully. In particular, it was known that exports were hedged on the Chicago market against soybean price volatility, and although the hedges were of the overall position rather than cargo by cargo, and so were not pledged to the facility, nevertheless this was an additional comfort to the protection offered by the LTV ratio and the Escalation clause.

It is not clear whether there was a *penhor agricola* over the field crops, but there was certainly a *penhor mercantil* at the mill level. *Fiel depositario* was deemed to be difficult because of the co-operative nature of Eximcoop, but the lenders did get guarantees from the shareholders. Apart from the escalation clause, there was the usual pledged offshore Collection Account, Change of Ownership clause, Material Adverse Change and so on. Another detail that seemed minor at the time was that the documentation triggered actions by the agent to invoke escalation in the event of a shortfall in cashflow from the date that cash was actually received on the collection account (see Chapter 5 below). Finally, the lenders had the right at any time to send in an independent inspection agency to check the collateral was actually there (in this case SGS). Apart from the structure, and the apparently good condition and position of Eximcoop, pricing was also right in the target range for the period, and the deal was successfully sold to Mees Pierson (the Dutch commodity bank), Erste Bank (the Austrian bank, also very experienced in structured deals) and Deutsche Bank, with Standard Bank retaining a similar amount to the other banks. Drawdown was funded by the agent direct into Brazil, then the participants refinanced Standard Bank's account in New York.

What went wrong?

SGS indeed checked the seeds and fertiliser, and again later the silos, confirming all was in order. Shipments began to run through, and everything was looking good, at least at facility level. Brazil as a country, however, was having major problems with the fallout of the Emerging Markets crisis. Interest rates soared, business conditions became very difficult, hard currency reserves plummeted and, by the end of January 1999, the Reis was devalued. It became clear that the shareholders were looking to realise some of their assets, and in February it was announced that Itochu, one of the existing offtakers, was buying 51% of Eximcoop (which owned 100% of Graincoop). In practice Itochu did this through three Itochu companies, including Itochu International in New York and Itochu Brazil, which was a major Itochu unit in its own right, controlling *inter alia* the Mitsubishi dealership for Brazil. Itochu was allegedly paying $16 million for this stake, but Corol and Carol remained substantial minority shareholders (with in the region of 20% and 25% respectively), and they were asked by Itochu to inject further funds into Eximcoop. At the same time there were market rumours in Brazil and Chicago that all was not well at Eximcoop, and the lenders asked to see management financial information (as allowed by their loan documentation). This was not forthcoming, but this was blamed on the takeover. Generally, under the circumstances, lenders could be forgiven for thinking that Itochu's entry was a positive development. However, to be on the safe side the lenders sought a new shareholders' guarantee from Itochu. This too was not forthcoming. The Agent contacted the banks, suggesting that the stature of Itochu, and particularly the offshore component of the Itochu shareholding, made this a burdensome requirement and the lenders should settle for a Letter of Comfort. In the event this was not forthcoming either, and the best the lenders could get were verbal assurances from the senior management of Itochu Brazil (also well known to some of the lenders) that the Facility would be respected. The whole issue of Change of Ownership as outlined in the loan documentation was dropped.

It then became clear that major changes were afoot at Eximcoop. Much of the Brazilian management was first 'shadowed' by imported Japanese personnel, then replaced outright. There was clearly a dispute between Itochu and the other shareholders, who were claiming they were making their 'cash injection' in the form of soya deliveries, a view that Itochu seemed not to share. Mees Pierson was separately financing some of Eximcoop's futures positions in Chicago. The lenders heard from the market that all Eximcoop's hedge positions on the Chicago exchange were suddenly closed out over March/April, and the rumour was that this had precipitated a substantial loss. Further rumour in Brazil was that this move was instigated by the Japanese, against the wishes of the Brazilians, with both sides blaming each other for the loss. When first quarter financials were finally available in the summer of 1999, there was indeed a substantial loss, even ahead of the complete liquidation of the Chicago position. The banks asked for the subordination of an $8 million loan Itochu had made to Eximcoop. Again their demand was to be disappointed.

Nevertheless the Facility continued to amortise. In the event it had already repaid over 90% before problems finally hit. As the price of soya continued to decline, the last shipment to be made left a shortfall on the Amortisation Schedule. This was not picked up until the cash hit the Collection

Account, although the Agent might have noticed this from the time the invoice and shipping documents went through some time earlier. This left the banks looking for additional soya. With approximately \$2 million remaining outstanding, the banks still had something like \$7 million in notional collateral in Brazil, evidenced by warehouse 'warrants' held by the Agent. The banks were asked by Eximcoop to release some of this against the last shipment, which had been paid for, correctly, into the Collection Account, and to give Eximcoop a further three months' extension in which to make the last payment. Although not an ideal situation, the lenders agreed. Performance to date had been satisfactory. The amounts involved were not huge when split between the banks, which meant that the effort and expense of forced recovery was likely to outweigh the amounts actually recovered, and anyway it was by no means clear that the lenders' position was really so bad. The lenders could retain the larger of the two warrants, from Carol's silo, in theory worth something like \$4 million, which was still a good collateralisation level. However, as a precaution, the lenders agreed among themselves to ask SGS to inspect the collateral towards the end of this extended period, in case they would need to realise the soya themselves.

Things then went very quiet in Brazil. There was what one of the Dutch bankers involved called 'full silence' from both Eximcoop and Itochu. Further repayments did not materialise. Then the last remaining Brazilian manager of Eximcoop visited Europe in the autumn of 1999 with news. He went to see one of the large French offtakers and banks in Belgium, Netherlands and London. Eximcoop was working on setting up a joint venture with Dow Chemical, to establish the largest fertiliser distribution company in Brazil. Rather usefully, he also promised the lenders settlement of existing outstandings in instalments of half a million dollars. After his return to Brazil, an amount slightly less than promised was indeed paid, in cash, in November 1999 and split between the lenders. Things went quiet again. A further visit followed in the New Year, with promises of a further instalment. However, this time when the Eximcoop manager returned to Brazil, all the lenders received was a copy of his letter of resignation – he had moved to join Dow Chemical, claiming the Japanese had blocked the payment. With him went the last contact the banks had known at the original Eximcoop.

It was learned that the Eximcoop five-year lease on the silo at the port had been broken open and the cash paid out (allegedly to Itochu). The (now) entirely Japanese management of Eximcoop did not renew Graincoop's membership of the Aruba Chamber of Commerce. Itochu Brazil, whose senior manager had been known to the lenders (and who had been repeatedly lobbied as a result), transferred its shareholding to Itochu Latin America, a lesser entity, whose new Japanese chief was neither known to the lenders nor was at all senior. Itochu continued to ship Brazilian soya, but in the name of Itochu Latin America, using the same offices and infrastructure, but completely bypassing

Eximcoop and Graincoop as legal entities. This meant that the banks were unable to seize Itochu cargoes, since they were never legally the property of either Eximcoop or Graincoop. The assigned contracts simply were not delivered. Under pressure from the other banks, the Agent finally sent in SGS to look at the collateral. SGS was refused access to the Carol silo.

The Agent's main response to this unfortunate turn of events was to pursue Itochu, since Itochu clearly had management control of Eximcoop, and rather conveniently it had the deepest pockets. The other lenders were rather more commodity-orientated in their credit rationale and asked to realise the collateral. They did not get an altogether satisfactory response from Standard Bank on this. Eventually, some months into 2000, Standard Bank admitted it had actually physically lost the warrant. However, it then fielded a legal opinion, which said basically that the Bank could pursue Itochu on a moral basis, the other shareholders on a legal basis and/or claim the collateral if it existed. At the same time the Agent had finally taken legal action to push for bankruptcy against both the borrower and Eximcoop, although as usual the foreign banks are not high on the list of favourite litigants in the Brazilian (or Aruban) courts. First Graincoop and then Eximcoop filed for and were awarded Concordata, the Brazilian equivalent of Chapter 11 protection from creditors.

The Itochu Latin America manager reported to Itochu International in New York, itself also a shareholder in Eximcoop, but representations to New York were stonewalled by the Japanese, who said simply that they had also lost money on Eximcoop. The lenders attended a meeting with Itochu in New York along with the Agent, in the summer of 2000, at which they were met by three Japanese gentlemen. One of these was clearly some form of trainee. The senior man present announced he was returning to Japan and regretted that he would have no further responsibility. His replacement actually slept in the meeting. At least, he closed his eyes, his body went motionless, and his breathing became very rhythmic and regular. Itochu had been careful to stay within the letter of the law, and it never undertook in writing to take on the debts of the company it acquired. However, it is probably fair to say it has been less than helpful in this matter.

At the time of writing, Standard Bank was taking legal action against the shareholders of Eximcoop. The bank had managed to identify various revenues and cash resources, but every time it got a court order for an attachment, the shareholders appealed, claiming they needed those revenues to pay hard-working Brazilians their wages, and they succeeded in getting the order overturned. The lenders meanwhile are in the invidious position that if they pursue legal action against either the shareholders in Brazil or the Agent in London, the legal fees could very quickly eat up the few hundred thousand dollars they each have outstanding.

Post mortem

Again as a general issue we can say that the structure did not fail because of Brazilian political risk or currency inconvertibility: this was a commercial risk failure. However, there seem to be two main points here. First, loan documentation does not have a 'Change of Ownership' clause for nothing: this is a very high-risk event for any lender in any jurisdiction, because if you are not careful the new owners of the company will be able to take over the company with absolutely no legal liability for pre-existing debt. It seems clear that Itochu did not like what it found in its acquisition, stripped out the useful or valuable parts and then carried on in its own name. This behaviour is not a good advertisement for Itochu in the conduct of its affairs with banks, but it had done nothing legally wrong. It may be unlikely that the participating banks will extend credit for Itochu again, but this is equally unlikely to have a significant impact on Itochu. Lesson: never believe syndication salesmen who tell you that a company will do something it is not legally bound to do, merely 'to protect their reputation' – money wins over reputation every time. The moment to have obtained a shareholders' guarantee from Itochu was the moment it was trying to purchase the company, when the banks still had some leverage and could plausibly have blocked the takeover until their conditions were met. Again, hindsight is a wonderful thing. Of course, it may have been that the banks were not informed of this event prior to it happening. The answer then is that Change of Ownership is an Event of Default. If the new owners do not want this to be invoked, then they should match the guarantees of the previous owners. At this stage, before Itochu became thoroughly disillusioned with Eximcoop, it may even have conceded the guarantee, at least from Itochu Brazil.

Secondly, the approach of the Agent has been perhaps too reliant on the efficacy of the Brazilian legal system. We should not be surprised that the Brazilian shareholders' guarantees have been impossible to realise so far. If we honestly thought we could rely on them making straight payments of cash to the banks out of their general liquidity, then nobody would have bothered with having a structure in the first place. The whole edifice of borrowers' Covenants, Undertakings and Representations in the Emerging Markets seems to me wholly useless unless its purpose is simply to make the Emerging Market borrower feel more like an OECD borrower. It simply cannot be relied upon if the accounting standard is insufficiently rigorous and the local courts are biased towards local entities. Nevertheless, however late it was to start this process Standard Bank was right to take legal action against both the company and the shareholders to protect the banks' interests and to use as leverage against these antagonists. It may not work, but it is a burden for the shareholders, and any pressure that can be brought to bear will help at the negotiating table.

Where we really part company with the Agent in this case is in the collateral management. It is clear that Standard Bank always saw the soya itself as ‘nice to have’ rather than meaningful collateral. Standard Bank is an experienced structured trade finance bank, and it is also a top-tier gold bullion finance bank, but it is not a commodity bank as such, and a number of the colleagues involved in this transaction had come out of either a forfaiting background (i.e. historically trading paper obligations) or a corporate banking background (i.e. used to relying on covenants, undertakings and other legally documented ‘security’). At this distance it seems unlikely that the Carol warehouse still contains the soya, which nominally belonged to the banks. Usually it doesn’t help collateral management either if, as in this case, the warehouse is owned and controlled by the obligor’s group itself. However, earlier attention to the fact that the soya was actually there and might have been realised to achieve repayment is singularly absent from this story, and the other banks concerned put this squarely down to the agent. Of course, having lost the warrant, it is in the Agent’s interests to play down the relevance or usefulness of the physical collateral, just in case it turns out that the soya was indeed there but could only have been realised if the Agent had retained the physical warrant. In such a case the agent would then be looking very closely at the ‘absent gross negligence’ riders on the ‘Agent’s Indemnities’ clauses, and the other lenders would have a target not only with deep pockets but also one which is eminently accessible.

There are other more minor niggles. The absence of a dedicated offtaker, in my view, is generally a weakness albeit not a terminal one. Standard Bank and others have successfully run numerous facilities on this ‘borrowing base’ type of structure in which the lenders accept a panel of offtakers. The upside here is that then it is very clearly a facility offered by the banks to the producer, rather than the bank being the creature of the offtaker (as we saw with the Andre/Crédit Agricole Indosuez facility for Olvepar). Personally, I see the offtaker’s role as a credit enhancement. In between the extremes of the trader-led facility at one end, and the borrowing base facility at the other, there is plenty of scope for bank and offtaker to work together to deliver a facility to the producer that makes them both look good. An offtaker who has a stake in the transaction, even if only around 10%, is better still and has a positive interest in seeing the export contracts performed. One might also comment that, had Itochu been locked in from the beginning as a dedicated offtaker, even in a fairly passive capacity, it might have been rather more difficult for it to walk away as it was later to do.

Another minor annoyance is the way in which all the banks accepted documentation that only triggered action once a shortfall was apparent on the Collection Account. If the Agent is doing his job properly, he knows from the amount of the commodity leaving the warehouse and the current value pretty much exactly what the shipment will be worth, and any shortfall can be anticipated days or weeks ahead of seeing the actual cash proceeds. This is a frequently overlooked point and comes up repeatedly when we see first drafts of loan documentation for structured deals. If it is only going to make a difference of a couple of days (unlikely, given the time it takes to achieve even for payment 'at sight' of shipping documents, but still), then perhaps this is not something about which to get too excited. However recently we were presented with first-draft documentation from a leading law firm, which proposed not only that nothing should happen until cash turned up (or not, as the case may be) but accepted the borrower's suggestion that the in-house offshore trader be given 90 days' credit terms even though the final offtaker was paying at 30 days from bill of lading date: not only should the agent have known a good three months ahead of the date proposed by the lawyers if there was going to be a shortfall, but also for some reason the cashflow was to be 'parked' in the in-house trader for some two months.

Apart from being wonderful, hindsight allows us to be harsh. This was a deal of missed opportunities. The first was not locking in a dedicated offtaker for the lifetime of the deal (possibly even Itochu, since we are told it was one of the largest of Eximcoop's customers). The second came when change of ownership should have rung more alarm bells than it did, and the structure that was in the documentation should have been used to extract a new shareholder's guarantee from Itochu. The third (and perhaps least susceptible to the charge that our hindsight is making unreasonable demands compared with the common perception at the time) was when the borrower asked for an extension on the grounds that the lenders still had 'collateral'. At that moment the agent should have moved the collateral to an independent warehouse as a safeguard, and when final payment was not made on the extended maturity date, it should have liquidated the soya (possibly using its warrant) at once. Instead, as 'full silence' reigns in Brazil and from Itochu all we hear is some gentle snoring, the legal action to enforce the guarantees continues, and the banks are now going through the process of trying to make life as uncomfortable as possible for Carol, Corol and the others. A number of individuals in the banks concerned also tell me they have made mental notes about dealing with Itochu in the future.

CUBA

Cuban commodity countertrade is one of the old chestnuts of the STCF market. It is rather like being pregnant: either you do Cuba or you don't, but there is no such thing as half-pregnant. The reason Cuba tests a lot of theories is the way the structures work, or don't work, depending on your view of Cuba and of the rules, as we believe in them, of the structured trade transaction. To understand this in context it is necessary to review a certain amount of history, and to look in detail at the performance of more than one Cuban structure over time. The case studies here are drawn from 1996–9.

Background

Cuba is a very interesting place. There is a huge amount of rubbish written about it. To many Americans it is right up there among the Great Satans: Saddam Hussein, Fidel Castro and lawyers in general. To the loony, and indeed also much of the liberal, European Left, it is a paradigm of the socialist model (and there are few enough of those left, mercifully). The truth naturally lies somewhere in the middle, but as a consequence of these extremely polarised views, Cuba has a special place in the practice of STCF, in that some form of structured countertrade, even now over ten years after the fall of the USSR, is the absolute norm rather than the exception. One consequence of the US antagonism to Cuba, and of the embarrassing wealth of US anti-Cuban legislation, is that the practitioners of the supply of goods to Cuba against various streams of Cuban commodity exports coming in the opposite direction generally go to considerable lengths to keep a low profile. At the time of writing, all the major export credit agencies apart from US Exim had credit lines for Cuba, at least ad hoc, and accepted repayment in commodity flows. Some commercial enterprises, like Sherritt of Canada, have come out of the closet and said openly that they support business in Cuba. Most Western market participants, however, particularly in the sugar/oil or nickel/oil countertrades, are rather less keen on publicity and indeed have gone to great lengths to avoid infringing any legislation anywhere. Even those active in this market can find it difficult to establish who else is active. In this instance, naming names beyond those already public knowledge would serve no useful purpose beyond giving ammunition to the more rabid elements of the anti-Castro lobby in Miami.

Since the revolution of 1959, and the subsequent nationalisation of formerly US-owned assets, Cuba has been subject to a blockade by the US which, if anything, has tightened with the passage of time of the subsequent decades. *Inter alia*, this cut the island off from any form of capital markets access, with the result that it is one of those rare markets not overrun by US investment bankers. In the 1980s Cuba defaulted on its international debt. To be precise, it was not the first to fall in the Latin American debt crisis. Rather, it saw others get away with simply stopping repayment of sovereign debt and realised it could probably get away with it too. Apart from the norms of Marxist democratic centralism and state ownership of the means of production, the economy was based on the client-state relationship with the USSR. At its most basic level, this meant that Cuba supplied sugar to the USSR and was delivered Soviet Export Blend Crude Oil or oil products, in a ratio of roughly one to three by weight (in the days when sugar prices were high and oil prices relatively low). On occasion the Cubans would be in the position where they had an oil surplus, and could on-sell the oil into the world market to realise the cash value. There were of course other protocols, both economic and military.

The sugar industry was the major employer on the island (at one stage larger even than the army), and production in the 1980s peaked at nearly 8 million metric tonnes a year. The industry was vast. Cuba is a big island, comparable to England without the Celtic fringe. All 14 provinces produced sugar. The cane was cut by an army of workers both by hand and mechanically, and delivered to no fewer than 156 sugar mills spread throughout the island. Five refineries converted raw sugar to white, and allowed Cuba to supply its domestic market as well as export the finished product. Shipment of raw sugar was through any one of eight ports. From an analyst's point of view, the sheer size of the monolithic Cuban sugar industry gave it a strength that made it beautiful. Any number of things could go wrong and still Cubans would produce sugar. The geographic diversification gave them statistical protection from Caribbean hurricanes. When Hurricane Hugo ripped through nearby Jamaica in 1987, it destroyed huge parts of the coffee production (a 'cherry' crop, the coffee berries were simply blown off the trees), and reduced sugar production by 17% (sugar, likened to glorified grass, survives rather better as a crop, provided it has time to dry out before harvest and that the cane is flattened rather than actually broken). Cuban production was spread out over so large an area that the hurricane's dent was only 2%. A quick glance at the map will show Jamaica would fit into Cuba many times over.

The Cuban/Soviet sugar/oil protocol was the only such protocol really to survive the collapse of the Soviet Union in 1991. However, the Cuban economy as a whole was devastated by the Soviet collapse, and even sugar was not spared. Cuban GDP fell by half in the 18 months following the Soviet collapse. Very quickly sugar production dropped from over 7 million tons a year to 4 million tons, and then in 1993–4 to 3.3 million tons. Agricultural imports ceased. No pesticides, no fertiliser and very little replanting went into maintaining production. The mills, however, were judged on throughput, so such cane as was replanted was cut before ideal maturity. This sacrificed the following year's crop to maintain volumes in the current year. Lack of fuel and spares meant that mechanical recovery of the crop ceased. The size of the island now became a burden, as some cane that was actually harvested could not be removed to any mills for lack of diesel to transport it, so it rotted in the fields. Although the volume of cane was lower, nevertheless the infrastructure – the 156 mills, eight ports etc. – remained, although the white sugar refineries more or less ceased activity.

Meanwhile the country had a basic Balance of Payments crisis. It still needed to import fuel and food, and it needed to pay for it.

Very early on in the conversion of the Soviet countertrade protocol into a Russian one, commercial enterprises became involved. Although in Cuba Cubazucar remains the state sugar exporter, on the Russian side the domestic sugar industry fragmented completely after the collapse of the USSR, to the extent that almost every refinery became a separate company. Russia remains a big importer of sugar, and its mills refine the domestic/regional beet sugar crop for half the year, and imported cane sugar (largely from Cuba) for the rest of the year. Post-1991, this cane import trade fell into the hands of commercial trading entities like Alfa-Eko (a Russian incorporated company), which in turn often bought the Cuban sugar indirectly from Western (European) traders. The export of what was now Russian export blend crude oil was also entrusted to Russian trading companies (Alfa-Eko was on both sides of such transactions, trading both sugar and oil), which in turn mandated Western oil majors and traders actually to handle the business. These Western oil companies trod a fine line, complying on the one hand with an EU directive that forbids compliance with third party embargoes (a useful European rule that originated during the Arab Boycott of Israel), while also in practice endeavouring to comply with the US legislation which, in its ultimate form, the so-called Helms–Burton Act passed in 1996, forbids 'trafficking' in goods or assets that ought properly to be US assets.

While Helms–Burton as passed (and to the extent waived by presidential order) offers relatively minor penalties, this was a hugely effective piece of legislation that successfully frightened off many European companies whose managements typically had not actually read it, but who felt it was simply not worth antagonising the Americans over a market as small as Cuba. The discovery by the Cubans that they could attract tourists in the mid-1990s took some of the sting out of this decline, and by 1995 tourism had outstripped sugar as the leading hard currency earner. However, continued weakness in the Cuban economy in general and in sugar production in particular, meant that by the mid-1990s the oil companies were being asked not only to accept repayment from sugar or nickel flows, as they had done since 1991, but also to provide finance: oil in this year, sugar out next year. For such oil companies experienced not just in Cuban countertrade but in structured commodity-backed solutions to repayment challenges around the world, and employing probably the most experienced specialists anywhere, this was not a great problem.

Clearly, a major oil company will have a limit to how much Cuban risk it would want to take on, and beyond that it would seek to lay the risk off. Enter the banks and insurers. A number of European banks were active from early on in financing Cuban countertrades, in support of their European clients (typically the oil majors and traders, or the sugar/nickel traders). In the 1990s the bank finance of Cuban countertrade grew into a substantial niche market in which European commercial banks funded and shared the risk of facilities that were and regularly are in the region of $100 million to $300 million each for a country that has no other credit access other than suppliers and export credit agencies.

There is a fundamental difference of approach, however, between the bank and the trading company, even if the trading company is the trading unit of an oil major, and even if the STCF specialists there are thick with the ranks of ex-bankers. It is not a new observation to say that banks expect each transaction to repay in full, as an immaculate conception (it has, after all, passed the Credit Committee), while the insurers calculate for example that the 80% of deals that go right should pay for the 20% of deals that go wrong, accepting that some percentage of deals will indeed go wrong. The traders are somewhere between these parameters. They take a view of risk that hangs upon balance between the acceptable and the unacceptable. This is often empirical stuff, with up-to-the-minute monitoring of deliveries, payments and track record, and very swift action in the event of any hiccups. Banks, by contrast, want to feel that they have analysed a proposition, made their decision, and that that decision will stand and be safe until the next review date. This encourages bankers to come up with a lot of theory as to how things work, which percolates through to the banking rules for provisioning, capital allocation, allocation of country lines and even non-bank items like credit ratings. A lot of this is reflected in this book.

One of the basic theories is that ‘performance’ risk is preferable to ‘payment’ risk, and this is accepted by most bank regulators. This means that for a bank lender, it is preferable to rely on the performance risk that a company or entity will continue to perform what it does for a living anyway than to rely on its ability to repay you. It will in all probability continue to perform long after the point where it is economic to do so, and this is only a small segment of the typical asset conversion cycle; payment risk, on the other hand, as discussed elsewhere, relies on the entire asset conversion cycle, and on the borrower being sufficiently profitable and liquid to repay in cash, through a local bank, which must also be profitable and liquid, and via a central bank, which again in its turn must be profitable and liquid. However, if the borrower does not perform, or does perform but simply does not send the goods to you, where does that leave us? The cynic might be tempted to say that it leaves us with the same payment risk we were trying to avoid in the first place.

There have been many Western participants in this market in recent years. Some got repaid, most have got repaid after some delay, and one or two are still waiting. From the Cuban side, the Cuban counterparties are only now changing. Historically the oil importer has been Cubametales, though it is now being replaced in this role by Cuba Petroleo (Cupet). The sugar exporter was and is Cubazucar. The nickel exporter has been Cubaniquel (recently merged with producer Union del Niquel to become Union de Cubaniquel), although technically it does not actually export nickel but rather an unfinished product. All the countertrades typically bear a guarantee from Banco Nacional de Cuba – formerly the central bank, now being replaced for this purpose by Banco Exterior and other Cuban banks. All of these are state-owned enterprises.

The deal

The structure of the Cuban countertrade is essentially as described above. The basic deal in that instance was that oil went in, for example, in the summer of 1997, to Cubametales, and the intention was to get repaid from Cubazucar's sugar export proceeds the following export season, January–July 1998. Two Western oil majors of the same nationality supplied oil at the same time, using very similar documentation drawn up by the same law firm, and financed by virtually the same club of European banks. In the larger deal, $150 million, the documentation was 'Full Metal Jacket', as one would expect from a top US law firm (it was not contravening US law because it was working for European clients). The overall deal was embodied in a quadripartite Frame Agreement between Cubametales, as oil importer, Cubazucar as sugar exporter, the oil company and the oil company's agent bank. The Facility Agreement was a 'Full and Limited Recourse Facility' in the name of the oil company as the borrower of record (the banks therefore stood behind the oil company and did not lend direct to the Cubans). The oil company took a risk share of 20% (the 'full recourse' portion), and in addition guaranteed the interest payments to the banks (this was to be an important detail). The 'limited recourse' element was effectively non-recourse to the oil company except in certain circumstances, principally those where it might be illegal for the banks to stay in the transaction.

The structure envisaged multiple deliveries of oil, during the second half of 1997, followed by multiple deliveries of sugar out in the first half of 1998. Drawdown was to be by the oil company, against evidence of shipment by the oil company and evidence from Cubametales that it accepted the shipment. The sugar was to be delivered to various European sugar traders, but since not all the banks had credit lines for these sugar traders, the oil company agreed to take the payment risk on the sugar; so, provided the sugar was shipped, the oil company would repay the banks directly offshore into a dedicated collection account that was not available to the Cubans until debt service had been met – pure offshore cashflow.

The credit analysis was lengthy but compelling. Political risk existed in both Cuba itself and the US. However, transfer risk on the Cuban central bank was eliminated by the 'performance risk' nature of the deal, specifically by the offshore cashflow. Moreover, this was clearly the 'structure of last resort', and the Cubans did not have many alternatives if they defaulted on this type of deal. Comfort was also taken from the role of the oil company, which had a track record dating back to the 1980s. It was felt that while the Cubans might well put two fingers up to a big foreign bank with ostensibly deep pockets, they were much less likely to do the same to a long-standing commercial counterparty like the oil company, which had often helped them in difficult times. The nationality of the oil company was also encouraging, since it was deemed to be less susceptible to US pressure over Cuba than some other European governments, and it was felt that the Cubans would be less likely to antagonise one of the few governments that was half-way friendly towards it.

Great lengths were also taken to mitigate US political risk. A study was commissioned in Washington to identify all Cuban sugar-related assets claimed by the US in 1959 and subsequently to include claims by ex-Cuban US citizens, at the US Foreign Claims Settlement Commission, including farms, land, mills and port facilities. A further study was sponsored at a US university to establish all the changes of names of fields, farms, mills etc. since 1959 in Cuba, so that the identity of US-claimed assets could be tracked through to the modern sugar industry. The results were interesting. At the time, the 'Cuban American Foundation' – one of the more active groups in an already febrile community – was claiming that any sugar from Cuba was subject to US claims and therefore potentially made traders and their financiers susceptible to action under Helms–Burton. In truth, the US including the ex-Cubans could only claim 26% of the Cuban sugar industry infrastructure. Even if it were assumed somehow that these assets had maintained their production levels from 1959 into 1997, that would still give them little over half the 4 million tons or more that Cuba was expected to produce. Clearly 'non-Helms–Burton' sugar existed on Cuba. To get it, the banks demanded, and rather incredibly the Cubans agreed, to provide 'Helms–Burton-proof' certificates (these are all expressions used at the time – and this is not being made up), which declared the sugar was not from a disputed origin. The banks felt under the circumstances that they had conducted sufficient due diligence to support the proposition that such a Cuban declaration could be relied upon, but as an added safeguard the agent bank was put on notice to reject any sugar that was clearly from one of the claimed assets on the Washington list, as amended by the university list, and the loan documentation said that such sugar although delivered would not count for repayment purposes.

Analysis of performance risk was similarly exhaustive. Suffice to say that it could be proven on the basis of publicly available statistics going back to pre-Castro times that, fire, flood, drought and tempest all being equal, the Cubans would have enough sugar to fulfil the assigned contracts the following year. The question of whether they had also committed this sugar to others was rather more open, and the further question of whether they would actually in the event choose to deliver it against the finance contracts, as opposed to some other contracts where the cashflow was not being siphoned off, relied entirely on the banks' relations with the sugar traders (which, as we have established, were not altogether strong).

Payment risk as discussed fell on the oil company itself. This did not represent a challenge. This was a first-class company, with a specific team dedicated to precisely this kind of transaction. The leader of this team (as is often the case with oil companies) had been in the job at this company for many years and was highly experienced. Moreover, before working in the oil industry, he had several years' experience in the sugar trade, which made him the ideal man for the job. To work together with this company and this team was one of the great attractions of the transaction, and gave the banks a lot more confidence than they might have had going to Cuba on their own.

Price risk analysis on the underlying commodities said what commodity price forecasts always say: a 10% plus or minus variation from where we are now, easily handled by the 25% cushion afforded by the initial loan to value (LTV) ratio. There was, of course, no price risk on the oil, since oil was only delivered up to the value of the facility.

Structural risk was considered to be low, because the advantage of the command economy is that linkage – the weak link of most commercial countertrades – between the Cuban importer and Cuban exporter was strong, and indeed evidenced by the central bank guarantee (not considered exactly 'bankable', but a useful sign that the deal was accepted by the controllers of the Cuban financial system) and a letter of awareness from the Ministry for Foreign Trade. The structure also had a good track record, which always helps. It also had a track record of passing audit as 'non-provisionable' in an environment in which normal provisioning levels on exposures to Cuba would be 90 to 100%. The usual Escalation, Acceleration, MAC and other clauses were all in place. Finally there was also a useful undertaking by the oil company not to supply additional oil until the facility had been repaid except as agreed by the lenders. By this mechanism, new oil deliveries could be delayed until the Cubans were up to date on their sugar deliveries.

Underwriting risk for the arrangers was known to be high, because they had sold the previous year's deal into the teeth of the newly passed Helms–Burton Act and knew this to be a deal more beloved by the specialists than by the main boards of Western banks. They expected most of the banks involved previously to renew, and two of these stepped up a level to join the underwriting group. There were also a handful of new entrants with whom the deal had been discussed for some time, so the underwriting club had a good idea of what the final hold would be, and this was the level it got approved by the respective credit committees.

The second transaction, for the other oil company, was smaller, at $43 million, but was essentially the same deal, with the underwriting group from the first countertrade plus two additional names, in a club facility routed through a different oil company, which nevertheless shared many of the characteristics of the first. This company was also a first-class company. Bigger than the first, it also had a dedicated specialist team for these types of transaction, led by another highly experienced professional who had been in the seat for a number of years. There were one or two differences. For a start, this oil company's risk share was only 10%, and importantly it did not guarantee the interest. The 'limited recourse' events were also rather more tightly written, in the oil company's favour. It did not take the payment risk on the sugar trader (there was only one in this instance), and the banks had to conduct separate analysis of the trader to accept that. The track record and the other business the oil company had in Cuba was neither as long nor as extensive as with the first oil company: this company had come relatively late to this market, having seen its rival make money there. Overall it would be fair to say that it simply drove a harder bargain with the banks.

What went wrong?

The way the previous year's transaction (1996) had gone was as follows. The oil that went in was more or less according to plan, although the oil company had to delay a few shipments to encourage the Cubans to pay for oil received under the facility for the year before that. Sugar delivery scheduled to start in January 1997 was not seen until February, the Cubans blaming rain (sugar generally cannot be loaded in the rain). Deliveries continued in a more or less haphazard but effective manner until the then final maturity date of June, by which time there was only one amortisation outstanding. The Cubans then asked to spread this final amortisation over the next six months, taking them into the light crop period sometimes seen in September/October. In the end compromise was reached and the Cubans were given an additional four months, amortisation to be spread equally, to finish at the end of October. At this point the banks went on to finalise that facility for the following year, as discussed above. The Cubans delivered nothing for two months, until the new facility was signed. When it was duly signed, they then repaid in dribs and drabs (as the oil company delivered oil under the new facility in a similar fashion), finally finishing in November. When in the end it was established that they had paid all fees, interest and penalty interest for late repayment, this was deemed close enough to the various agreements to be acceptable, and the banks proceeded to allow full drawdown under the new facility. Talks also started, in order to be ready, on the facility to be in place for the year after that, which, it was presumed, should commence by July 1998.

For the $150 million 1997/8 facility, then, the oil deliveries were completed by late January 1998. Sugar was meant to have been delivered from March (statistically the January shipments if any are always tiny; there was no incentive from the structurers to hold out for a February delivery when it had been problematical the year before, and amortisation could still be achieved commencing March as a more achievable deadline). Cuba being Cuba, this turned up in April, with the Cubans again blaming rain and hurricanes, although the El Niño drought experienced throughout the Caribbean basin was also cited as a factor putting pressure on the crop. Rumours started to circulate among the lenders that others were receiving their sugar, but by the end of April everything was more or less on track. Then nothing was delivered in May, and by June the bankers were starting to worry. As might have been expected, a request was received to extend the original final maturity date to the year-end, and again the bankers, reasonably enough, thought that if October meant November to the Cubans, then a December deadline was uncomfortably close to the banks' balance sheet year-end, and potential 90%-plus provisioning if the Cubans were late again over the year-end reporting date.

The $43 million facility was if anything going even worse. Because of the relatively low size of the facility (at least, relative to the oil business), drawdown had been in one amount in July 1997. This oil company was to have no leverage of other cargoes to be withheld if sugar was not forthcoming. Amortisation was due to have started in April 1998. As the new year broke in 1998, the oil company started warming up the banks for a bigger and better facility to replace the one then in place, once it had been repaid. Approval was sought and gained from the various credit committees. The lenders were ready by March, but in a rare moment of sanity managed to withhold commitment to the new facility until some evidence of performance under the old facility had been seen (this oil company, remember, did not enjoy the track record of its rival). Yet when in April 1997 the other facility was getting its best performance, on this smaller facility the Cubans delivered not a sausage.

At this point the oil company's guarantee of the interest – or the absence of it – became a critical component. When the interest payment on the smaller facility was not made, the facility was catapulted into the 'non-performing loan' category in the banks' books. This put the facility under the direct scrutiny and authority of the various credit departments (as opposed to the front-office STCF teams which had previously managed Cuban recoveries). Combined with the fact the facility was for Cuba, immediate provisioning was invoked and the STCF teams took an instant 90 to 100% write-off of the asset direct from their Profit and Loss account. This was not good. The immediate impact was that all bets were off with respect to the renewal, the credit approvals were cancelled, and for the sake of making an interest payment of less than $1 million, the Cubans kissed goodbye to an already approved facility for repayment the following year, of $50 million plus.

By the summer of 1998, the main Cuban sugar harvest was over, the sugar price had been collapsing all year, the harvest for the following year was predicted to be dire, neither facility was on track, and the STCF teams were operating under the close attention of their credit departments and their own managements. Eventually, with much hard work, most notably on the part of the first oil company, the $150 million facility lurched towards and through agreements on revised payment schedules, which said final maturity October, then November, and finally 15 December. The banks were asked to commit to a new facility before repayment of the old one (as, to be fair, they had done in the past), but refused. The oil company, however, signed up to a new oil contract with a commitment to raise the associated finance. Final repayment was made just in time for Christmas, and the banks were spared an almighty write-off over year-end.

The second facility, however, was not so blessed. Negotiations rumbled on. As the oil company had driven a hard bargain with the banks, so it now transpired it had driven a hard bargain with the Cubans. Although the oil men were suitably impressive in their problem-solving skills in the meetings, nevertheless there was the feeling that they simply were not as flexible as the other oil company, and the banks suffered for it. In early 1999 pressure began to grow within the bank to call the BNC guarantee. This was seen as something of a nuclear option, in the sense that it was assumed the Cubans still would not have the money, and then non-payment of the BNC guarantee would trigger cross-default across all the ECA facilities (which relied on BNC guarantees). This had been considered before but rejected, because the cross-default would also have hit the larger facility, which was nevertheless current to interest, so the oil company would no longer have been liable to interest after such an event of default, and instead the banks would have been faced with even more Cuban provisions.

Once the larger facility was repaid, the nuclear option looked more attractive (at least to anybody not also in the ECA facilities). The BNC guarantee was called in February 1999. The Cuban response was to ask for one year in which to pay it. As one of the bankers said at the time, 'if you didn't have a sense of humour you shouldn't have joined the deal…'. It then became clear that the ECAs would not know the BNC had not been paid unless their attention was drawn to it. The next threat therefore was to go public. This would also necessarily prevent banks from countries whose ECAs had not been repaid from making new loans, thereby further restricting Cuba's already parlous credit access. With increasingly unsubtle indications from the banks that they could not continue in Cuba with this outstanding facility, and that they would consider seizing Cuban sugar cargoes that were now again in the full swing of the export season, but also clear hints that they would return to new business once it was cleared up, the facility was finally repaid in May 1999.

Post mortem

So, was the 'assignment of export contract' a waste of time? Was the much-vaunted 'offshore cashflow' a figment of the regulators' imagination? Did the structure work?

By our original criteria, the structure did indeed work. The lenders received everything they were due, including penalty interest at Libor plus 7.5% p.a., at a time when Angola, as said before, was paying Libor plus 2.5% for three-year commodity-backed loans despite being in the middle of a 25-year-long civil war. Moreover, lenders were not forced into renewal, with a number, including one of the original underwriters, who had had a Cuban 'hold' of $37 million, walking away free and clear, repaid to zero. The next question, then, is precisely *how* did the structures work?

It is important to appreciate the context in which all this was happening. Sugar prices in general were declining steeply: they more than halved to 5 US cents per pound during this period, having been over 12 US cents per pound in 1996, as Asian demand collapsed and Brazil's meteoric rise to be number one sugar producer in the world saw it top 18 million tons of raw sugar in 1999, ahead even of the European Union, to push the world into global oversupply. Cuba's own sugar production, however, was going in the opposite direction, and in 1998 fell to a 50-year low of 3.2 million tons. The Russian collapse of August 1998 hit Cuba's main destination for its sugar very hard, an effect that was exacerbated by integrated oil/sugar traders being seen to dump Cuban sugar on the market to realise the value as quickly as possible to effect payment for their oil. Also the wave of optimism that overtook Cuba in 1995, as the new foreign investment law was passed and the economy opened up slightly, was stymied by the Helms–Burton Act of 1996, and this put a very effective brake on a number of inward investment projects. None of this was good news, but then the banks and oil companies knew they were going into a difficult market from the outset, that the Cubans were up against the wall, and they expected to be compensated for this risk by the higher than average rewards.

It is also fair to say that the Cuban performance was hit by an at times chaotic performance on its own part. Had the Cubans made the $1 million interest payment on time in April 1998, they would have secured fifty times that amount within a matter of weeks, if not days, which could plausibly have made everyone's life in 1998 a whole lot easier. One might also comment that the 'mañana principle' is alive and well and living in Havana. One has to conclude that, with the best will in the world, there will always be delay in Cuba, and that one has to structure for this (with penalty interest, recovery periods and flexibility built into the amortisation schedule – as opposed to the shipping schedule – which should not be given to the Cubans, and if possible the interest guaranteed by a reputable party or deposited with the agent in advance).

The bankers for their part lost track of the facility altogether in August 1998 as Russia defaulted, and by the time year-end approached, the provisions for Cuba had been dwarfed by some of the other items on the horizon. The agent in particular had a divergence of interests with the rest of the bank group, having a far larger exposure to Cuba in its own right. It was clear at several points that the agent did not want to enforce the structure as it stood in the documentation. It was against seizing other sugar cargoes, because it had financed a lot of these as well, or it was financing in some other way the sugar traders concerned who would stand to lose out, and resisted for a long time the pressure to call the BNC guarantee. None of the bankers wanted to enforce the security on the interest-guaranteed loan, because the moment they did that, the oil company would be off the hook for the interest payments, and at least the facility was 'current'. The oil men had their own agenda, and in the case of the second oil company, this did not necessarily include helping the banks – or at least helping the agent.

The Cubans were not slow to sense these considerations and to profit from them. They offered nothing in August 1998 because they were not asked for anything, and so gained an extra month. They offered the banks nothing while they negotiated with the oil company, and offered the oil company nothing while they spoke to the banks. This whole process took time. They also had a rather closer relationship with many of the sugar traders than the banks had. The result was that Cubazucar was able to cancel sugar export contracts that had been assigned to the facilities, and replace them with new contracts with the same counterparties and same delivery date, safe in the knowledge that the sugar trader was not going to refuse and that the agent bank, if it noticed, was not going to take action against another client (the sugar trader) to seize the cargo.

But what really happened in Cuba was that, structure or no structure, any repayments of anything in hard currency had to go in front of the Currency Committee. This sits in Havana with a list of all the hard currency receipts coming into the various state exporters – Cubazucar, Cubaniquel and the rest. It has a rather longer list on the other side, which might be termed a 'wish list', of all the items for which it has to pay. The real aim of any structure in Cuba has to be to get the repayment of the facility as high up as possible on the wish list, in order to get paid. This is done by the traditional method of carrot and stick (as with Sidanko). If the Cubans feel you will come back with new finance, that's a carrot, even if in the event you don't. If they feel you will seize their cargoes afloat by taking action in the European courts to enforce the assignment of contract, or call the BNC guarantee, that is clearly a stick. This is a technique practised better by some than by others, highlighted by the relative performances of the two oil companies, and it helps if the Cubans like you. The moral can only be to choose your partners and your specialists with care: in the end this is proverbially a 'people' business, and the track record of the individual is as important as that of the structure, the institution or the country.

At this level, then, the value of the structure at its most basic and realistic is to give you as many bargaining chips (whether carrots or sticks) as possible when it comes to haggling over how and when you will be repaid. We can say this works because in the end the Cubans paid everything, whereas the Russian government, which also had some repayment difficulties at the same time, and which might perhaps be seen to have had a similar outlook, did not. However, the theory of the structured trade deal, especially that performance is better than payment risk, is not altogether dead because in the end on these particular Cuban deals we can also see that the banks and oil companies did not enforce their performance-risk structures as they could have done.

In its worst year in 1998 Cubazucar still exported nearly 3 million tons of sugar, which even at the depressed prices of 1998 was worth around $375 million. It even sold it to the same traders in theory locked into the countertrade structures. It was just that it exported it under contracts that were not assigned to the structures, and the action that could have restored these cargoes to the original contracts was not taken by the banks or the oil companies. The creditors were not the only people with carrots and sticks. In the end, you cannot blame the structure as inadequate, nor fault the theory that supports it, if you are not prepared to enforce the provisions of the structure. The acid test was did the structure work? The answer has to be 'yes', but it was both despite and because of the people involved.

5 Other cautionary tales

This chapter will round up some shorter tales that were either too long ago or too thinly reported to do justice to a full case study, but which might provide some food for thought. Some of these are personal experiences and some are from press reports. The intention here is not to scare people off structured deals in difficult countries, rather to help people to ensure the structure they apply indeed mitigates the risks that certainly do exist.

IVORY COAST COCOA: TO SHIP OR NOT TO SHIP?

One of the claims most of us will make on a regular basis is 'they have to ship, because they need the hard currency and anyway there is no domestic market, so if they don't ship they can only store it'. *Generally* this is very valid. However, in 1989 Ivory Coast, still then in the grip of President Houphuet-Boigny, decided that the price it was getting for its 300,000 mt of annual cocoa production was too low. The Ivorians hit upon the brilliant idea of holding back production, of not selling. Exports were frozen and anybody with an export contract was stuck. Since Ivory Coast at that time was generally either the number one or two producer in the world, this move had quite an impact and indeed drove the price up. Meanwhile Ivory Coast received not a penny. Commercial traders were forced to cover their deliveries to Europe and the London Commodity Exchange from other origins, at the new higher price.

Months passed and, as the new harvest approached, it was felt in Ivory Coast that prices were sufficiently high. Anyway, it had no more storage room available. Ivory Coast consequently announced its decision to sell. The cocoa price as a result crashed, and the traders who had had to cover their terminal positions with a high physical price now found they were long in a plummeting market. Ivory Coast still didn't access the higher price, and objectively its move made no commercial sense at all, but it still happened and the extreme price volatility it engendered buried a number of the teams trading cocoa at the time. Even more incredibly, Ivory Coast attempted to do the same thing the following year, though by that time it needed one counterparty to buy the entire crop because it knew the normal trade would not take the risk of banking on Ivory Coast deliveries.

So, we can never guarantee that delivery will take place, though we can make a plausible case for believing it *should* happen, and in the end the difference is probably only a matter of timing. Track record over time is an important indicator for performance, while the magnitude of the track record between given counterparties may also help: how important is the offtaker you are financing to the producer/exporter in question? One feature of the Ivory Coast pattern of cocoa trade previously (and frequently of the cocoa industry generally) was that the annual exports before this were divided between many relatively small buyers, few of which had any clout with the Ivory Coast government on an individual basis. Producers seem less likely to default on an important offtaker, and if they do, then the larger offtakers may have more clout at their disposal to ensure a remedy. Eventually Ivory Coast went down the route of selling the entire crop to a single lifter, but even this did not eliminate the volatility this producer was able to wreak on the markets, for it promised the entire crop to two mega-offtakers at the same time. Bearing in mind both of these sophisticated large traders would have each hedged its physical commitment, when one of them inevitably lost the physical supply, the result was market turmoil and further casualties.

We generally accept that we are active in the Emerging Markets because as a consequence of the higher risk we can access a higher reward. However, there should always be a point where we should look at a producer or exporter or country and just say no.

UGANDAN COFFEE: PRODUCTION AT ANY COST

An even older tale this, but again the triumph of dictatorship logic over common sense. In the final days of the military regime in Uganda in the early 1980s, coffee production was suffering along, one is tempted to observe, with the rest of the country, and there were concerns in the government that the hard currency revenues might not be sustained unless ‘something was done’. Something was indeed done, and troops were sent in to collect the coffee harvest. As a former professional soldier myself, I have some sympathy for these troops because generally coffee harvesting is not on the curriculum of basic military training in most countries. The soldiers recovered the harvest by cutting down the coffee trees and loading them on to the back of their trucks. Typically it takes several years for coffee trees to attain maturity and be ready for harvesting. The moral of this story is probably to stick to the shorter tenors when financing soft commodity production for military dictatorships.

Another Ugandan coffee story from the early 1980s relates to the practice of unscrupulous East African coastal traders making up multiple sets of bills of lading for just one cargo, and then selling the same cargo several times over. By the time the cargo landed in Rotterdam these documents might have changed hands several times over, and it was even possible for one London-based coffee trader to find it had two sets of shipping documents for the same cargo. Normally the problems would not come to light until anyone attempted to take possession of the parcel upon discharge at the destination. Most experienced traders are very alive to this former practice and, combined with the very significant strides made in-country by the independent collateral management companies such as ACE, this is no longer a frequent event. From the financier's point of view, it always pays to finance the most difficult origins through an offtaker who will have sufficient people on the ground to ensure security of shipment, and even then it may still be advisable to use a collateral manager.

ENGLISH TOMATO PURÉE: POLITICAL RISK

Not altogether a 'commodity' story this one, but a useful lesson in looking out for third party political risks, and in the idea that random political decisions are not a purely African preserve. In the early 1990s, a UK producer of tomato purée had a contract to deliver his product to a wholesaler in New York. The deal was struck and the risk analysis looked simple: performance risk on the UK company, payment risk on the US bank of the New York company. Unfortunately for the English tomato purée man, the US was at that time in dispute with the EU over steel quotas, and the Americans were particularly affronted by what they saw as the neo-communist attitude of the Italians to supporting the Italian domestic steel industry. The US invoked one of its more interesting pieces of legislation and slapped immediate punitive import duties on a range of EU exports that it felt would have an Italian 'flavour'. Sadly for the English, top of this list was tomato purée. Don't let anybody tell you any cross-border transaction bears no risk.

IRANIAN CRUDE OIL PREFINANCE: THE DOWNSIDE OF DIY DOCUMENTATION

NIOC – the National Iranian Oil Corporation – is another of the staple prefinances of the STCF world, like Sonangol and Cocobod. NIOC enjoys an enviable reputation for good delivery, as a result of which it can access amounts, tenors and pricing all of which would be beyond the strongest of the Iranian banks. This is not to say that a NIOC prefinancing is a 'no-brainer'. There is certainly a well-trodden path for NIOC prefinances, and NIOC as a sophisticated counterparty has very clear ideas about what sort of documentation it is prepared to sign (and with whom – first you must get onto the NIOC list of acceptable banks).

As a result of a merger in the late 1990s, I once 'inherited' a NIOC Iranian crude oil prefinancing that had apparently just passed its final stages of documentation. Drawdown had not yet been allowed, and a meeting was set up at NIOC's offices in London to explain why this was the case. The new colleagues from the other half of my bank were very experienced gentlemen (both since retired), but essentially from an ECA finance background. They were certainly no fools, but neither were they 'oil' men, and they invited me along partly to show me how good their primary origination was, and partly to check just in case they had missed anything. They had taken the view that since the basic NIOC crude oil prefinance structure was well-established, the easy thing to do was to ask for a specimen of loan documentation that NIOC had accepted before, update it themselves, pass it across the (very good) in-house lawyer, and use that to document the new deal.

The colleagues made a good team. One spoke excellent English, was travelled, affable and charming, and within a couple of minutes of walking into the meeting with NIOC, appeared to have calmed the Iranians down about the fact that this deal was taking an inordinate amount of time to go through (in fact it had been delayed by the merger and a new requirement to get the deal agreed with our central bank as non-provisionable for country risk purposes – which agreement duly came through). He was not, however, in all fairness a 'details man' – more of a 'front man'. The other colleague, by contrast, spoke very poor English, was almost silent in the meeting, but was clearly the man who had done all the work, knew all the numbers and had a very clear grasp of what was going on.

The difficulty was that between them, neither had noticed that the formula given in the documentation for calculation of the Loan to Value Ratio was simply wrong. This was to be a two-year deal with a one-year grace period and then amortising over the second year. The way their LTV definition was expressed (with 'numerators' and 'denominators' and so on), they had taken the value of the oil contract over the full two years, and proposed to advance 80% of it up-front. The obvious difficulty with this was that any oil delivered during the grace period was not used for amortisation, rather the proceeds went straight back to Iran. Thus the only oil that mattered for the purposes of the LTV and calculating the advance was the oil to be delivered in the second year. This made quite a difference to how much oil you need to back a $100 million structure. This point, discussed unsatisfactorily in the taxi en route, came out again in front of the representative of

NIOC who, despite also having just flown in for the meeting, also spoke excellent English. With the help of a diagram it was rather easier to explain.

The difficulty had been that the arcane legalese English of the LTV formula definition had defeated the language proficiency of the details man, was not a legal issue for our in-house lawyer and had exceeded the attention span of my ‘front man’ colleague. Mercifully, NIOC were relaxed about the issue: ‘Yes, I wondered why you put it like that’ is what I recall being said. NIOC were good enough to rectify the documentation without complaint. In the Sidanko case study, I espoused the idea of getting a ‘good’ offtaker. It also helps to have a ‘good’ borrower.

IRAQI CRUDE OIL PREFINANCE: ON THE SUBJECT OF GOOD BORROWERS

In 1989 UBS and a club of European banks underwrote a medium-term crude oil revolving prefinance for Sonangol in Angola, with BP as the dedicated offtaker. This was (and remains) a spectacularly successful structure, which has survived unscathed by civil war and political turmoil in the host country, and has rightly become a benchmark for what can be achieved with a good structure. Some of the banks in this group, I think it is fair to say, found themselves there almost by accident and suddenly discovered that on a single deal they stood to make something in the region of \$2 million each. Obviously this went down rather well with the management, and once the dust had settled, the quest was on for the ‘next Sonangol’.

The first candidate to come up was SOMO, the State Oil Marketing Organisation of Iraq. The bank group and finance structure were broadly similar. The offtaker in this case was to be Chevron, though its role was rather more passive than BP’s had been with Sonangol, and basically all Chevron was doing was purchasing crude oil in the normal course of business. Based on the Chevron receivables, the banks sought and gained credit approval to underwrite the deal, which would see some hundreds of millions of dollars go into Iraq on a medium-term basis. Documentation was prepared, with some initial haggling over the details. The commercial oil contract was signed and Chevron dispatched two very large crude carriers to go to collect the oil. However, before the facility agreement could be signed, things began to slow down rapidly at the Iraqi end. The chief negotiator from UBS volunteered to go to Baghdad, either on his own or with all the banks, to settle any last-minute issues so they could sign the deal, but SOMO held off, and suggested it might be better to wait a while. A few days later, Iraq invaded Kuwait, and all bets were off.

As part of the sanctions imposed on Iraq, all bank accounts were frozen, all debt repayments consequently ceased, and the oil contracts were abrogated. Had drawdown been made, it was hard to see at the time how the banks could have got their money back, and this scared a number of banks off further prefinancings. Since then we have seen the UN-authorised Iraqi oil-for-food programme operate quite successfully, and there have been substantial recoveries of unpaid Iraqi debts through the achievements of Omni Finance of the Netherlands and others, through pursuing and attaching Iraqi assets held overseas. However, perhaps we should also spare a kind thought for the Iraqi oil men who advised caution at a critical moment. Again, a good borrower is the best place to start in any structure.

CAMEROON CRUDE OIL: LEGAL COSTS SHOULD BE MET BY THE BORROWER

The second 'next Sonangol' for this bank club in 1990–1 was also a limited success, but for very different reasons. Details at this distance are difficult to establish, but essentially the old team of BP and UBS found themselves discussing a similar Sonangol-type crude oil prefinance deal for Cameroon, in West Africa, which was linked at various stages to the financial arrangements for the redevelopment of part of the airport at Yaoundé. The difficulty was that the ideas of the Cameroonians were by no means fixed, much less agreed with UBS, at the time lawyers were engaged. The deal started out with a headline amount discussed informally for around \$200 to \$300 million, with underwriters lined up to look at taking something like \$50 million each. The deal then changed, and shrank in size, steadily falling lower until in the end it became a facility of just \$35 million, agented by UBS and sold down to those few of the originally lined-up underwriting group as would consent to be participants rather than underwriters. It is not clear whether a cap was agreed on legal fees beyond which point UBS was bound to pay, or whether there was no cap and UBS was simply on the hook for the legal fees. However, while the many changes that arose in negotiation severely exacerbated the problem, the challenge faced by the agent was that the documentation for a \$35 million structure on this basis is not wildly different from the documentation for a \$300 million deal. What might have looked 'par for the course' in terms of legal fees on the latter was, according to talk at the time, actually rather more than the bank stood to earn altogether on the former.

As we say, details are imprecise and we are not privy to the secret of whether UBS actually made any money in the end out of this transaction, but it was no secret at the time that the level of legal fees, after all the changes inflicted on the facility, significantly eroded the profitability of the rump deal that went through. On the plus side, at least UBS was able to bring off the residual deal to cover the bulk of its costs (I am told the lawyers also took some of the pain), and the deal itself progressed normally. The moral of this story has to be to avoid incurring legal expense until you are more or less clear what the parameters of the deal will be (some lawyers may even be encouraged to work on a 'no win/no pay' basis, but they are hard to find in a buoyant market). When you do have to incur legal costs, ensure that they are met by the borrower as part of the cost of finance. Borrowers tend to try to resist this, or encourage 'DIY' documentation, but this is not necessarily in the best interests of lenders/investors, for in the end, it is they who are providing the funds.

NIGERIAN COCOA: A TALE OF WOE

This cautionary tale is a personal one for me that left a deep impression at the time. In particular, it taught me to choose local partners with care: people with whom one starts out very amicably may in the end prove to be a disappointment, and in such circumstances we will all end up scrutinising our documentation in the hope of it revealing some route to salvation that has yet to spring to mind. It also taught me, as they said in the Marines, 'if you didn't have a sense of humour, you shouldn't have joined'.

In 1988, at the behest of the IMF, Nigeria did away with its old Cocoa Marketing Board, and the whole cocoa industry was thrown open to market forces and the entrepreneurs. This lofty macro-economic stroke immediately wrought absolute chaos within Nigeria, and was possibly the best single argument for the continued functioning of the remaining marketing boards elsewhere in Africa (the most famous being Cocobod in Ghana, which, in contrast to any of the 'privatised' cocoa producers, has been able to attract phenomenally cheap financing for its producers). The former staff of the Nigerian Cocoa Marketing Board were snaffled up by various producers, traders and warehouse companies. The big challenge facing the private sector was how to get cocoa down from the cocoa-growing areas to the port of Lagos, bearing in mind that most individual farmers did not produce enough at any one time actually to fill a single lorry. The solution was to establish warehouses up-country, to which local buying agents would bring in the goods from individual farmers, and then complete truckloads would be driven down to Lagos for shipment. Some of these warehouses were established by traditional international warehouse companies, like Cornelders. For a European trader, however, this also seemed like an opportunity to lock in a good-quality origin and possibly also make a turn on the preshipment end of the trade.

August Agencies Ltd (AA) was set up as a joint venture between one such European trader, for whom I happened to be working at the time, and a local company run by the then chairman of the Cocoa Association of Nigeria (commonly known as 'the Chief'), on a 40/60 basis, as was the Nigerian law on joint ventures at that time. AA was to establish a warehouse up-country, feed down to the port and then ship to the European trader. For this it needed access to credit, and the rationale at the time was for the European trader to provide an offshore guarantee, from a European bank, in favour of one or more of the local Nigerian banks, which would then provide credit facilities on the basis of this security. The honour to represent the European end of this partnership fell to me, and literally weeks after joining the European trader on the basis of a desk job countertrading in London, I was dispatched to Lagos. Armed with a guarantee for $5 million from the London branch of Banque Internationale pour l'Afrique Occidentale (BIAO – then a subsidiary of BNP), based on the balance sheet of the European trader, I was able to establish a number of credit lines with local Nigerian banks (mainly also 40/60 joint ventures with various international banks). A young professional expatriate (mercifully not me) was installed to ride shotgun on the Chief, and plans were made to build the warehouse up-country, at Akure. Meanwhile, AA busied itself with making preparations in Lagos, and in a wave of optimism ordered two containers of jute bags from a manufacturer in Bangladesh, suitable for bagging cocoa.

Three months later, in January 1989, the Nigerian government's new budget did a number of things. For one, it made illegal the use of offshore guarantees such as had been set up for AA. For another, it banned the import of jute bags, on the basis that it wanted to encourage the local jute bag industry. This was particularly unfortunate because, first, there wasn't a local jute bag industry, or at least, not one making bags for the local cocoa industry, and, second, the Bangladeshi bags had just landed in Lagos, with the result that they were unable to clear customs and looked set to join the social infrastructure of Lagos port. Faced with notice of the budget, which was to come into effect in April 1989, BIAO tried to get notice of utilisation of its guarantee from the Nigerian banks. There was a small utilisation at First National Bank of Nigeria, which had been used to fund the purchase of two cars and a second-hand truck, amounting to something like $80,000, but the big surprise was that another of the Nigerian joint venture banks showed utilisation of $5 million. This was a surprise not only because it exceeded the size of the line, but also because AA had not actually bought any cocoa yet, nor was the warehouse, although completed (according to the photos we had been sent in London), yet in use. I was dispatched to Lagos a second time to establish what was going on.

The first thing I did was visit the warehouse up-country. This building site was clearly a long way from civilisation, much less completion, and did not even have four walls, much less a roof. I was advised that the roof had been *about to* go on, when a storm had inadvertently brought down one of the walls. All I can say is that they had done a good job of clearing up any rubble and replanting the vegetation where the foundations should have been. The photos looked to me to be of the Cornelder warehouse some miles down what passed for a road. Some weeks of ping-pong followed, whereby the Chief would deny all knowledge of what this mystery $5 million drawdown could be, and referred me to the Nigerian bank, who would refer me back to the Chief. Having made an appointment with the bank some days later (my contact not being 'on station'), I would be met by the charming Manager of Export Finance who would explain very patiently that I couldn't possibly be told anything about the accounts of AA since I was not a representative of the company and this would be a clear breach of client confidentiality. I would then return to the AA office in Western House where the Chief, it would have transpired, had gone to the capital for a few days.

Checking our documentation, it would show that to become a representative, indeed any new employment, would require ratification by the board of directors and the chairman of AA (i.e. the Chief). When the Chief was finally back 'on station', he would then be very sympathetic, and after some persuasion agree to make me a 'representative' of AA, after which the necessary board resolution would be procured. Another appointment at the bank would be made, rather later in the year than I had really intended staying in Lagos, since again I would discover, with the inevitability of rain on a Bank Holiday, that the Manager of Export Finance would not be 'on station' upon my first enquiry. The Manager of Export Finance would then say that I might be a representative of AA but I was not an *authorised signatory* (even though I had set up these accounts personally), so perhaps I would be so kind as to return when I had achieved proper authorisation for my enquiry.

Back to the documentation. The Chief would be sympathetic again and eventually allow himself to be persuaded to make me an authorised signatory, with this time board and shareholders' resolutions. In the end I managed to get myself on the board of directors of AA and armed myself with a signed and stamped board resolution, and letters from the shareholders, and *still* was refused information at the bank, by the Manager of Export Finance. At this point I had been in Nigeria for some months and had something of a sense-of-humour failure. We had a frank exchange of views, and I demanded to see the senior expatriate manager at the bank, at which point the Manager of Export Finance's charm waned, I was informed that the Deputy General Manager was not 'on station' and that I should vacate the premises immediately.

He then called the security guards on me (bearing in mind this was in a military dictatorship). However, commando training is not without its uses (and I don't mean violence: it's amazing how many people will obey when given a direct order using the 'voice of command', and I made my way unhindered to the top floor of the building, where I managed to get past the secretary there and burst into the offices of the senior expatriate in the bank, the German Deputy General Manager.

This gentleman was very helpful. He explained he had heard we were in town, and had been trying to reach me for some weeks at AA but was always told I was not 'on station'. Five minutes later and all was made clear. It transpired that the Manager of Export Finance and the Chief were of the same tribe. The Chief had drawn down against the BIAO guarantee to fund an opportunity that arose to buy a cargo of fish from a Soviet factory vessel then offshore Lagos. This business had nothing to do with the European trader except that, unknown to the trader, they were financing it. The Chief had paid, but the factory vessel's refrigeration had broken down, and offshore tropical West Africa in a steel box, the cargo did not last more than a few hours. Worse, the vessel was so old it had been uninsurable, and the Soviets had already sent the money home. The Chief, and consequently AA, was out of pocket, but at this stage we discovered that under the joint-venture agreement, the Chief had rather more power than in retrospect any of the other shareholders might have wished. The European trader sent down a number of rather more senior people, the net result of which was that we all became convinced that AA was a write-off. After quietly getting rid of the fixed assets, and finding a reputable local Lebanese trader to take the jute bags off our hands (for some reason he was convinced he would find a way to clear Lagos customs), the damage was not serious except for the $5 million outstanding at the local bank.

The solution to this predicament came from BIAO. First National Bank of Nigeria had already called the guarantee for its $80,000 and BIAO had paid it, as it was bound to do. The situation with the other Nigerian bank was less clear. Although BIAO became aware of the Chief's actions, he was legally empowered by the joint-venture agreement (a better 'Purpose and Application of Funds' clause would have gone a long way) to use the AA facilities. Any breach of his understanding with the European trader, nor even his efforts to hide the truth, did not affect the bank. However, the Government deadline for an end to the offshore guarantees was by this time looming. BIAO suggested replacing its guarantee with a Red-Clause Letter of Credit, to be advised and drawn through the local Nigerian bank, which made the use of funds rather more clear since it required a 'declaration of intent to ship', to be signed by any AA board member *plus* the AA expatriate manager, as part of the drawdown mechanism. It also incidentally had a relatively short Availability Period. The Nigerian bank accepted this, and the utilisation under the guarantee was moved across to the red-clause L/C so the guarantee was released. Once the guarantee was released, on advice from BIAO, both I and the expatriate manager of AA returned to London. At this stage, the Nigerian bank made a claim for reimbursement under the Red-Clause Letter of Credit. BIAO stalled this for a few days, then as the expiry of the Availability Period approached, advised that the claim for reimbursement was rejected, because it was not accompanied by a valid ‘declaration of intent to ship’ from AA. Sadly, such a declaration could not be made in time, because the AA expatriate manager was not ‘on station’ so the obligation to repay the $5 million to the Nigerian bank was left squarely with the Chief.

So, it also pays to have a good bank.

6 Documentation – dos and don'ts

It should be no surprise that the longest single discussion apart from the case studies is on documentation. In any work of this nature, the author will be encouraged by his publisher to include a section entitled 'legal aspects' or some variety on that theme. The author will then be left with an invidious choice between, on the one hand, sticking his neck out in front of an audience of lawyers all of whom will want to preserve the law as *their* domain, rather than a subject open also to amateurs from the banking world, and a number of whom will actually know the law better than the banker (it is always very satisfying for the banker to catch out the lawyer on a matter of law: sadly, one has to concede this is generally the exception rather than the rule); and, on the other hand, actually engaging a friendly lawyer to write the section outright. However, my experience of friendly lawyers is that they have been obliged to do this so often, and know already how minuscule is the pecuniary reward on offer from the publisher that their first inclination, reasonably enough, is simply to hand over the 'off-the-shelf text'. Fair enough, but this also tells us something of the nature of the first draft of any legal document: very few are written from scratch, and while most will be 'legally valid, binding and enforceable' in the legal sense, this is some distance from saying that they necessarily achieve the commercial purposes of the protagonists of the deal.

Recently we have also had to face another development that it is fair to say has not really helped. The inexorable march of the US pattern of investment banking across the Emerging Markets has encouraged a whole raft of legal advisers to replicate a pattern of loan documentation that is grounded firmly in the assumptions and predicates of US Generally Accepted Accounting Principles (GAAP) and the US capital market standards of balance-sheet debt. There was always a tendency in mainstream commercial banking anyway to follow the traditional corporate banking approach to credit analysis, based, as we saw earlier, on analysis of the Balance Sheet, the relationship it reveals between equity and debt, between the financing structure and the asset base, and consequently to trust the promises of the Profit and Loss account as the primary criterion upon which to base the credit decision. Combine the modern investment banking trend with the historic corporate banking tendency, and the result more and more is seen in the way in which experienced banks and their lawyers produce loan documentation for ostensibly structured transactions that nevertheless really look like glorified versions of the average US corporate banking facility.

Of course, there is more than one school of thought on this. The ranks of project finance professionals are thick with 'cashflow modellers', who will project a cashflow model far into the future to establish the Debt Service Coverage Ratio (a ratio beloved by the credit ratings agencies). This is legitimate enough when based on an historic model, adjusted for the actual production parameters and including a view on the future price of the goods to be produced. But if the cashflow model is based purely and simply on a balance-sheet projection, and the balance sheet is for a producer in Khazakhstan from 1997, then you have to wonder whether you've woken up one day to discover you've been asleep for a couple of decades and the world has moved on without you. I have actually been presented with documentation for a pre-export finance where the story went something like this.

Comment of the arranging bank as the info memo is distributed to the co-arrangers: 'We're including the Balance Sheet, but it's not really meaningful because it's two and a half years old; it's the only one they've ever done to US GAAP so there is no "previous year comparison"; and as a result of that and some other issues (such as the difficulty in valuing the assets in a country where this has never been done before, and where there is no free market in such assets), the auditors included no fewer than seven qualifications . . . so what you want to look at is the production capacity and the projections.'

We did this, and indeed I liked the story: good track record of improving production of a major commodity over the previous three years, good independent technical report on the producing units, good story on relations with the government and the employees, good track record on exports, no obvious third party threats and a well-established offtaker who had put in some subordinated debt and who could accept a number of alternative delivery routes. The loan documentation duly arrived, but with no monitoring of, or control over, the exports. Rather, it came armed with a whole raft of balance-sheet covenants and undertakings based on the cashflow model: 'Well, we've got a minimum net worth covenant, and if their total indebtedness rises above this given threshold, then the producer has given an undertaking to retain the subordinated debt from the offtaker rather than continue to pay it down . . .' One could be forgiven for feeling one was suddenly dealing with a metal-bashing factory in Minnesota, especially when it then transpired that the cashflow model, which up to that point had looked pretty convincing, was actually based on the Profit and Loss from the one year for which the company had the (rather heavily qualified) audited results. All the remedies available to the lenders in 120 pages of detailed loan documentation were triggered either by balance-sheet events, or by insufficient funds arriving in the collection account to make the amortisation schedule. The arranger had told us to disregard the producer's Balance Sheet, and the documentation when it arrived in first draft based the whole structure on a cashflow model which was a projection of that Balance Sheet, enshrining conformity to that model as the primary mission of the documentation. Maybe they see it differently, I don't know. They were kind enough to humour me in my old-fashioned commodity-banker approach, and monitoring and control of the export flow was duly included in the security structure. If we saw a shortfall in deliveries, or a drop in the value of deliveries, we could take immediate action to escalate the cashflow in time to meet the amortisation schedule, rather than waiting to see how much cash actually turned up when we could already calculate the anticipated value.

In the event, then, the documentation included both the old-style commodity banker's concept of collateral management, with the rival security of balance-sheet covenants and the rest. However, this was not a unique event, and also, in the banks I have worked for, I have continually had to face documentation that would probably be perfectly laudable when used to evidence finance for a lathe manufacturer in Garmisch-Partenkirchen, but which is largely wasted on the average ex-CIS, or African, or Latin American commodity producer. Admittedly, all structured trade finance specialists – and many from other disciplines – are guilty of saying at some stage: 'Don't bother looking at the balance sheet because it won't help you.' Often this is true, but we shouldn't ignore it altogether, and particularly we should not ignore it and then go on to base a lot of the documentation of our structure and monitoring on balance-sheet reporting. This is not a legal issue because both styles of facility documentation will look equally good legally; rather, it is a commercial credit issue.

Accordingly, this section will not be a review of legal aspects, but a general tour of things to look out for as a protagonist in loan documentation for structured deals, with particular attention to distinguishing the legally valid from the commercially desirable. I assume from the outset that you have a good lawyer. My feeling is that banks and offtakers should resist the temptation to try to do documentation in-house. The 'piggy-back' approach to documentation, with the Facility Agreement cobbled together from previous deals, is never wholly satisfactory. For a start, no-one, no matter how experienced, is infallible. Do your own documentation from scratch and you are bound to miss something that a critical legal eye is much more likely to pick up (like the NIOC prefinance howler in the last chapter). Of course, if the deal is to be distributed, it is a very tough sell to get other banks to accept in-house documentation. In-house lawyers (and I have been lucky enough to work with some very good ones) may defer to the specialist expertise of an outside law firm, but most of them will be damned before they submit to the scribblings of *another* in-house lawyer. Where the lawyers really score, in my view, is in their clarity and thoroughness in preparing and monitoring the Conditions

Precedent. They may make all sorts of other contributions, notably at the early stages when you are trying to get your basic ideas straight, but assuming that, like me, you are arrogant enough to feel you can work out your own structures, it is in the Conditions Precedent that the specialist law firm provides a real safety-net to the self-belief of lenders and offtakers alike. That said, lawyers rarely lose money on a deal, generally because it is the rest of us who are taking the risk. We cannot abdicate documentation to the lawyers. Assuming, then, you have a good lawyer, the following review is aimed at highlighting what might be commercially important, rather than simply repeating the legal implications, which the lawyer will tell you anyway for a fee that is more than reasonable.

Let us consider a standard format set of documentation for a structured pre-export finance. Points are taken in the order in which they generally arise, but please don't read any importance into it if this is not the case.

DEFINITIONS

Don't skip the definitions. Admittedly, a lot of the definitions are pretty tedious, even for the hardened professional, for example, where 'Libor' is explained in three lengthy paragraphs, or where 'US dollars' are routinely described over several lines as (eventually) the legal tender and currency of the United States of America (clearly, for some, 'Definitions' itself might be defined as 'a lengthy and sustained exercise in stating the bloody obvious'). The result is that the definitions section can easily run to 15 to 20 pages. However, there is an increasing tendency for more and more of the structure to be buried in the definitions rather than enshrined in any sort of logical sequence of clauses.

Items to look out for include 'Full Recourse Event' and 'Limited Recourse Event', which between them may describe a large part of the circumstances under which the lender expects to be let off the hook by the deal sponsors. The list below is not exhaustive but is intended to highlight certain definitions.

Business days

It sounds obvious, but you would be surprised at how many people take a lender-centric view of the concept of business days. A business day should be any day on which banks are open for business in *all* of the countries from which the various protagonists (including participant banks and the borrower) are drawn. We recently led a deal where a German bank did not see why business day should be anything beyond when banks are open in Germany. The borrower was Russian, while the Agent was in Amsterdam (albeit at a branch of the German bank). There is absolutely no point in having a business day on a date when thanks to some obscure Russian saint, it is impossible to reach anybody at the borrower's offices. In the land of the Maastricht employment contract it can also be quite difficult to get staff to come in when it is a bank holiday in Amsterdam too.

Events of Default

Events of Default can be a lengthy definition. Nevertheless, what happens after an Event of Default should properly be in the main text of the Agreement. From a lender's perspective, the definition should be as wide-ranging and subjective as possible, giving the lender the right but not the obligation to do anything he needs to do (see also EOD under 'Agreement').

Export/Offtake Contract Value

The fact that a particular commodity has a well-known benchmark price to which everybody commonly refers does not necessarily mean that this is the price that pertains to the particular grade or variety we are financing. A common example is crude oil, which in the European time zone and beyond is typically priced off Brent crude oil. It is useful to check the 'Export Contract Value' definition in the Facility Agreement with the Price Clause in the Export Contract. You need to establish whether you have the right benchmark, and whether there is a discount or premium to the benchmark. REBCO, for example, commonly trades at $1 to $1.5 below the relevant Brent. This can make quite a difference to your LTV (loan to value) cushion if the latter is calculated on Brent flat.

It is also customary to set a notional value to the Export or Offtake Contract somewhat below the current spot price. Exactly where this 'base price' should be cannot be written in stone. Obviously, the lenders would want the base price as low as possible, while borrowers will argue it should be as high as possible. However, at some point in putting together the documentation the protagonists will have to agree a base price so that they can establish an indicative volume of goods to be committed to the financing. For example, if the current price of oil is $31 per barrel (/bbl) and the protagonists agree they are looking to put together a facility of $100 million, then early on in the proceedings they will need to have some idea of how much oil they need to back this. For a start there will be the normal advance ratio (the LTV), typically 80%, meaning that a $100 million financing requires $125 million in oil. However, the protagonists also need a nominal oil price, and since oil prices in recent times have been anywhere between $25 and $35/bbl, it can be seen there is a certain amount of volatility that goes beyond the cushion provided by the LTV. The spot price is often a long way off the annualised average. Over the period of one year, prices may vary between $10/bbl and $30/bbl, to give an average of $15/bbl, which would make an indicative base price of $30/bbl look wildly out of court. Ideally, the base price should be founded in the average price during the year preceding the financing. Most exchange-traded commodities are blessed with a freely available mountain of available statistics on price, so it should not be too difficult. Alternatively, one may agree to use a target price set by some industry body (provided it is lower than the current spot price), e.g. OPEC's target of $22–$24/bbl for oil when the spot price is $31 and recent peak was $35/bbl doesn't look too bad. Of course, if the spot price were $20/bbl then the Opec target would probably not be acceptable to lenders as the base price.

Finance Parties

It is best not to leave anybody out, especially if they are the people actually producing the goods.

Guarantor

The definition of Guarantor is always worth considering carefully. We may not give much credence to the value of certain Central Bank guarantors, not least on the basis that if the Central Bank was at all creditworthy we wouldn't be messing around with a structure in the first place. Nevertheless, a guarantee is often worth having, if only for the additional leverage it provides. It can be particularly useful, as we saw in the Cuban case study, to have a Guarantor that is also the State's Guarantor for its ECA-backed facilities, since the possibility of cross-defaulting all the ECA debt adds considerably to the leverage of the guaranteed facility. In Russia, of course, for a Russian entity to issue a US dollar guarantee requires a Central Bank of Russia licence, whereas a 'suretyship' according to some legal advice does not. A fine distinction, perhaps, but the 'commercial suretyship' has for the structurer the additional benefit over a guarantee of being an undertaking to deliver goods, and of being more or less freely assignable. Less convincing is the 'financial suretyship', which is beloved of certain Western lawyers practising in Moscow and happily accepted by bankers looking for the more familiar, which seems essentially to be a 'guarantee' redenominated as a 'suretyship'. Central banks may be difficult, even Byzantine, but they are rarely stupid, and if it looks like a duck and quacks like a duck, there is a certain inevitability about what the Central Bank is likely to call it.

Interest Payment Dates

'Interest Payment Dates' is another interesting item which may dictate how the Facility actually runs. Contrary to the opinion of some, there is nothing advantageous or desirable about having monthly interest payments for the sake of having monthly interest payments, when there is no underlying cashflow to support these payments. If the deal is going to work well, the lenders really want to do as little damage as possible to an existing pattern of trade. If the underlying oil contract being financed has no deliveries for six months, you might as well fund the deal to the end of that six months and only ask for interest when the oil begins to flow. If the deliveries thereafter are every five weeks, much better to match the funding to the underlying cashflow than try to exact repayment out of thin air. For a lot of soft commodities, but also a consideration for any deal in which goods are to be shipped, it makes sense to build in a little leeway between the Shipping Schedule and the Repayment Schedule. Ships can be delayed by something as simple as bad weather. Sugar may be delayed because it is raining at the port, and rain in the tropics may last weeks. But if the goods are there, what are you going to do: declare a default? On the other hand, borrowers will resent being charged Libor plus a margin while their cash sits on the Collection Account at the Agent: some sort of compromise should be reached.

Licences

Licences of whatever kind are useful to have 'in a form and substance acceptable to the lenders'. Obviously, they have to be in a form and substance acceptable to whoever issues them as well, but it may be that the Lenders would like the licence to say rather more than the Borrower might want it to say.

Majority Lenders

'Majority Lenders' is always a slightly tricky definition. Arrangers will generally want to avoid being held to ransom by individual banks holding 2% of a deal (and who may be tempted to be as awkward as possible in the hope that one of the other lenders buys them out). On the other hand, the other lenders will want the threshold set sufficiently high that they cannot be railroaded into decisions by the Arranger alone. However, if the eventual outcome is something like 66%, as is common these days, participants using Political Risk Insurance (PRI) will need to ensure their insurers know they may be outvoted on decisions by 'Majority Banks'.

Material Adverse Effect or Material Adverse Change

Material Adverse Effect and Material Adverse Change (MAC) are also worth looking at carefully, since these are triggers for changes in the operation of the facility (usually to put the lender in a better position). See below in 'Agreement'.

Permitted Encumbrance

Permitted encumbrance is a concept by which the lender agrees it is satisfactory for the borrower to have other secured debts owing to other creditors. It is interesting since this is where the lender frequently talks himself into major concessions on one of the items lenders should worry about most, namely, the possibility of the structure being brought down by third party creditors. A recent facility we saw had a PE definition running to two whole pages, pinning down the borrower on exactly what they could and couldn't do, then more or less blew the lot by conceding that all existing encumbrances were acceptable, further encumbrances of up to $75 million didn't count, and worse, that encumbrances with the major local state-owned bank didn't count either. Lawyers have to eat too, but this was simply a waste of space.

Pledges

Ideally, every link in the chain between even thinking about production, through to export and payment of export receivables should be either pledged or assigned. Pledges should include anything for which there is a document of title (however flimsy), any accounts (transit, local currency and of course the collection account), and anything in a pile anywhere.

Potential Event of Default

As a definition, Potential Event of Default should ideally be short and sweet, leaving it up to the lenders to decide what is and what is not a PEOD. Beware, however, the full-blown structural clause appearing here in disguise, when it should be in the Agreement (see below).

Offtaker Acknowledgement

Strictly speaking, if you have an assignment from the producer, it is not necessary to get it acknowledged by the Offtaker. However, if you expect the offtaker to pay into a specified collection account, it is always safest to get the assignment of export contract acknowledged by the offtaker. Obviously, for a facility in which the offtaker's role is simply to buy and pay for the goods if they turn up, there may be a certain amount of resistance to some of the more glorious edifices constructed by the lawyers as 'Acknowledgements of Assignment', which can look suspiciously like short-form loan agreements themselves, and we should not be surprised if the Offtaker declines to sign such a document. At the very minimum the Offtaker should agree not to pay into any other account than the specified collection account without agreement of the Agent.

Repayment Mechanism

Repayment Mechanism is another definition that can hide substantial components of the structure. Beware in particular, as we pointed out on Eximcoop and the Khazakhstan story, mechanisms which trigger all Events of Default and remedial actions by the Agent/Lenders from insufficient cash turning up on the Collection Account. Admittedly, if there is a cash shortfall, this is generally not good news. However, a good agent should really have known before that point that there would be a shortfall, from the shipping documents, and even earlier, from the proposed Shipping Schedule matched to the current commodity price (which the agent should also monitor). If you have to call for more goods, the earlier the better.

Security Documents

In theory Security Documents should comprise a comprehensive list of everything to do with the security package. However, it can always be useful to have an 'other documents' definition or clause in the agreement whereby the lender gets to have any document it may reasonably require, just in case anything gets overlooked in the rush to make the drawdown.

Subsidiary

Look out for 'Subsidiary', also for definitions of 'Group'. Generally the intention will be to wrap in any subsidiaries of the obligor, especially operating companies. Ideally, the lender would want this also to include 'associate companies', especially if they perform key roles – such as the offshore, group-related but often not wholly-owned trading companies used by many Russian and Brazilian borrowers. Best is to name the companies intended, but then it should be made clear that the list is 'including but not restricted to . . .'

Taxes

Taxes should be defined as widely as possible, to include any future taxes.

AGREEMENTS

Purpose and Application

Purpose and Application are of greater importance to lenders than is often realised, and not just because lenders are increasingly touchy about being asked to finance things of which they ought not to approve and which others may find out (the feared 'reputational' risk). More crucially, if the purpose and application of funds is not strictly controlled, lenders may find themselves taking on rather more risk than they really anticipated. This was highlighted most radically by the Russian banks pre-crisis. Anyone lending to the Russian banks might have been forgiven for thinking that they were avoiding the riskier segments of the Russian market. They were lending in dollars, not local currency. They were lending to banks, not corporates and not federal or local authorities. The Purpose of these bank loans was generally given as 'normal corporate purposes' or 'general working capital', often combined with '*and* trade finance' just for that added touch of respectability. Now, of course, we know that what they were doing was borrowing relatively cheaply abroad and lending very expensively to the Russian government at exorbitant rates in local currency. It was fun while it lasted. When the Russian government failed to pay back its debts, the Russian banks collapsed overnight, and the foreign lenders would have been better off lending to the Russian government directly, because at least then they might have made more money before the wheels fell off the bandwagon. Similarly, we saw with Tatneft and Ovetril how even corporate borrowers in structured trade deals can in fact quite easily lose all the loan proceeds without having touched the primary purpose, which was ostensibly to finance future exports, by using them for some entirely different purpose.

Purpose and Application is a difficult one to control, but some effort at least should be made to encourage the Borrower to feel he must use the proceeds for something that fits the objectives of those advancing the funds, and that he has no mandate to use the funds for anything else. If it is clear this is not going to be the case, then either the loan should not go through, or if it has, this breach should be an Event of Default because this is a potentially dangerous situation for lenders.

Information of Deliveries

Ideally, the Borrower should be bound to tell the Agent everything about every movement of goods throughout the lifetime of the Facility, on pain of an Event of Default. With the more sophisticated borrowers this may not be achievable, and lenders will need to balance the desirable with the commercially realistic. It may also be that this is operationally burdensome, for example, if movement is by railway wagon (some Central Asian trains can easily be over 100 wagons, each of which will have a railway bill). If this is the case, the Borrower should be required to bundle such information for convenience. Even so, the agent should always retain the right to demand evidence of all movement, even if as a matter of course he doesn't want to receive it every day, if only to concentrate the mind of the Borrower. The agent should also normally seek to get such information within a reasonable timeframe.

Prepayment

We have discussed Repayment Mechanism above, and clearly this will be the major focus of most lenders. *Pre*payment as a concept may seem somewhat optimistic with some borrowers, but this is often a clause that actually gives more difficulty. Prepayment comes most commonly in one of two scenarios. In a facility in which the tenor exceeds the business cycle of the country, it may well be the case that some years or even months after drawdown the Borrower could have achieved a very much cheaper deal than he got from you, and so will seek to refinance. Normally the existing lenders would want to encourage the Borrower to conduct such a refinancing with them. This gives them the chance to repeat fee income on a known risk that they have already accepted, at the cost of margin income. This will have the advantage to the Borrower of speed and certainty of result (unless he has fallen out with his banks), while he will not escape the fee component of the cost no matter to which bank he takes his deal.

The other scenario in which prepayment is an issue is where cashflow comes in ahead of the Repayment Schedule. No-one wants to see the Repayment Schedule set too aggressively close to the Shipping Schedule, because in the end no-one controls the weather, but on the other hand too much leeway will result in cash sloshing around the Agent's books while the Borrower is still paying margin. Some compromise ought to be reached, even if only to give the Borrower interest on cash balances. Personally, I would rather err towards having the cash sloshing around and accept having to pay credit interest back to the Borrower rather than be faced with a Repayment Date and no cashflow, which is one of those scenarios that, even if it occurs as a result of a perfectly coincidental series of mischances quite beyond the power of the Borrower to avoid, is nevertheless guaranteed to upset investors, the credit department and those nice people who set provisioning levels for front office departments at banks. If the Borrower wants to argue this point, the usual US remedy is to have a Reserve Account, which generally translates as having cash sloshing around the Agent's books throughout the lifetime of the Facility.

Two final things to watch on Prepayment are, first, that it generally doesn't go down too well with insurers, so if you have PRI, you will need to anticipate the prospect of prepayment in your policy wording; secondly, of course, any break costs arising from Prepayment should be for the account of the Borrower.

Acceleration clause

This is always worth having even on short-term loans, though generally more commonly seen on deals of over one year. Essentially this is a clause that allows lenders to accelerate the Repayment Schedule so that the loan is paid down more quickly. This concept has a number of applications. Frequently it is used in medium- to long-term deals where commercial lenders would attract mandatory provisioning requirements from their regulators if they did not have such a clause. For example, the classic Sonangol crude oil prefinance structures in Angola since 1989 have been of tenors between three and five years. Angola by most ratings of country risk comes in the category of 'basket case'. Nevertheless, the Sonangol prefinancings are very well supported by the commercial banking world, and regulators in all the European jurisdictions have ruled that these are not provisionable. They do this by combining a revolving (but not amortising) structure with an Acceleration clause. At initial drawdown, the Offtaker typically requests the Agent to issue a 12-month L/C in favour of Sonangol, payable against deliveries of crude oil evidenced by shipping documents. This payment L/C is replaced every six months by a new L/C for similar value. Deliveries are typically monthly or every 40 days. Provided performance is as per contract, or at least no more than an agreed number of delays per six-month period (Monitoring Period), then the L/C is revolved and can be characterised 'short-term trade' . Typically, default/delay on two cargoes during such a six-month period would trigger Acceleration. This entails a new 12-month L/C still coming into place, but with each delivery under the L/C being used to amortise the prefinance. Again this can be characterised as 'short-term trade'. The lenders can justifiably say their exposure is no more than 12 months at any one time (or 18 months if an entire Monitoring Period is included). QED.

The corollary is that in calculating the 'prefinanceable' amount available for a medium structure relying on an Acceleration clause, the value of commodities must be the value deliverable in a 12-month period, not what is delivered over the full period of the financing. Acceleration is also used where a two-tier amortisation is envisaged, depending on the availability of Conditions Subsequent. This is commonly seen in Russia. As mentioned elsewhere, a 180-day prefinance does not, at the time of writing, require a Central Bank of Russia licence. However, a longer term will require a licence. If the Lenders and the Obligor are in a position where the pressure of time makes it impossible to get the CBR licence prior to drawdown, then it is possible to structure the deal on an initial horizon of 180 days, to be extended to the ultimate horizon (say one to two years), if and when the CBR licence becomes available. However, if the structure is to be self-liquidating, some effort must be made to allow accelerated amortisation if the CBR licence does not come through by a certain pre-agreed breakpoint (for example at the 90-day mark). In such a case, the value of the Facility is then whatever value of commodities can be delivered over the remaining three months. This is not as much of a test as it might sound if a single oil cargo is worth $35 million plus, but becomes harder for lower-valued shipments or when prices are low anyway. On a short-term deal the use of such a clause may be less obvious, but if things start to go wrong it will always be useful to the Lenders to be able to make the entire Facility 'immediately due and payable', as a prelude to taking action for Recovery.

Brokerage clause

If the producer/seller is exporting under a term contract, the chances are that at some stage he will be required to demonstrate for tax purposes, or even just for public relations, that the goods were sold at full market value. The taxman will be interested in whether the exporter is guilty of transfer pricing. Government producers, and particularly any producer of precious metals or gems, will be under a certain amount of pressure to show that there has been no 'behind the scenes' fix, or any suggestion of favouritism towards the Offtaker. The easy way to achieve this is through a Brokerage clause, which allows the seller actually to sell to any counterparty who offers a higher price, provided the new buyer, first, pays through the Collection Account and, second, pays the original Buyer/Offtaker a brokerage commission. This commission is then generally set high enough to discourage frivolous use of this clause. This should keep everybody happy, and it should then be extremely unlikely that the clause will ever be invoked. Note that a Brokerage clause in the Facility Agreement will need to be reflected in the actual purchase and sale contracts.

Conditions Precedent

Ideally, the entire security structure being in place, registered with every authority on the planet, acknowledged by all parties, safely deposited in the vault of the Agent, and then blessed by the Pope, should be a Condition Precedent. To paraphrase Scar from Disney's *The Lion King*, however, life's not fair, is it? In practice as the momentum towards drawdown builds, the Agent and Lenders will be under increasing pressure to waive CP after CP, and clearly every one waived further erodes the security package. One has to be practical. There is no point holding out for something that simply is not going to be obtainable within the time horizon envisaged. Lenders have to have in mind a minimum position, on which they can still put hand on heart and consider themselves protected from the major perils of the transaction. Once the Borrower has the money, the incentive for him to deliver the CPs simply isn't there, and everything will go into Dead Slow Stop mode. The final position is in the eye of the beholder, but any CP that becomes a Condition Subsequent should be one you feel you can probably live without, because your chances of ever seeing it again drop to minimal the moment that drawdown is made.

Payments and Calculations

As we saw with the NIOC story, it is always worth checking the basis on which calculations are made. Lawyers tend to favour formulae which might make a lot of sense to anyone with a good grasp of medieval Latin, but which can be somewhat intractable for the rest of us. *Caveat lector*, as they say.

Taxation

As you might expect, normally the intention is that the Borrower should repay the Lenders free and clear of any taxes that might be imposed. This is not altogether plain sailing since in a number of jurisdictions (Russia, for example) in theory borrowers are not allowed to gross up payments in this way to negate the impact of Withholding Tax. The main remedy is to ensure that the Lender or Lenders of Record are incorporated in jurisdictions enjoying double tax treaties with the jurisdiction of the Borrower, and to get the Facility registered as falling under the double tax treaty treatment before the first Interest Payment is due. Again ideally, this is something to get as a CP. If it is not possible to get this sorted out before drawdown, then lenders would be well advised not to give themselves impossible targets, for example, by setting the first Interest Payment Date so nearby that the registration will not be complete before this is payable. It is *not* safe to assume that the main lending jurisdictions are *bound* to have double tax treaties with all Emerging Market borrowers. At the time of writing Switzerland does not have a double tax treaty with Russia, while, on the other hand, it is one of the few European jurisdictions to have one with Egypt.

As a separate issue, most lenders into the CIS and particularly Russia are so overawed now by the apparent omnipotence of the post-Soviet Taxman that they will require the Borrower to provide a certificate to the effect that his tax affairs are in order. Sometimes this will be an Undertaking but it is generally common now to get something from some third party, at very least an independent auditor, but preferably something from the Tax Office itself.

Illegality/Change in Circumstances

It is generally desirable to have a clause somewhere allowing the lenders, or an individual lender, to withdraw should it become illegal for him to continue. Grounds for this are not as uncommon as one might suppose, bearing in mind that the type of legal sanctions imposed in the London market on Kuwait, Iraq, Yugoslavia and even Argentina all within memory, without even touching on the pronouncements of the more rabid Acts in US federal and state laws. This clause may not altogether be a universal panacea, however. After the Helms–Burton Act was passed in 1996, tightening the US embargo of Cuba, one European participant of a French-sponsored countertrade seized upon the Illegality clause, saying clearly it was illegal for them to continue and they would like their money back, please. Unfortunately for them, the Arrangers by that stage had no fewer than five Legal opinions (every bank board member has his favourite law firm) telling them that it was indeed perfectly legal for them to continue. A number of these also pointed out that it was in fact illegal for anyone incorporated within the EU to comply with Helms–Burton, under a rather useful piece of EU legislation against third party embargoes not agreed by the EU itself, brought in with the encouragement of the US to deter European companies from complying with the Arab Boycott of Israel in the 1970s. The words 'petard' and hoist' spring to mind.

Change of Ownership (COO)

Change of Ownership is a high-risk event for any loan and should be an Event of Default that gives the lenders sufficient scope to be as awkward as possible for the new shareholders until they renew/confirm the Facility and its Security (including, as we saw with Eximcoop, any shareholders' guarantees).

Escalation clause

Escalation clause is also known as a Top-Up clause. It would be extremely unusual for any performance risk structure not to have one of these, though it may be in the Assignment of Contract rather than in the Agreement itself. If you don't know what it is, then you clearly haven't read the book yet, but see the Glossary (Appendix B).

Negative Pledge

A Negative Pledge is obviously good if you can get it. It is one thing to say we have a decent LTV plus an Escalation clause, but you know that if the commodity price falls to the extent that you need to invoke the Escalation clause, then everybody else will be escalating at the same time, and this will put a lot of pressure on the Producer to find goods that are not already committed by virtue of the plummeting commodity price. In analysis, you are looking for Contractual Headroom, between the level of prefinance (existing commitments of production to financing facilities) and the level of outright exports (and we really mean 'exports' rather than 'production'). One way to lock in Contractual Headroom is by Negative Pledge. This can be difficult to monitor depending on the borrower and the availability of production/export statistics. Statistics on most oil producers and LME metal producers are generally very good. Similarly, most national sugar producers are also well-documented and have a statistical base going back decades. Harder to follow are the smaller private producers.

Pledge over Accounts

Ideally, everything should be pledged: Collection Account, Escrow Account, Clearing Accounts, plus any goods, stock, inventory, work in progress or personnel who stand still for too long. For exactly where they should be pledged, see 'Jurisdiction' below.

Assignment of Contract

Typically the Assignment as such will be a separate legal document, but there will probably be some reference to it in the Agreement. This is the backbone of the performance risk deal, because it is the export contract that the lenders finance. The lawyers will tell you that the Assignment is necessary to prevent anyone else getting a court order to attach the revenues from which we are expecting to be repaid. Very true. There is also the concept to which many lenders adhere that Assignment allows lenders if necessary to 'step into the shoes' of the Offtaker, in case there is some irretrievable breakdown of relations between Producer and Offtaker. A number of the large oil majors are these days resisting full assignments of their contracts, preferring instead Contingent Assignments, or assignments only of the financial provisions of the oil contract (for example, in a prepayment structure where the prepayment is detailed as a supplement to the oil contract per se). This cannot be ideal for lenders, but most of us take the commercial view that there is no alternative but to accept. If this is the case, it should be an English law document since, as we detail elsewhere, contingent assignments do not work under most Roman law jurisdictions. Note that generally lenders will want the benefits, without the obligations, of the contract to be assigned.

Representations and Warranties, Undertakings

Corporate banking facilities are generally long of these, and corporate lawyers will generally encourage STCF facility documentation similarly to include a substantial list of Representations and Warranties to be made by the Borrower. Often the Borrower will be asked to repeat almost everything that is already in the Agreement as Affirmative Representations. Well, it can't hurt, can it, especially if it can be used to justify some action by the Agent? Just don't rely on them. Always remember that if you felt you could rely on simple Representations by the Borrower, you wouldn't be using a structure in the first place (ditto Warranties, ditto Guarantees, and so on: these should not be neglected because if you are lucky they may actually mean something to the Borrower or Guarantor, but just don't elevate them too high in your sense of security).

A particular Representation to watch is 'No Material Default', whereby the Borrower represents that at the time of signing he is not in default to any material degree to any creditor. Often the counterparties will be asked to agree a maximum number for what is material (such as '$5 million'), meaning that the Borrower is not in default above this level on any other agreement. This is the moment for lenders to look at the level of exposure they have under other facilities with the Borrower to see what ought to be 'material' to them. Again, Cross-Default should tie off this potential loose end.

Also under the category of 'nice to have' are 'No Disposals' and 'Corporate Reorganisation', since these are both potentially high-risk events for lenders. Ideally, lenders should have the right to block either of these unless they are completely happy.

Covenants

Covenants are slightly more useful because typically they can be married to components of the structure to enshrine its maintenance. For example, maintenance of the LTV ratio should be a Covenant. Adherence to the Shipping Schedule should be a Covenant, similarly adherence to the export contract being banked. Negative Pledge, if you can get it, is also worth covenanting. Breach of any Covenant (or indeed of any Representation) should be an Event of Default.

Events of Default

Again, Events of Default is a provision you may wish to cast as wide as possible. However, you may like to draw a distinction between an Event of Default and a Potential Event of Default. Often outright Event of Default will trigger certain further events from which the Agent and/or Lenders might wish to hold back, at least in the short term. One example would be if the deal sponsor (typically the Offtaker) was guaranteeing the interest (not a common achievement, but seen reasonably regularly on the Cuban countertrades). If there is an outright Event of Default, the guarantee of the interest will probably have to be released, whereas if it is merely a question of delays, the Lenders might find the fact that their Facility remains current to interest is a useful tool in avoiding 90+% Provisioning, meaning the negotiations over resolving the delays/arrears are a lot less tense (and less likely to be driven by controllers/credit/senior management far removed from the coal face).

Also, as said earlier, generally if you do want to trigger remedial action, ideally, you want at least the right to trigger it as early as possible. This doesn't mean you have to, it just means you can. There is no point waiting until there is a shortfall on the Collection Account if you know what the value of a particular delivery is going to be from either the Shipping Schedule or the actual shipping documents.

Events of Default should include: Failure to Pay (and incorrect payment, for example, if the Borrower converts the offshore cashflow into an onshore repayment), Breach of Covenant/ Representation/Warranty/Undertaking, Cross-default (by anyone remotely related to the Borrower), Insolvency/Bankruptcy/Rescheduling (ditto), Execution or Distress (i.e. if any other creditor starts to realise their collateral), (potential) Material Adverse Change, Loss of (any) Licence (necessary to continuing performance of the underlying export contract and repaying the debt, from whatever authority), Illegality and Repudiation. These are the main ones. Your lawyer will of course come up with a more comprehensive list (we were recently presented with 31 sub-headings under Events of Default, not including sub-paragraphs).

Material Adverse Change (MAC)

Often these days, Material Adverse Change is not a separate clause at all, though generally it will at least be a defined item. This will not just be restricted to balance-sheet events within the Borrower's presumed influence, but also third party events, such as economic deterioration in the country in which the transaction takes place, or change of government. Typically MACs are either 'subjective' or 'objective'. An objective MAC will be triggered by a test event, for example, a third party event such as devaluation, or a performance test such as non-delivery of a minimum number of cargoes within a given timeframe. A subjective MAC will be down to the opinion of the Lenders. Clearly, from a Lender's point of view the subjective is preferable and gives greater flexibility to the Lender. This may be reduced if a subjective MAC requires Majority Banks to agree. Funnily enough, borrowers tend to prefer the performance-test type of hurdle, since this is most likely to be in their control. See also 'Illegality'.

Fees and Expenses

Clearly, Fees and Expenses is an important section for any banker. Lawyers also tend to be careful to make sure that liability to pay legal fees is very clearly expressed, although more often than not you will find this particular item high up the list of Conditions Precedent. The lawyers clearly know a thing or two about the relevant psychology here. As a general rule, it is usually much easier to get fees paid prior to, or even from, the initial drawdown than at any other time. Expenses, however, are also important and can lead to protracted haggling. A personal observation would be that generally people do not haggle unless it is important to them. The most likely reason for it to be important is that there will be a very real possibility that it could and probably will cost them money. Additional and often unforeseen costs and expenses are always a possibility, especially in countries prone to changing the rules on a regular basis. It should not be assumed this will be a minor item.

Default Interest

If we accept the slogan 'default is rare, but delay is common', which could apply really to all trade finance, we have then to anticipate the scenario in which our Borrower sadly has not been able to pay on the Due Date, but we are all still more or less on speaking terms and we anticipate repayment before too long. This not uncommon position could become an extended period of additional credit to the Borrower unless he is given some disincentive to encourage him to sort things out sooner rather than later. The traditional method for this is 'Default Interest', also known as 'Penalty Interest' or 'Late Payment Interest'. Effectively what we want is a punitive rate of interest that the Borrower can sustain for a short period but which he will not want to have to pay for any great length of time. Of course, as with all things, everything is relative. We saw a structure in which the

Penalty Interest was Libor plus 7%, which sounds pretty punitive. However, the Obligor was Cubazucar, which at the time was paying anything between Libor plus 6% and Libor plus 7.5%, so the 7% margin was pretty much normal to it. The Cubans generally seek to avoid penalty rates more than 1% over the margin, since there is a certain inevitability about the fact that at some stage during the life of the Facility, perhaps even for most of it after the first maturity date, they will end up paying the higher rate. More commonly penalty rates in the market at large are around 2% over the margin. Note that in some jurisdictions this can be difficult to enforce.

Indemnities

Again there are two types of Indemnities. There are the indemnities that the Borrower gives to the Lenders, which serve basically to reiterate that if anything goes wrong, it is of course all the Borrower's fault and he is liable not only for any costs involved but also for any loss of expected revenues by the Lenders. Then there are the Indemnities the other Lenders give to the Agent/Arranger, whereby the Agent/Arranging bank steering the documentation will endeavour to extinguish any liability on its part for absolutely anything, should anything go remotely pear-shaped. Of course, your view on just how reasonable these indemnities are really rather depends on whether you are a Participant or the Agent. Banks generally agree, however, not to pursue individual officers of other banks, while agents also generally concede they will remain liable in the event of 'gross misconduct and/or wilful negligence'. Commonly these days the Agent will seek to avoid any liability for monitoring. This is probably the result of very sound legal advice, but is regrettable nonetheless. A good Agent, in my view, is one who does indeed monitor, inform and anticipate throughout the life of the Facility. In the absence of any sort of pressure by way of legal obligation on agents to do this, the only way really to distinguish the good from the bad or plain ugly is simply experience. In practice the agency section of loan agreements seems to get longer and longer, as agents seek to distance themselves from liability while maintaining the right to protect their own interests.

One important item in this section is what the Lenders do when things go wrong. Typically, as things deteriorate, there will be what we used to call in the Cold War a 'Time of Tension', also known as a 'Cure Period', during which the Lenders will try to recover their position. Generally it should be the case that for the purposes of the Cure Period, and even beyond, should they so agree, the banks/investors will agree to work together through the Agent, possibly also submitting to decision by Majority Lenders. At some point, however, they will want the right to take independent action (including legal action) for recovery, and this should not be refused by the Agent. A typical timescale might be three months between non-payment and possibility of independent action. Of course, the fact that they have this right does not mean they have to exercise it, and personally I believe lenders in a single facility will do best by sticking together: borrowers can be very quick to exploit divisions between the lenders, and the whole process can become correspondingly very slow.

Another item under the Agent's Provisions will be that typically the Agent will want to reserve the right to conduct other business with the Borrower. The other Lenders may wish to get some idea of how extensive this relationship is. At the very least this can be useful information should things start to go wrong and it becomes apparent that the Agent seems reluctant to enforce the structure to its full potential. I would not suggest that an agent bank would do anything illegal, but that is not the same thing at all as suggesting that the agent will have his own commercial best interests at heart.

Finally under this section, somewhere it will probably say that lenders/investors are under their 'own responsibility' to make their own investigations and decisions on whether to come in to the deal or not. A lot of people skim over this item, but in light of the case studies you might feel encouraged to do your own due diligence. A travel budget is essential to doing this business properly.

Set-off

Generally borrowers will not want to concede right of set off to banks if they can possibly avoid it. Agent banks may also be against including this, since it may link together other facilities they have with the Borrower that may be completely unrelated. Of course, this may be academic if the Facility in question is the only one you are likely ever to have with a given Borrower. Having said all that, it makes little sense to have one facility with the Borrower in default while in another facility for the same Borrower the Agent or other Lenders are constrained to allow cash to pass through to the Borrower as if there were no problem. One way round this is to make sure you have Cross-Default. The Lender can then decide whether Set-Off is in his interests or not, safe in the knowledge that the Borrower cannot pursue 'selective default' as an option. If the Lenders agree they do want Set-Off, and if any one of them seems to have a lot of business with the Borrower outside the Facility, the other Lenders will typically want set-off to include 'Sharing', whereby any bank making recoveries will be bound to share them with the other banks as though these funds had come into the Agent.

Transfer

Most banks these days will want to retain the right to on-sell their stake in a deal. Having expounded the virtues of sticking with the structured deal to ensure an eventual reimbursement in full, it would be foolish to ignore the possibilities of the Secondary Debt Market. To be a specialist is a lonely place when things are going wrong, and it may be that the time horizon of the prospective route to full recovery exceeds the time horizon of likely tenure of the office of 'resident specialist'. If the secondary price exceeds the provisioning valuation (remembering that this is most definitely not a transparent market), then selling out can be a very tempting route. I note, however, that anybody blessed enough to be able to take the contra-cyclical view can stand to make a mint. In 1998 Standard Bank of London had such a poor year after post-Russian crisis provisions and the collapse of the mark-to-market valuation of the forfaiting book that it had to be recapitalised. However, in 1999 it made it all back and more by buying out lenders and participants in (particularly) Russian structured deals, and then selling the deals back to the Russian borrowers and others at a (substantially) higher price as the deals 'came right'. One can only applaud such instincts and bemoan the drive seen at so many banks to sell at any price just to make a clean break and close the book. However, ideally the method of transfer should be as painless as possible. It is not customary to give the Borrower any such right.

Language

These days the vast majority of structured facilities are documented in the English language. Quite often, however (especially on Russian deals), there will be a semi-official translation available in the language of the Borrower. It is important to state in the agreement that, in the event of conflict between the two versions, the English-language version takes precedence (unless you want to do the whole thing in Russian). I actually had a senior colleague ask recently for this to be deleted from a loan agreement 'to avoid drawing too much attention to this issue'. Sadly, English law doesn't work like that (and, as we will discuss in 'Jurisdiction' below, a lot of English-language documentation is drawn up under English law). English law will recognise whatever the counterparties agree. If the counterparties agree that the English-language version takes precedence, then in the event of a dispute that ends up in court, the English court will only consider the English-language version of the documentation. If, however, this point is avoided, then the English court will give equal importance to *both* versions, and may end up deciding on a particular point that the Russian version is the correct application, because, by English law logic, had the counterparties meant for the English-language version alone to take precedence, then they would have said so in their Loan Agreement.

Jurisdiction

I used to think Jurisdiction was an obvious one, but recently I have been required to justify the concepts involved so many times that it probably bears re-examination. Generally, there is an 'umbrella' Jurisdiction for the Facility Agreement and principal documents, which most lenders and offtakers would wish to be a jurisdiction in which one is not punished by the courts for being a big international enterprise. The most commonly chosen jurisdiction for this is English Law, not just because of the prominence of the City of London in international finance (New York and Tokyo may be bigger markets, but Tokyo is almost entirely domestic and New York is 85% domestic, 10% Mexican and the rest Latin American, whereas if the City had to rely on its domestic market it would have an atmosphere more like a university library – like Frankfurt, in fact), but also because the courts in London are generally held to be genuinely neutral irrespective of nationality. When the French document their countertrades with Cuba, or the Spanish their prefinances in Russia, they do it under English Law. Please note (in case this has not been engraved on your consciousness already) that there is no such thing as 'British Law': Scotland has its own law, which is nothing like English Law.

Actually, New York Law is also a popular choice for a lot of Latin American deals, and use of a US jurisdiction is obligatory if the intention is to sell the deal into the US capital markets. Some US jurisdictions may also confer particular tax advantages. All these Anglo-Saxon jurisdictions more or less allow the counterparties to agree to anything (legal) they like, provided it is documented in the agreement. Anglo-Saxons from the European side of the water will generally be sceptical on what will happen if they end up in a jury trial in the US, since American juries, and some judges, have some reputation for taking a somewhat partisan view of legal liability, particularly favouring the American Boy, and the 'Little Guy' (even if the Little Guy in question is, say, Big (US) Steel, or even Big (US) Bananas, up against those nasty foreigners at, for example, the European Commission, as recent trade disputes have shown). Realistically, however, what the Americans lose in nationalism, they probably gain over the English in having judges under the age of 110, who can sometimes stay awake for the entire case and who may even have heard of the Beatles.

Both jurisdictions can be recommended to lenders and investors. It is also possible to find structured deals under Roman law jurisdictions such as French Law, German Law, Swiss Law and so on, used for the 'umbrella', and they score in having substantially shorter documentation because, of course, they can rely on a written body of law that specifies what can and cannot be done. The only difficulty with this arises in the event that what the counterparties want to be done is not as specified by the fixed body of the law. Particularly this can affect what happens in an insolvency. In Dutch Law, for example, like many Roman law jurisdictions, 'Contingent Assignments' do not work because the lender will be deemed to be trying to gain a superior security position to other creditors *after* the bankruptcy of the Borrower. This is not allowed under the Dutch insolvency laws, but it would be allowed under English Law *if* both sides agreed to it. In many EU jurisdictions there is also rather more protection for the rights of workers to get paid by a bankrupt borrower than a lender might necessarily wish to concede, particularly if, as is often the case in Russia or Brazil, the bankrupt management is also the owner of the company and is clearly using the legitimate claims of the workers to protect its own position. There is also a concept in most Roman Law jurisdictions of 'too much collateral', i.e. collateral in such sufficiency, or possibly documentation so much in favour of the lenders that a court would rule it 'unfair'. In the context of the Emerging Markets this strikes me as rather like saying you can have too much oxygen-pipe repair-tape on a Russian space station. Personally, I believe collateral is like chocolate: there is no such thing as 'too much'.

So much for 'umbrellas'. Unfortunately, a ruling by a court in the 'umbrella' Jurisdiction only gets us so far. As a general rule, collateral should be pledged under the jurisdiction in which it is located. So if you have a pledge over, say, sugar in a Brazilian warehouse, the pledge should be under Brazilian Law (this will also make it easier to register), whereas the Assignment of the export contract should ideally be construed under the jurisdiction pertaining to the contract (likely to be either New York or English Law). If the Collection Account for the export proceeds is then in the Netherlands, then the pledge over that should be Dutch Law. Thus under your 'umbrella' Facility Agreement you can have a number of security documents all construed under different jurisdictions, depending on where the best place is to pursue that particular asset. This can mean you will end up with a lot of Legal Opinions (i.e. one per Jurisdiction), but, frankly, the typical legal opinion these days comprises two thin paragraphs saying that, first, they have read certain documents and, second, the documents are legally valid, binding and enforceable, followed by (in one recent example) 14 pages of disclaimers stating why the lawyers are not to blame should the second statement prove ultimately not to be the case. The words 'money' and 'old rope' spring to mind.

Finally, 'Arbitration' need not be in the same place as Jurisdiction. Many Russian borrowers are more or less happy to agree to English Law for the 'umbrella' documentation, but want Arbitration to be somewhere even more neutral, with the International Commercial Arbitration Court of Sweden and the International Chamber of Commerce in either Geneva or Paris all being popular alternatives. Arbitration under the actual export contracts is usually under the rules of the principal trade association, e.g. the London Sugar Association rules (even for New York contracts), Liverpool Cotton Traders' Association (despite the fact that very few of these actually remain in Liverpool), and so on. Having said that, obviously for lenders it is simpler if Arbitration and Jurisdiction are not potentially contradictory.

Schedules

To avoid confusion, this has nothing to do with shipping or repayment, rather we mean the attachments at the back of the Agreement. Generally anything that anyone has to do to make the Facility operate should be the subject of a 'Schedule'. If the Borrower has to give 'Notice of Drawdown', the form in which that is made should be specified in a Schedule. If the Offtaker has to acknowledge the Assignment of Contract, the form of that Acknowledgement should be in a Schedule (attached to the Assignment), and so on. Schedules can also be useful as the means by which to sign up Lenders who come in subsequent to drawdown in a club deal. Thus if the Agent wants to get the Facility off the ground at least in part, as early as possible, but also feels it important to bring in other banks as *Lenders* rather than as *Participants,* the Agent and Borrower can agree the primary documentation first, and then as individual Lenders come in, getting added to the deal by their own Schedule, giving details of how much they will fund and when the funding will commence, all other details of their loan being as per the main Loan Agreement. Of course, this presupposes the other lenders agree on the main Agreement. Possibly the most useful Schedule for lenders, however, is a simple list of Conditions Precedent. If the lawyers don't come up with this off their own bat, it is always worth asking for since it is a lot easier to manage than having to plough through the reams of text for the CPs buried in the main body of the Agreement.

CONCLUSIONS

Documentation is a crucial component of the art of STCF. At the stage where we are all friends, looking towards the mutually satisfactory resolution of the transaction, the temptation is strong to leave certain things to trust, because they are 'understood'. When things go wrong, and you are no longer friends, if a certain item or right is not there in your documentation in black and white, you simply don't have it. The art, therefore, is to get as much as possible into the documentation and still remain friends, and this can be a tall order. The first thing for the lender/investor to do is to establish the underlying pattern of trade: who is buying what from whom? Where do raw materials originate, who processes them, where do they stop during the process, where do they go prior to shipment, where do they end up after shipment and how is all this evidenced? Once this is clear, it is possible to see where security may be taken, from whom and how it should be pledged (and if possible registered). It is also then reasonable to prioritise what you need at a minimum to secure your position during the time your money is away from home.

The lawyers will steer us through the legal principles involved and provide the framework for the documentation (and more, if you have a good one), but the commercial counterparties have to decide what is important to them. I would argue that our basic premise is that our repayment will follow the liquidation of an export contract, so our aim has to be to stay as close as possible to the collateral in whatever form it is available which will lead to the fulfilment of that export contract. In the end there can be no such thing as 'too much collateral', and if you don't ask, you don't get (just make sure you get it in writing).

7 Conclusion

In any work of this kind, with the focus on what *can* go wrong, it is easy to give the misleading impression that *everything* always goes wrong. This is simply not the case, and was not the case at any point through the period 1997–2000. If we wanted to write a book about the 'Wrong Property Finance Deals', for example, or the 'Wrong Bond Deals', without even getting onto EU or US corporate loans, rogue traders in banks, or the funding of political parties in certain highly developed countries, we would have needed a whole lot more space. Compared to any other form of lending or investing in the Emerging Markets, the STCF deals have demonstrated an enviable track record of 'survivability' under extreme stress testing. This impressive track record has been rewarded by the common attitude of the various ECAs to the structured 'performance risk' type of deals as a means of gaining ECA backing where otherwise it would not be forthcoming. It has also been reflected in the remarkable price stability of the structured deals, no matter what the rest of the markets were doing.

As we have seen, Ghana achieved a margin of 35 basis points for its Cocobod prefinancing *post* Emerging Market crisis. Similarly, Jamaica raised medium-term prefinancing for its sugar in the teeth of the Latin American shocks in the first quarter of 1999 at a margin of 3% for its first medium-term deal, when equivalent bond spreads would have been up to 15% over Treasuries. Cuba has remained immune to it all, paying margins between 6 and 7.5% p.a., crisis or no crisis, between 1995 and 2000. Considering the environment in which they have been operating, this has been quite an achievement. Despite its 'minority sport' status, the success of the STCF product through so many trials has been sufficient to yield gainful employment to an army of specialists in banks, oil companies, big traders and consultancies in all the major global financial centres, and particularly in Europe where, apart from London, we see thriving activity in Paris, Vienna, Geneva, Zürich, Zug, Lausanne, Amsterdam, Rotterdam, Antwerp, Hamburg, Düsseldorf, Madrid and Frankfurt. Commercial enterprises take an unromantic view of operations, particularly where pricing and headcount are concerned: this scale of activity would simply not be there if the product itself didn't work.

Also difficult when focusing on the 'wrong deals' is to avoid giving the impression that certain banks have had a torrid time of it by being involved in or even responsible for whole series of deals which have 'gone wrong'. It is very important to look at this in context. If West LB, Standard Bank, UBS and the rest have appeared rather more often than some of the others, this is no more than a reflection of their outstanding prominence in this field. I was once told by a professor at Cambridge to beware the historically negative impression Western Europeans have traditionally had of the Byzantine Empire. His argument was that Byzantium was rather like a medieval United States: it was the richest kid in the playground, which naturally provoked an element of resentment, which led to some very critical assessments of everything it ever did, on top of which it was so impressive in its context that you could not avoid looking at it. The banks whose deals I have critiqued here have led this field for some while. Personally, I would rate some better than others, but the point is that they have been active, they have pushed back the boundaries and kept the doors open for business in some very challenging environments and at some very difficult moments, with great success.

In the late 1980s and early 1990s, UBS had the 'A-team' of structured trade finance in its London office, until most of the group lifted en masse to go to KBC. Although Banker's Trust managed the odd short-term prefinance of Sonangol in the 1980s, it was UBS that established it as an industry benchmark of how to structure a successful medium-term deal for financing operations in a war zone, and it has run ever since. Since then West LB has taken on the world from Düsseldorf and achieved some very innovative structures. In particular, West LB put in the first post-Russian crisis financing, still in 1998, and got repaid according to plan. Now its Russian clients loyally steer their business towards West LB because West LB kept the doors open when virtually all others were running for cover. Standard Bank similarly has punched way above its weight in this market and was very quick to see what the opportunities were in the crises to operate on a structured basis.

I am painfully aware that in any work of this nature the author will be guilty of 20/20 hindsight. However, if we accept that our aim here is to look at what can go wrong, with a view to executing better structures in future, then we should also accept that despite the arrival of the Era of the Young, where the sell-by date of many bankers seems to be somewhere in the thirties, nevertheless plain old-fashioned experience is invaluable in avoiding making mistakes. On this subject, a notable absentee from the ranks of banks whose deals make up the catalogue of disasters is KBC, whence the old UBS team went. So far as I am aware, KBC participated in the Sidanko deal, but in the deals it actually structured and ran itself, it maintained an enviable record of success, despite being still a leading activist in the 'performance risk' market. You live and learn. One of my more uncharitable Dutch colleagues observed that this just meant that if KBC had had a duff deal, it had been more successful at keeping it quiet. This may be so, and I have not contacted KBC to confirm or deny this, but even if so this in itself is also an achievement: clearly, therefore, it has successfully avoided 'reputational' risk in addition to its other achievements.

When we look at our 'problem' case studies, and even the other horror stories, we see it has been a long time since a structured deal actually failed owing to straight political risk. Generally, while political turmoil reigned, the structured 'performance risk' type of deal survived serenely sheltered from the storms that ravaged less fortunate creditors. This is not to say that the various crises did not create stress, but generally the politics of it was not the principal cause of difficulties. Cuba is the case study that comes closest to demonstrating the impact of 'pure' political risk, yet the Cuban countertrades in which I was involved paid out in full. Anyone following these markets will be aware that others may not have been so lucky, so then our question should be: why do some structures succeed yet others not?

More commonly with our case studies we have seen problems arise because the structure was either not sufficiently well-implemented, in the sense that the title and access to the collateral that the lenders thought they had was not perfected, or in the sense that there was a reluctance, notably by agents who had other business with the borrower, to implement the structure which in some cases was seen as the 'nuclear option'. You cannot blame the structure if it was not properly implemented in the first place (Sidanko) or not properly maintained or enforced (Eximcoop, Cuba). We also saw the consequences of not structuring adequately for the type of distribution to be used to sell the deal down. We may yet feel some sympathy for Yukos, which got its oil contracts right but was failed by the 'structure for distribution' part of the equation and thus subsequently pilloried. Remarkably, through most of our case studies and other stories, we saw lenders and investors getting repaid in some pretty unpromising scenarios. Bearing in mind that the two Brazilian examples have yet to run to their conclusion, the comments we made about the implementation, monitoring and tenor of the structures in the context of those borrowers, and the fact that the lenders are not altogether yet dead in the water, the only true structural failure of the six case studies was Solo. Fraud of the type seen with Solo Industries is clearly a very difficult event against which to structure, and is a lesson against ignoring the ubiquitous riders we see on information memorandums and elsewhere disclaiming liability for information provided by the Borrower and inviting lenders and investors to make their own decisions based on their own due diligence.

I would comment that, Information Age or no Information Age, you cannot and should not be active in this market on a purely 'desk-top' basis. You must have a travel budget, and you should go down and look at what you are financing. Reports in writing on paper do not convey the smell and gut feel of an Emerging Market deal: the result of the electronic age is a presentation which has been sanitised, packaged for consumption and expurgated of much of the detail that might be superfluous to the decision-makers seeking their two-page summary, but which might just hint at the challenges that may lurk just out of arc of the webcam or EIU report, and somebody must take on the role of looking more closely. Just by showing up on the ground, the lender or investor will show that he's looking, he's paying attention to what is going on and may not be so easily fooled.

However, we need more. One of the more depressing presentations I saw during the Emerging Markets crisis was made by the then head of structured trade finance at the New York branch of a leading STF bank, shortly before it pulled out of trade finance altogether and he himself chose a change of direction in his career, away from trade. His background was forfaiting, and I understand a lot of the deals on which he had worked were Latin American. Rather sadly, he told me he felt he had been misled years earlier when he was persuaded to go into forfaiting, and he no longer saw it as something he wanted to do. His basic theme in the presentation was that the pricing and credit access of structured trade deals (including, in his presentation, the forfaiting market) may be more stable than other sources of finance, but that essentially if we thought the structure was really going to help us when it came to the crunch, then we were kidding ourselves.

Again, this rather jaundiced view has to be seen in context. The American colleagues in particular and forfaiters in general have spent years in successive attempts to achieve US standards of corporate behaviour from enterprises in Mexico, Brazil and Argentina, not to mention the more challenging markets, in the expectation that when it came to legal enforcement of their rights, their documentation would yield the same results in São Paulo as might be the case in Idaho. To be fair, progress is being made, and Mexico in particular has seen a recent insolvency of GAM, a major sugar miller where the secured creditors sailed through the legal process successfully to get their money back. On the whole, however, despite all the structures available to the Latin American markets and to the forfaiting market as a whole, the two most successful pieces of documentation for the forfaiters remain the Promissory Note and the Payment Undertaking, which are basically a one- or two-page document promising to pay money at a future date. This is perfectly good when we are structuring solely for distribution purposes, and the forfaiting market can be very liquid (in Europe now we are even forfaiting transferred soccer players). However, if we really intend to structure a deal for credit enhancement, then we have to look extremely carefully at what is going on.

This brings us back to our lending rationales. In the end we have to admit that the light of experience is that all these lending rationales, in isolation, are flawed. The value of the Balance Sheet in the Emerging Markets is severely circumscribed, but the concept of requiring financial information remains good. In particular, we need to know who are the third party creditors who may threaten our security and the borrower's solvency or control. The Cashflow rationale may look as though it is entirely dependent on the company surviving financially, but there are significant areas of the world where this is simply not true, where bankruptcy of the borrower is not a possibility and where the classic 'performance' risk-style of analysis will be a hundred times more useful than seeing the balance sheet. Asset-backed lending these days has strong connotations of aircraft finance or securitisations, but in principle this is one of the oldest methodologies in the book: if you are going to lend, take collateral. The success of the Cashflow and Asset-backed approaches has opened a major source of additional security to structurers in the form of third party providers of credit enhancement. Any individual component of these rationales has been around for a very long time – the red-clause Letter of Credit allegedly dates back to the Wool Trade in Australia in the 1840s when traders on the coast had to send money up-country to local buying agents who would purchase the wool from farmers; ECAs may not have been around so long, but they are a major feature of the post-war OECD world, and so on.

As the divisions between banking products break down, and we begin to focus more on resolving the challenges which people face in Emerging Markets rather than necessarily how banks like to organise their various teams, we see that what we need is an approach that combines all these disciplines, with the empirical ability to learn from past mistakes. We need to identify the balance-sheet threats even when the balance sheet itself is an inadequate document, ringfence the current assets, ensure repayment is from offshore, top-line, sales, rather than bottom-line, profits, and, in the light of our Russian experience, we need to recognise that a certain minimum level of cashflow through to the producer is essential to cover high fixed production costs (where these exist – it is another challenge to work out *whether* these exist and to what extent), and thereby ensure continuing performance. This in turn gives us a market risk exposure to commodity price volatility, which should be addressed either by outright hedging or by accepting that a certain element of delay is an inevitable consequence of a fall in the relevant commodity prices. Then when we come to document all this we need to follow the entire asset conversion cycle of the Borrower and take *and perfect* security at every possible stage. Finally, after we disburse the funds, we need to monitor and control the Facility throughout, possibly with specialist collateral managers, at very least with a decent back and middle office at the Agent, enforcing the provisions of the structure to maintain security through to ultimate repayment. Having done all that, we need to look at how we refinance these structures and in particular how we refine and resolve the challenges of taking the structured product to the capital markets.

So much, then, for the 'structured' approach. It goes without saying we should pick our partners with care, that a good deal sponsor/offtaker is worth a hundred covenants, that a good borrower – even, dare we say it, a good bank – will make life a whole lot easier. This would be true of any credit business, though I would stress again that, for a lender or investor, to have a good partner in the Offtaker of the goods is a huge advance on simply buying a Promissory Note from the borrower. Often we will say that we are targeting the 'good' borrowers, who merely have the misfortune to be incorporated in the 'wrong' country. Sometimes, however, we must concede it is not possible to choose or even know whether the partner we get is 'good', or perhaps less so, and even if we all start out as friends, it is entirely possible that under the stress of falling commodity prices, political and economic turmoil and so on, the relationship will go wrong. The structure, we should be clear, is aimed partly at the Borrower's country risk in the broadest sense, and partly at the Borrower himself. The case studies drawn from the recent crises differ, as we have said, from some of the earlier stories, in that even these 'problem' deals performed well through the recent crises in terms of the country risk, and particularly transfer risk.

The remaining challenge, it seems, therefore, is to find structures that protect us better from the Borrower. Here we come back to our documentation. If in the end we feel our structures are sufficiently strong, through the offshore cashflow/onshore performance risk-only approach, possibly further strengthened by ECA or some other cover, to protect us from the country risk, nevertheless the question remains: what is going to happen when things go wrong with the Borrower? The chances are strong that we are going to end up around a negotiating table with our Borrower and possibly everyone else remotely involved, looking for a way out. Here we part company with our New York colleague. This is where the structure finally scores. If we have physical collateral that we can realise and exit, fine. Most structures depending on a future delivery are not so blessed with clear access to a physical asset. This doesn't mean that the creditors do not have the right to attach assets, and the first task must be to identify where the assets of the Borrower are to be found. Everyone will pore over the documentation to see what arguments they have, how much basic 'ammunition' they have. Whatever the legal environment and whatever the nature of the courts locally or internationally, in the end we will come down to the 'carrot and stick' argument we saw in Cuba and Brazil: how much pain can I inflict on him to bring him round, and how much encouragement am I prepared to offer to make it worth his while?

So, to return to our original question, why do some structured deals work better than others? I think, in the final analysis, the deals that do best will be the ones where, accepting the 'combined' lending rationale espoused above, the structure is properly executed, properly maintained, and when it all goes horribly wrong, properly enforced and *sensitively* negotiated. We should never forget that human nature, also in the Emerging Markets, requires carrots as well as sticks.

Appendix A: Information and where to find it

It used to be the case that in any market-related work intended for reference, huge appendices of statistics would be attached, partly because the appendices were where everyone went to look up useful statistics and partly to fill out the text. Now of course the World Wide Web has changed everything, perhaps taking us from the sublime to the ridiculous insofar as we now have an embarrassment of answers to any given search. Even something as simple as looking up, say, ‘sugar’ can produce a number of results which perhaps lie well beyond the scope of the question. The following list has been built up from usage with the consequence that it is selective, but also perhaps representative of common enquiries for structured trade. It is presented to cover the main commodities utilised in trade-related structures, plus some useful corporate and governmental sites which illustrate the sort of material which can be found on the web.

The corporate sites are not meant to be comprehensive, but rather are indicative of what one can expect to find from Emerging Market producers and international traders across the range of industries. These range from the ‘pidgin English’ variety to the most sophisticated websites one could expect to find in any country. The government (particularly US government) sites are challenged mostly by the sheer wealth of data available, with the consequence that some detail has been given to show what is available, though these sites are subject to reasonably frequent change. I have not included site locations for tin simply because I have never seen prefinances or other structures involving this LME-traded metal, but there is some information available on the LME website.

GENERAL INFORMATION

http://www.info.FT.com/(*Financial Times*)
http://www.exim.gov/pres/jul 1699.html (US government finance)
http://www.commods.reuters.com/energy/index.html (Reuters)
http://www.bz.minbuza.ni/home/titel/t - homepage.html (Dutch government)

http://www.worldbank.org/data/ (World Bank statistics, projects etc.)

http://www.marketfile.com/ (market reports)

http://www.moscowtimes.ru/ (Russian news)

http://www.sugaronline.com/SurveyLinks.htm

http://www.standardandpoors.com/

http://hbn.hoovers.com/company/all/list/0,2504,116_N_all_500_600,00.html

http://www.emerging-markets.com/la/latam.html

COMPANIES

http://www-cargill.com/perf/Performance.html

http://www.sucden.co.uk/

http://www.oxfordshire.co.uk/data/001017.html

http://www.refco.com/links.asp

http://www.edfman.com/

http://www.Idng.com/

http://total.com/

http://bpamoco.com/

http://www.copersucar.com.br/

http://www.cosan.com.br/defaulti/htm

http://www.m3m.com/azunet/ingenios/prop.htm

http://www.finasa.com.mx/

http://www.sibneft.ru/

http://www.sibirskyalum.ru/eng/sa-ooe.html

www.sibal.ru

http://www.bsm.com.mx/bsm/productos.htm

COUNTRY REPORTS

http://www.state.gov/

http://www.worldbank.org/data/

http://mbendi.co.za/cyancy.htm/

www.bcemag.com (data on European countries)

NAFTA

NAFTA	www.dtonline.com/northamr/nanafta.htm
NAFTA Facts Index	www.tradecompass.com/library/doc/nafta
NAFTA Countries	http://infoserv2.ita.doc.gov/TicWeb/naftaweb.nsf
NAFTAnet	www.nafta.net
SICE Trade Agreements NAFTA	www.sice.oas.org/tradee.stm#NAFTA
SICE North American Free Trade Agreement	www.sice.oas.org/trade/nafta/naftatce.stm
OAS Overview of the NAFTA	www.sice.oas.org/summary/nafta/naftatoc.stm
Take Advantage of NAFTA	www.i-trade.com/dir07
SECOFI NAFTA Homepage	www.naftaworks.org
North American Integration & Development Center	http://naid.sppsr.ucla.edu
Cooperation	www.naalc.org
Arbitrage	www.nafta-sec-aleha.org
Business contacts	www.naftaconnect.com
Customs	www.nafta-customs.org
	www.customs.treas.gov/impoexpo/nafta.htm
Environment	www.cec.org

NEWSPAPERS

Argentina	http://www.buenosairesherald.com/
Brazil	
La Gazeta Mercantil	http://www.brazilinfo.net/news.html
Jamaica	http://dev.go-jamaica.com/gleaner/20000403/index.html
Mexico	http://www.economista.com.mx/
Russia	
Moscow Times	http://www.moscowtimes.ru/31-Mar-2000/homepage.htm
	http://www.russiapost.com/
Thailand	http://www.bkkpost.samart.co.th/
Vietnam	http://vietnamnews.vnagency.com.vn/back_issue.htm
	http://www.saigon-news.com/
	http://www.nhandan.org.vn/english/backissue.htm
	http://www.vneconomy.com.vn/

COMMODITIES

Sugar

US Department of Agriculture: http://www.fas.usda.gov/

Sugar: World Market and Trade: http://www.fas.usda.gov/htp/sugar/1998/98-11/toc.html

(1) Part 1 http://www.fas.usda.gov/htp/sugar/1998/98-11/world.html

→ World Sugar Situation: Summary

→ World and Domestic Sugar Prices

→ Situation and Outlook in Selected Countries

→ US/97/98 Raw Sugar Tariff Rate quota

→ Marketing Years of Centrifugal Sugar

(2) Part 2 World Sugar Production, Supply and Distribution:

http://www.fas.usda.gov/htp/sugar/1998/98-11/oct98-5i.pdf

Non-Governmental Sources

http://www.sugaronline.com/

http://www.isugar.com/

http://www.sugarinfo.co.uk/markets.htm

Association

International Sugar Organisation

(+44) 020 7513 1144

http://www.isosugar.org

Soya

(1) US Department of Agriculture: http://www.fas.usda.gov/

(1.1) Oilseeds: Market and Trade: http://www.fas.usda.gov/oilseeds/circular/1999/99-04/toc.htm

Text

→ April Cover

→ April Summary and Text

→ Special Report: China to Restrict Soybean Meal Imports

→ Special Report: Malaysian Palm Oil Output Set To Recover

Production, Supply, Distribution Tables

→ Tables l–3. Oilseeds and Products

→ Table 4. Major oilseeds: Area, Yield and Production

→ Tables 5-7. Soybean and Products PSD

→ Table 8. Soybean and Products: World Trade

→ Table 9. Vegetable Oil Production, Consumption, & Trade: Selected Countries

→ Tables 10-14. United States, Brazil, & Argentina PSD

→ Tables 15-18. EU, China, Russia, India PSD

→ Table 19. Malaysia: Palm Oil Supply and Distribution

Prices and Programs

→ Table 20. Selected Monthly Prices and Ratios

→ Tables 21-23. US and World Oilseed, Meal, and Oil Prices

→ Table 24. GSM 102 Program Announcements and Sales Registrations

→ Table 25. PL480 Title 1 Obligations: Agreements Signed and Sales Registered

→ Table 26. Vegetable Oil Export Enhancement Program (EEP) Allocations

US Trade Tables (Marketing Year through January)

→ Table 1. US Fiscal Year Exports of Oilseeds, Meal, Oil

→ Tables 2–3, 5–6, 8. Exports: Oilseeds & Products, Volume & Value, Soybean Meal & Oil, Sunflowerseed Oil

→ Tables 4,7. Exports: Soybeans, Sunflowerseed

→ Table 9. Exports: Peanuts

→ Tables 10–13. Exports: Cottonseed Oil, Corn Oil, Corn Gluten Feed & Meal

→ Tables 14–15. Imports: Oilseeds & Products, Volume & Value

→ Table 16. Export and Import Unit Values: Selected Oilseeds & Products

(1.2) *Oilseeds Statistics and Reports:* http://www.fas.usda.gov/oilseeds/circular/1999/oilstats.html

→ US Soybean Exports by Country, Metric Tons, Marketing Years (Sep–Aug) 1996/97, 1997/98, and (Sep –Feb) 1997/98, 1998/99 and February 1998 & 1999

→ US Soybean Cake and Meal Exports by Country, Metric Tons, Marketing Years (Oct–Sep) 1996/97, 1997/98, and (Oct–Feb) 1997/98, 1998/99 and February 1998 & 1999

→ US Soybean Oil Exports by Country, Metric Tons, Marketing Years (Oct–Sep) 1996/97, 1997/98, and (Oct–Feb) 1997/98, 1998/99 and February 1998 & 1999

→ Oilseeds: World Markets and Trade – Past Issues – Foreign Agricultural Service, USDA

→ USDA Production, Supply and Distribution Database – Description

→ USDA Production, Supply and Distribution Database – Cornell University

→ Monthly Soybean Complex Statistics – Brazilian Association of Vegetable Oils

→ Daily Settlement Prices for Commodity Futures – Chicago Board of Trade

→ Fats and Oils Statistics – US Bureau of the Census

→ Argentine Soybean Complex Statistics – The Argentine Oil Industry Chamber (CIARA)

(2) *Brazilian Association of Vegetable Oil Industries (ABIOVE): http://www.abiove.com.br/english.html*

→ Soybean Complex Monthly Statistics – 1999/2000

→ Soybean Complex Monthly Crushing – 1992/99

→ Soybean Complex Supply/Demand

→ Soybean Complex Exports

→ Soybean Complex Shipments

→ Soybean Net Purchases

→ Soymeal and Soyoil Consumption

→ Soybean Complex Average Prices – 1997

→ Soybean Complex Average Prices – 1998

→ Soybean Complex Average Prices – 1999

→ Oilseeds Crushing Capacity

Soyabeans

http://www.asa-europe.org/asa.htm

Coffee

(1) International Coffee Organisation: http://www.ico.org/

(1.1)	Statistics	→ Monthly Trade Statistics
		→ Total Production of Exporting Members
		→ Daily Indicator Prices
		→ Latest Month Prices
(1.2)	About Coffee	→ Botanical Aspects
		→ Caffeine
		→ Coffee in History
		→ Ecology and Physical Properties
		→ Field Processing
		→ Frost and Droughts in Brazil
		→ Recent Coffee Events
(1.3)	Links	

(2) Brazilian Federation of Coffee Exports (FEBEC): http://www.febec.org.br/

(2.1)	Exports	→ Daily Export of Brazilian Green Coffee (Current Month)
		→ Daily Export of Brazilian Green Coffee (Previous Month)
(2.2)	Prices	
(2.3)	Reports	
(2.4)	News	
(2.5)	Research	

(3) US Department of Agriculture. Tropical Products: World Market and Trade. Coffee updates: http://www.fas.usda.gov/htp/tropical/1999/99-03/troptoc.htm

(3.1) 'Coffee Updates': http://www.fas.usda.gov/htp/tropical/1999/99-03/mar99txt.htm#CoffeeUpdate

(3.2) Other Contents

→ Per Capita Consumption of Coffee
→ Coffee: Specified Country Imports
→ US Coffee Stocks
→ US Green Coffee Roastings
→ Average Monthly: US Retail Prices for Roasted Coffee
→ Average Monthly: US Retail Prices for Instant Coffee
→ US Exports of Coffee Tables:
  Exports of Unroasted Coffee
  Exports of Instant Coffee
  Exports of Roasted Coffee
  Exports of Other Coffee Extracts, Essences and Concentrates
→ US Imports of Coffee Tables:
  Imports of Green Coffee
  Imports of Roasted Coffee
  Imports of Soluble Coffee
→ US Coffee Prices Tables:
  New York Spot Prices for Brazilian Arabica Coffee
  Coffee: ICO Monthly and Composite Indicator Prices
  http://www.nespresso.com/np/uk/universe/market/producers.htm
  http://www.noircafe.com/ang/marchcaf/marchcaf.htlm

Metals

London Metal Exchange	http://www.LME.co.uk/
	http://www.nma.org/
	www.infomine.com
Copper	http://www.copper.org/homepage.htm
Aluminium	http://www.aluminum.org/
	http://www.aluminium.net

	www.world-aluminium.org
Zinc and lead	www.ilzsg.org

Oil

http://www.gasandoil.com/goc/main.htm
http://www.worldoil.com/
http://www.ldng.com/glossary.htm
http:/mbendi.co.za/indy/oilganis.stm
www.Oildirectory.com/
www.oilonline.com/
http://www.opisnet.com/
http://www.oil.com/
http://www.wtrg.com/daily/crudeoilprice.html
http://afi.interfax.msk.su/pp/og.htm
http//www.eia.doe.gov/oil_gas/petroleum/data_publications/petroleum_market_report/pmr_historical.html

Cocoa

(1) International Cocoa Organisation (ICCO): http://www.icco.org/

(1.1)	ICCO Statistics	→ ICCO Cocoa Bean Daily Prices
		→ Statistical Summary of Cocoa Market
		→ ICCO Press Releases
(1.2)	Links	

(2) US Department of Agriculture. Tropical Products: World Markets and Trade. World Cocoa Production and Trade

(2.1) Cocoa Update: http://www.fas.usda.gov/htp/tropical/1999/99-03/Mar99txt.htm#CocoaUpdate

(2.2) Other Contents: http://www.fas.usda.gov/htp/tropical/1999/99-03/troptoc.htm

→ Cocoa Beans: Imports by Selected Consuming Countries

→ World Consumption Tables:

Cocoa Beans: Total Consumption by Country

Cocoa Beans: Per Capita Consumption by Consuming Countries

→ Quarterly Cocoa Bean Grind Statistics

→ Cocoa Price Tables:

New York Cocoa Bean Futures Prices (Dollars per Metric Ton)

New York Cocoa Bean Futures Prices (Cents per Pound)

→ US Trade in Cocoa Beans and Products Tables:

Trade in Cocoa Beans and Products

Imports of Cocoa Beans by Port of Entry

Cocoa Exports: Cocoa Beans, Liquor, Paste, Butter

Cocoa Exports: Cocoa Powder, Unsweetened

Cocoa Exports: Other Cocoa & Chocolate Products (Argentina–Kuwait)

Cocoa Exports: Other Cocoa & Chocolate Products (Latvia–Total)

Cocoa Bean Imports by Country of Origin

Cocoa Imports: Chocolate Liquor, Cocoa Butter

Cocoa Imports: Cocoa Paste, Cocoa Powder

Cocoa Imports: Other Cocoa & Chocolate Products

Cotton

(1) The International Advisory Committee (ICAC): http://www.icac.org/

'Cotton Information'

→ Supply & Use by Country

→ Production & Research → Cost of Production

→ Production Practices

→ Organic Cotton

→ Bale Survey

→ Current Research Projects

→ Trends → Charts

(2) US Department of Agriculture: Current World Production, Market and Trade Reports: http://www.fas.usda.gov/currwmt.html

(2.1) 'Also Available' → Cotton: World Markets and Trade: http://www.fas.usda.gov/cotton/circular/1998/98–09/toc.htm

(2.2) 'Release Schedule' → Choose 'home page': http://www.fas.usda.gov/

(2.3) 'Short Reports'

→ Major World Cotton Producers as Percent of World Total: http://www.fas.usda.gov/WAP/circular/1998/98-12/Dec98.htm

→ 1998/99 Forecast of World Cotton Production: http://www.fas.usda.gov/WAP/circular/1998/98-07/jul98.htm

→ 1998/99 World Cotton Stocks-to-Use Ratio Projected to Decline after Rising 4 Years: http://www.fas.usda.gov/cotton/circular/1998/98-06/cover.pdf

→ India's Cotton Consumption: http://www.fas.usda.gov/cotton/circular/1998/98-0l/jan8cov.gif

→ Central American Cotton Imports Rising: http://www.fas.usda.gov/cotton/circu1ar/1998/98-04/toc.htm

Tobacco

(1) Tobacco: World Markets and Trade: http://www.fas.usda.gov/tobacco/circular/1998/8–05/index.htm

(1.1)	World Developments	→ Highlights
		→ Auctions
(1.2)	US developments	→ Highlights
		→ Auctions
(1.3)	Trade Summary	

(1.4) Special Reports → US Leaf Tobacco and Products Trade Summary
→ Download US Leaf Tobacco Trade Tables

(2) Universal Tobacco: http://www.universalcorp.com/Tobacco/

Choose: 'click here for information on tobacco growing regions'
→ Select Region → Select Country → View Country-specific Reports → Supply & Demand → Crop Market

(3) Tobaccoleaf: http://www.tobaccoleaf.org/spanpap/list.htm (see also English home page)

(3.1) El tabaco – un cultivo para distíntos climas, tierras y mercados
(3.2) El tabaco – un cultivo de importancia mundial
(3.3) El valor económico y social del tabaco en los países productores
(3.4) ¿existen alternativas al tabaco?
(3.5) Desforestaci6n y el uso de la madera en el curado de tabaco
(3.6) El curado del tabaco – las cuestiones
(3.7) La Asociación Internacional de Cultivadores de Tabaco (ITGA)
(3.8) Respuesta al artículo del Panos Institute El humo sopla hacia el Sur
(3.9) Respuesta a El tabaco en África
(3.10) Respuesta a la agriculturi del tabaco y su impacto medaoambiental
(3.11) El uso de leña para curar tabaco
(3.12) Respuesta Al Informe Panos El Tabaco Está Aniquilando La Selva Brasileña
(3.14) Resumen de lnformación Mundial Sobre El Tabaco

COUNTRIES

Mexico

(1) Instituto Nacional de Estadistica, Geografia e Informatica (INEGI): http:www.inegi.gob.mx/ → Banco de Información Económica (BIE)

(1.1) Spanish version → Buscador de temas → 'Buscar por': Exportaciones → 'En el tema': Sector Externo → Consulta BIE → Sector Externo → Por sectores: Minero, Comercio …

(1.2) English version → 'Economy' → 'Short-term indicators' → Economic Activity → Foreign Trade

(2) Banco Nacional de Comercio Exterior (BANCOMEX): http://www.bancomext.gob.mx/

(2.1) Spanish version → Estadísticas → Comercio Exterior
→ Información por sectores
→ Publicaciones → 'Revista de Comercio Exterior'
→ 'Revista de Negocio Intemacional'
→ 'Directorio de Exportadores'

(2.2) English version → Enterprises and Mexican Products
→ BANCOMEX Trade Directory of Mexico
→ Mexican Export Supply and Investment
→ Mexico Profile → Statistical Information → INEGI → Bank of Mexico
→ Publications

General	http://mx.yahoo.com/
	www.odci.gov/cia/publications/factbook/mx.html
Companies	www.mexonline.com/business.htm
	www.infosel.com
	www.anierm.org.mx/
Customs	www.secofi.gob.mx
Economy	www.ita.doc.gov/bems/Mexico.html
	http://mkaccdb.eu.int (Market Access Database)
	www.shcp.gob.mx/english/institu/index.html
	www.anierm.interconnection.com
	www.bancomext.gob.mx/europa/
Statistics	www.inegi.gob.mx
	www.lexadin.nl/index2.htm

Brazil

(1) Aduaneiras: http://www.aduaneiras.com.br/

(1.1) Datos Estadísticos (Statistical data): http://www.aduaneiras.com.br/estatistica/index.htm

For August, September, October/November and December

- Versión resumida → Aspectos Generales (General Questions)
  → Exportaciones (Exports)
  → Importaciones (Imports)
  → Mercados compradores (Buying Markets)
- Balanza Comercial Brasileña, versión completa (Trade Balance, complete version)

(1.2) Noticias (News)

(2) Banco Central de Brazil, English version: http://www.bcb.gov.br/htms/defaulti.htm

(3) Ministério do Desenvolvimiento, Indústria e Comércio: http://www.mdic.gov.br

(3.1) Politica Industrial (Industrial Policy)

(3.2) Café (Coffee)

(3.3) Azúcar y alcohol (Sugar and Alcohol)

(3.4) Comercio Exterior (Foreign Trade): http://www.mdic.gov.br/secex/scxindex.htm

- Departamento de Operaciones de Comercio Exterior
  → Estadísticas (Statistics)
  → SISCOMEX (Sistema Integrado de Comercio Exterior)
- Estadísticas de Comercio Exterior (Foreign Trade Statistics)
  → Brazilian Trade Balance: http://161.148.1.101/ingles.htm
  → Trade Balance with Mercosul Countries

(3.5) Others

Peru

(1) Ministerio de Relaciones Exteriores de Perú: http://www.rree.gob.pe/economica.nsf/

(1.1) 'Análisis de las exportaciones enero-agosto 1998' (January–August 1998 Exports analysis)
- → Written Explanation
- → Anexos → Exportaciones por sectores económicos (Exports by Economic Sector), August and January–August 97/98
- → Principales productos de exportación no tradicional por Sectores Económicos (Main Non-traditional Products Exported)

(1.2) Enlaces con páginas sobre Economia del Perú: http://www.rree.gob.pe/economia/entaces.htm

(2) Red Nacional de Aduanas (ADUANET): http://www.aduanet.gob.pe/aduanas/aduanet.htm

(2.1) Información General (General Information)

(2.2) Información Estadistica (Statistical Information)
- → Comentarios
- → Balanza Comercial 1998 & 1999 (Trade Balance)
- → Exports (En–Feb 99) → By Economic Sector
  - → By Exported Products
  - → By Destination Countries
  - → Main Exporters
- → Imports

Argentina

(1) Centro de Economia Internacional (CEI): http://cei.mrecic.ar/index.htm

(1.1) Cuadros → Información sobre el Comercio Exterior Argentino

- Comercio Exterior Argentino → Resumen (Cuadro 1)
  → Por regiones (Cuadro 2)
  → Por paises (Cuadro 2b)
  → Por grandes rubros y uso económico (C. 3a)
  → Por origenes y destinos principales (C.3b)
- Exportaciones por rubros y destinos principales (Cuadro 3c)
- Comercio Exterior Argentino → con los paises del Mercosur – anual (C. 4a), mensual (C. 4b)
  → con principales destinos/origenes fuera del Mercosur (C. 5)

(1.2) Gráficos → Comercio Exterior argentino, evolución anual y mensual
→ Déficit Comercial Acumulado
→ Composición de las Exportaciones/Importaciones
→ Orientación geográfica de las Exportaciones

(2) Instituto Nacional de Estadística y Comercio (INDEC): http://www.indec.mecon.ar/

(2.1) Indicadores de Coyuntura → Comercio Exterior: (http://www.indec.mecon.ar/comunica/comext.htm)

(2.2) Información Estadística → Estadísticas Básicas Nacionales → Sector Externo: (http://www.indec.mecon.ar/anuario/009.htm)
→ Sinopsis Estadística → Sector Externo: (http://www.indec.mecon.ar/sinopsis/sinopsis1998.htm)

Jamaica

http://www.go-jamaica.com/gleaner/business/index.html

USA

General	www.odci.gov/cia/publications/factbook/us.htlm
Companies	www.corporateinformation.com
Associations	www.asaenet.org/Gateway/OnlineAssocSlist.html
Customs	www.customs.treas.gov
Economy	www.bea.doc.gov
	www.whitehouse.gov/fsbr/esbr.html
	www.dismal.com
	http://dataweb.usitc.gov/scripts/tariff.asp
	www.gksoft.com/govt/en/us.html
Sector Information	www.ita.doc.gov/ita-home/itatdhom.html
	www.itds.treas.gov/ITDS/ITTA/commodityprof.htlm
Statistics	www.fedstats.gov
	www.census.gov
	http://fedlaw.gsa.gov
	www.law.cornell.edu
	http://thomas.loc.gov

Canada

Addresses	www.canadayellowpages.com
	http://strategis.ic.gc.ca
	www.frasers.com
	www.yellowpages.ca
General	www.odci.gov/cia/publications/factbook/ca.html
	http://corporateinformation.com/cacorp.html
	www.gksoft.com (Governments on the Web)
	www.canada.gc.ca (Government of Canada)
Customs	www.rc.gc.ca/menu (Revenue Canada)

	www.dfait-maeci.gc.ca/menu-asp (Department of Foreign Affairs)
	http://mkaccdb.eu.int (Market Access Database)
	www.tradeport.org/ts/countries
Statistics	www.statcan.ca/start.html (Statistics Canada)

Bulgaria

Government	http://www.bulgaria.bg
National Statistics Institute	http://hermes.nsi.bg/homef2.htm
Privatisation Agency	http://www.privatisation.online.bg
Foreign Investment Agency	http://www.bfia.org
Bulgarian Embassy	http://www.bulgaria-embassy.org
Bulgaria.com	http://www.bulgaria.com
BG2000	http://www.compconsulting.com/bg2000/index.html
Dir.bg	http://www.dir.bg/index.htm?Ver = Uk
All about Bulgaria	http://www.cs.columbia.edu/ ~ adev/bulginfo.html
Bulgaria online business research	http://www.online.bg/main/IMF.html
	http://www.slavophilia.net/bulgaria/business.htm
Statistics	http://www.online.bg/statistics/publications/bg98/bg98e.htm

European Union

General	http://europa.eu.int

Appendix B: Glossary

ABS Asset-Backed Securitization: typically this acronym has been applied to OECD securitisations rather than Emerging Market ones. As applied to Emerging Market performance risk structures, it is more common to see 'Securitized Export Notes' – sadly, we are constrained to use the American spelling since that is where these things will be sold.

Acceleration See Chapter 6. This is the process of calling for a faster schedule (or even immediate) repayment than was originally envisaged.

ACE Audit Control & Expertise: an independent, privately owned collateral management company based in Geneva, active mostly in Africa but also now seen elsewhere. ACE successfully identified a niche requirement for micro-collateral management for commodity-backed financings not covered (until they saw this competition) by the traditional warehouse and/or inspection companies like SGS and Cotecna.

Agent Typically we mean the Agent bank which holds the ring offshore between the various counterparties, the clearing accounts, the cashflows and any documentary collateral (such as shipping documents). On the more complex structures, there can often be two agents, one onshore, the other offshore (as on many Russian deals, where the onshore agent will typically be the passport bank), or a division of labour (and of operational risks and costs) between the banking Agent and a Security Trustee.

Arranger As with most banking, this is the bank that puts together the club, syndicate or investor pool that finances or refinances the deal. Unlike most banking, it is reasonably common to see the very big commodity traders arrange their own STCF deals, paying a bank to be Agent, but simply as a service. Mercifully, the oil majors have abandoned this practice some years ago. Personally, I can't help feeling that there is a divergence of interest between the banks and the offtakers at the point of credit risk management. I don't pretend that banks are better at identifying risks than traders, merely that banks are less likely to accept certain risks compared to traders. When the trader is making all the key decisions about the structure, no matter how many in-house bankers he employs, the tendency will be to push out the parameters of the structure as far as they will go. How acceptable this is depends on one's view of the Risk–Reward Ratio, but I would observe that another reason traders take on this role is to save themselves money, so clearly for banks coming into such deals the reward side of this equation is eroded too.

Avalise A forfaiting term used to mean 'countersign' in the sense of 'counterguarantee'. For example, company A issues a Promissory Note (at its own risk) but can then take the Note to its bank or to shareholder XYZ to countersign/avalise it and so it becomes XYZ's risk. The signature of the bank or other guarantor is usually written 'Per aval' followed by a signature and official stamp.

Bill of Lading A document of title to a cargo on board a ship, issued by the carrier and typically signed by the ship's master on the date of shipment.

BIS Bank for International Settlements.

Borrowing base Typically this is a pool of assets, usually receivables or goods in some form, used as collateral for a credit facility. The borrowing base does not have to be excessively detailed, some relying on mere representations by the Borrower. Others log individual warehouse warrants moving into or out of the borrowing base.

Brokerage clause See Chapter 6. This is a mechanism in contracts allowing the seller to sell to someone else at a higher price, provided the original buyer receives a broker's fee. This can be very useful when fixing medium- or long-term contracts for which the seller must demonstrate he is getting a fair market price.

Collateral Management The process of monitoring and controlling (typically physical) collateral pledged to the Lender. Generally this will include the movement and any processing of goods.

Collection Account This is the central clearing account at the Agent Bank where the receivables cashflow comes in. This should be pledged to the Agent as a matter of course.

COO Change of Ownership: this is typically a clause in structured trade finance (and other) documentation restricting the change of ownership by the Obligor, or related parties (especially production units related to the Obligor). Normally this will be in the form of a covenant by the

Obligor not to allow Change of Ownership during the transaction, and will be backed up by making such Change of Ownership an Event of Default, or a Potential Event of Default.

CP Conditions Precedent: all the conditions which have to be fulfilled prior to the borrower being allowed to draw down the funds. These are listed and discussed in Chapter 6.

Disintermediation Commonly used in banking to describe the positioning of someone (normally a bank) in between two other parties, i.e. the bank disintermediates between the depositor, putting money on deposit with the bank, and the borrower who borrows money from the bank. Historically banks would enter Emerging Markets or any foreign country through the local banks first, arguing that a bank was a better risk than a corporate. Always a tenuous argument in Emerging Markets, this strategy was shown to be spectacularly inadequate in the Russian crisis as bank after bank defaulted while the Russian commodity producers continued to export and were actually better off thanks to devaluation.

Drop Dead Fee Although many deals are structured on a 'No Win/No Pay' basis, it is also possible when the upfront costs are considerable to get a 'Drop Dead Fee', meaning a fee as pay-off even if the deal collapses.

EBITDA Earnings before Interest, Tax, Depreciation and Amortisation: a balance sheet figure used for a lending Covenant beloved of the Chase school of credit analysis.

EBRD European Bank for Reconstruction and Development, also known as the 'European Bank' (at least, internally): a multilateral supranational bank tasked with sponsoring/funding the redevelopment of post-communist Central and Eastern Europe.

ECA Export Credit Agency: OECD state-owned or state-guaranteed enterprises whose task it is to support exports by that OECD country. They do this by taking the risk that the importing country does not pay, either by guarantee, by an insurance policy or by funding the transaction. Typically, this is attractive to banks because ECA-backed transactions do not require any capital commitment/allocation from the bank, to the extent that the loan is guaranteed (usually 85–90%). Interest rates are consequently much cheaper than straight commercial loans. The credit lines of the ECAs for Emerging Market risks are often more aggressive than those of commercial creditors, especially in tenor, since they will often be supporting credits in support of the foreign policy objectives of the sponsoring OECD government.

EIU Economist Intelligence Unit: a respected source of country risk information, used by most banks. In truth, coverage of some of the minor countries can be mediocre, but generally much better than many in-house economists who may be asked to cover the entire planet on their own.

Escalation clause Also known as a 'top-up' clause: a clause in structured trade finance loan documentation that allows the creditor(s) to call for more collateral, typically in the context of a dedicated cashflow derived from a commodity export of variable value. If the value of the commodity flow is insufficient to achieve the amortisation schedule, or even a given collateralisation ratio as part of a security covenant, the creditor or the Agent under such a clause will have the right to call for an escalation of the underlying contract, to deliver additional goods, to top up the value of the cashflow.

Escrow account Not an expression seen very often these days, since the lawyers generally seem to advise against it. In principle it is an account in the name of someone who has no access to the funds sitting on it (rather it is controlled by the Agent).

Forfait Forfait is the purchase without recourse to the seller of an obligation (typically trade-related) of a third party, commonly evidenced by a simple bearer document such as a Bill of Exchange, Promissory Note or Payment Undertaking. As a trade finance technique it goes back centuries, but in modern usage it can also be used for sophisticated structures whereby any sort of corporate or sovereign obligation can be reduced to paper and sold in that form to investors or forfait market counterparties.

Haircut Term used for the discount to the nominal value of goods as collateral used by banks when making advances. Ideally, the bank will want to keep the advance as low as possible in relation to the collateral, while the borrower may have other ideas.

Hold What a bank will retain for its own account from a deal. Unlike the forfaiting and increasingly the ECA markets, most arrangers of STCF deals will be required to have a minimum hold for the lifetime of the deal. This hold will set the ceiling for the amount other banks are then prepared to commit. The rationale is that one should have a certain amount of confidence in one's own structure.

IBRD International Bank for Reconstruction and Development, the World Bank, not to be confused with the EBRD. Both are preferred creditors.

IFC International Finance Corporation: multilateral supranational subsidiary of the World Bank, tasked with private sector project finance. Typically aims to take commercial lenders with it in syndications, to tenors which they would not normally tolerate, under the so-called 'IFC umbrella'. They will be the Lender of Record, for an 'A' tranche for their own book, and make available a 'B' tranche to be syndicated to commercial or investment banks (the 'IFC 'B' loan). Because of the IFC's enviable record in avoiding defaults owing to currency inconvertibility (it is a 'preferred lender'), most OECD bank regulators grant exemption from mandatory or specific country risk provisioning for their national lenders who participate in IFC 'B' loans. Note that the EBRD also now uses A and B loan structures.

L/C (Letter of Credit) See red claused L/C.

LME The London Metal Exchange is the leading commodity exchange for non-ferrous metals (aluminium, aluminium alloy/secondary aluminium, copper, tin, zinc and lead) and is estimated to be the reference price for 80% of the global physical trade in these metals. Its share of futures trading in these metals is higher still, though it faces some competition now from Comex in New York. Nevertheless, Comex only has approximately 10% of futures trading in Copper despite some aggressive marketing. Technically the LME remains a forward physical market rather than a pure futures market, largely as a result of being one of the oldest institutions of its kind. One aspect of this is that contracts or trades can be satisfied by physical delivery across the exchange, evidenced in the form of warrants (LME warrants) which are issued only by 'LME-approved warehouses' located in certain key ports world-wide. These warrants are considered near-cash equivalents by banks. Metal so traded must conform to certain standardised technical specifications (also evidenced by the warrants) and producers must be 'LME-registered marques'. Trading across the LME ring (floor) is conducted by a relatively small number of 'ring-dealing members' but is conducted on behalf of a much wider group of associate members and clients. Trades are disintermediated by the London Clearing House, which also provides clearing services for the LIFFE exchange in London. See the LME website for more information (see page 160).

MAC Material Adverse Change: see Chapter 6. A change in the operational environment of a facility, usually not to the lender's advantage.

MIGA Multilateral Investment Guarantee Agency: another subsidiary of the IBRD, providing investment guarantees, useful for its impact on country risk provisioning.

Nice Bloke Fee Any fee a bank is able to elicit on fairly spurious grounds, for example, being 'nice blokes'.

OECD Organisation for Economic Co-operation and Development: a multilateral organisation comprising 'developed' countries, originally in North America and Western Europe but now including countries such as Mexico, Chile, Turkey and the Czech Republic. Of relevance to structured trade because loans to financial institutions, or guaranteed by them, in OECD countries attract a lower BIS capital weighting (currently 20%) than loans to non-OECD banks or to any corporates (100%).

Offtaker The buyer of the commodity taking the goods from point of shipment (or beyond).

OFZ Floating-rate rouble-denominated Russian government obligation with or without coupons with a tenor of between one and ten years.

Penhor Mercantil/Agricola Brazilian forms of mercantile or agricultural pledge over goods.

Petrobras hurdle The concept that says why do a complicated labour- and risk-intensive structured deal for a relatively low reward when you can get a higher price from a Petrobras Payment Undertaking, given that Petrobras is the best risk in Brazil (structure or no structure), which will give good documentary evidence of the oil import being financed (itself usually sufficient to gain 'trade finance' treatment in any moratorium)?

PRI Political Risk Insurance.

Red claused Letter of Credit Arose out of the Australian Wool Trade in the 1840s. Buyers' Letters of Credit payable against shipment of wool from the Australian coast started to contain clauses allowing partial drawdown of the Letter of Credit in advance of shipment (a pre-shipment advance) to allow the local buying agents to take this cash up country to pay farmers at the farm gate for the wool. This was deemed so dangerous from a banking perspective that the clause would be written in red ink. Later also arose the green claused L/C, written in green ink, allowing partial drawdown against evidence (such as warehouse receipts) that the goods at least were at the coast and awaiting shipment. Both red and green claused L/Cs are in regular use in modern structured trade finance. They are particularly useful for financing banks who want the credit to appear as a trade advance rather than as a bank loan, and because they provide a conduit both for movement of funds and for movement of shipping or other documents of title.

Reserve Account A pledged account at the Agent Bank holding at least one payment of principal plus interest, in case of any short-term delays. Particularly useful on deals aimed at the capital markets, or longer-tenor deals in general. Not seen on short-term deals.

SGS Société Générale de Surveillance Swiss-based international warehouse and inspection company. Now also doing 'collateral management'.

Skim The difference between what underwriting banks receive and what they pass on to participant banks. Many of us adhere to the dictum that margin is for risk, while fees are for work, so fees are skimmed but not margin, since the participants take the same risk. This philosophy is not universal.

SPV Special Purpose Vehicle: a very useful entity to evidence ringfencing of contractual obligations and cashflow. Can be set up under an orphan trust, so it does not actually belong to anyone, though some banks like to have a share in some SPVs. Ubiquitous in securitisations, increasingly common in the larger and longer-tenored traditional STCF deals.

True sale The concept that rights are sold in their entirety to another entity. Very useful in structured deals and stronger than a mere assignment. Also generally takes the asset thus sold off-balance sheet for the Borrower. Most often seen in securitisations and SPV structures.

Trust Receipt A document substituting for a document of title that has been withdrawn from the Security Agent (or simply the bank), but evidencing that the Borrower acknowledges the bank's title to the goods so represented and will either replace the withdrawn document with the next document of title (e.g. warehouse warrant after bill of lading), or with the proceeds of its sale. Easy to use, sadly often ignored (by banks).

Warrant Document of title to goods in warehouse. Generally deemed stronger than a warehouse receipt. Only as good as the warehouse company issuing it. 'LME warehouses' are generally seen as the aristocracy of warehouses, thanks to very stringent conditions imposed by the LME to qualify for this epithet, backed up by regular inspection, and their warrants are the best.

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