Warehouse Receipt Financing in Agriculture in Africa

AgriFin (April 2013) | This article was contributed by Gideon E. Onumah, Agricultural Economist/Rural Finance Specialist at the Natural Resources Institute (NRI), University of Greenwich in the United Kingdom. Dr Onumah is the Project Coordinator for the Farm Risk Management (FARMAF) Project. For additional information, please contact the author at: G.E.Onumah@gre.ac.uk (http://G.E.Onumah@gre.ac.uk) and visit: www.farmaf.org (http://www.farmaf.org).

The benefits of warehouse receipt financing

Warehouse receipts financing (WRF) has the potential to improve the supply of rural finance by directly easing collateral constraints and simultaneously enhancing the risk profile of farmers by fostering improvements in output markets that can lead to higher farm incomes. The system revolves around warehouse receipts (WR), which are issued as evidence that specified commodities of stated quantity and quality have been deposited at particular locations by named depositors. The WRs may be issued to farmers, traders, exporters, or processors as well as individuals or corporate bodies. Warehouse operators or collateral managers, who issue the WRs, guarantee that a bona fide holder of the receipt can take delivery of the underlying commodity.

They further warrant that they can make good any value lost through theft or damage by fire and other catastrophes – this is often underpinned by insurance. The guarantee is critical to the credibility of the WR system as it allows for the receipt to be pledged or transferred to trade counterparties.

For more than two decades, governments and donors have supported projects to promote WR systems in Africa, especially after agricultural and financial markets were liberalized. South Africa launched a silo receipt system, which has become the most successful WR program in Africa and underpins trading on its commodity exchange. The only other country that has taken substantial strides towards mainstreaming WRF is Tanzania (Box). In most African countries, progress has been rather slow, in part because of the difficulty in addressing risks such as business/market risks, credit risk, legal risk and process risk.

Box: Tanzania makes giant strides in promoting warehouse receipt financing

South Africa has the most advanced receipt system, which also underpins trading on its commodity exchange – the only futures exchange in Africa. WRS in Tanzania is the most developed in Africa. Almost the entire crop of cashew nuts produced in country is marketed through the WRS, which was first piloted for cashew in 2007 in response to concerns about lack of transparency in the marketing for raw nuts. Under the WRS, primary- (village) level Agricultural Marketing Cooperatives (AMCOs) leverage bank finance to aggregate raw nuts which are receipted nuts and traded through an auction system involving over 30 exporters and local processors. The inventory financing requirement in the region is US$85 million per season. Introduction of the two allied systems (WRS and auction system) has contributed to higher producer prices. In the 2007/08 season, cashew farmers in Tanzania obtained average farmgate prices estimated at about US$290 per tonne. By the 2011/12 season, the minimum price obtained by farmers was estimated at about US$750 per tonne – an increase of over 2.5 times.

The improved producer incentives impacted positively on cashew output, rising from 79,100 tonnes in the 2008/09 to over 158,000 tonnes in the 20011/12 season. In the coffee sub-sector, the greatest benefit of the WRS to smallholder farmers is their ability to directly market value-added "clean coffee" rather than the unprocessed parchment coffee. This occurs because smallholder farmers can sell through rural cooperative societies (RCS), which aggregate on behalf of members using inventory finance from banks (estimated at over US$12.0 million per season). The coffee is deposited with a coffee curing factories licensed by the Tanzania Warehouse Licensing Board (TWLB). The licensed warehouse operators process the parchment coffee which is marketed through the Moshi Coffee Auction (MCA).

Farmers selling through the RCS often receive an initial payment which is about 60 percent of the farmgate price offered by private traders for parchment. However subsequent payments, which they receive in two tranches, bring the gross incremental earnings to almost 70 percent above the parchment price. This is principally because they sell a value-added product and do not gain much from seasonal increase in prices. The system has contributed in improving the quality of Tanzanian coffee and also enhanced traceability. Estimates of inventory financing opportunities for grains traded in the domestic formal markets and into regional markets exceed US$100 million per season. However, this opportunity is currently under-exploited partly because the development of the WR system for the grains sub-sectors is being hampered by capacity issues and disabling policies.

Source: NRI review reports including recent study commissioned by Common Fund for Commodities.

Risks related to warehouse receipt financing

Market-related business risks include the risk of adverse price movements which reduce the market value of the underlying collateral and/or difficulties lenders have in liquidating the asset in the event of default by the borrower. Where viable commodity exchanges exist, lenders are able to use available market instruments to hedge price risk and also to liquidate the collateral. Where such markets are thin or non-existent, as is the case in most African countries, most lenders tend to insist on off-take contracts that guarantee sale as well as a minimum price. Though this requirement provides certainty for banks, it tends to restrict financing to borrowers who are able to secure such trade contracts – usually the larger-scale traders and exporters. Even for such borrowers, this requirement can limit marketing options. In South Africa some borrowers meet this requirement through buying over-the-counter put options but this is not available in other African countries. A common method adopted by banks to mitigate price risk is "hair-cutting", which entails discounting the market value of the commodity when financing. For instance, in most cases, lenders finance up to 75% of the value of grains during the harvest season. The discounting increases later in the marketing season.

Credit risk arises where borrowers do not have a demonstrable capacity to fully repay the loan if market and other risks lead to a loss. While it is preferred that WRF is principally secured against the stored commodities, lenders may require additional security and may also undertake a more thorough credit appraisal of potential borrowers. This is quite common with financing involving collateral managers. The absence of such requirements may have contributed to the slow uptake of inventory financing opportunities under other more widely-accessible warehouse receipt systems (WRS) discussed below. With the latter, lenders tend to discount at a higher rate.

Since collateralised stocks represent the main security under WRF, ***legal issues*** that detract from enforceability of the rights of third-party holders of WRs tend to raise a major uptake barrier. Legislation that recognizes WRs as documents of title tend to reduce the risk of lengthy and costly litigation where lenders have to exercise their right to liquidate the commodity in case of default. In countries like South Africa, "custom and practice" has established transferability of title with the WR. However, achieving this via legislation appears to be a much quicker solution. Another option is for lenders to execute repurchase or buy-back contracts which allow borrowers to buy the commodity at a future date and at a price that is based on the loan granted and associated interest. In this case the lender can liquidate the commodity if the borrower fails to exercise his right to buy it back.

To maintain the loan-to-market-value of the commodity, lenders need to closely monitor market developments. Many countries have invested in market information systems (MIS) which are intended to provide reliable, timely and readily accessible market-sensitive information. Quite often the focus is on price information but it is also important that market players have access to reliable crop forecasts as well as data on stock levels in target markets. Lenders and other parties will then be able to better forecast future price trends and take informed positions on timing the sale of the collateralized commodity. Market monitoring is an essential part of the internal management process for inventory finance. Other procedures relate to documentation of WRF transactions, internal administrative controls and monitoring of performance by operators holding the stored commodity.

Process or operational risks are associated with the effectiveness of systems and procedures which are external to lenders but which impact the value of stored commodities. They include the suitability of storage facilities used, receipting and storage management systems in the designated warehouse, and the capacity of the warehouse operator (or collateral manager) to make good any in-store losses. The basic means by which these risks are mitigated tend to define the WRS model as described below.

Warehouse receipt models

1. Collateral management agreements model

Where financing is under an unregulated commercial receipt system, which is very common in Africa, independent collateral managers take custody of stored commodities under tripartite collateral management agreements (CMAs) involving a bank, the borrower, and the collateral manager (i.e., the inspection company acting as warehouse operator). As a rule, borrowers deposit their stocks in warehouses which they either own or lease for this purpose. The warehouse is then "leased" to the collateral manager for a nominal fee, thereby transferring control over and access to it from the borrower to the collateral manager – who then issues warehouse receipts covering the stored commodities. The collateral manager is required to back the guarantee to hold the stock with insurance against stock losses as well as professional indemnity provided by "blue-chip" international insurance companies. These systems have been used mainly by large-scale borrowers to finance predominantly import and export transactions. However, they have been of limited use in fostering access to inventory finance by smallholder farmers and small-scale traders and processors. Their use in financing trade in domestic and regional markets is also very limited.

2. Targeted farmer groups model

To assure access to inventory finance, donors, and NGOs promoted models which exclusively targeted farmer groups. Under these systems low-capacity warehouses (some as low as 20 tons) were constructed in villages and managed by the farmer groups. The NGO/donor-funded project tends to monitor warehousing operations and offer funded guarantees to lenders, including microfinance institutions (MFIs) – the guarantee may be up to 100% of the value of the credit advanced. There are also cases where the warehouses are managed by collateral managers but their fees are heavily subsidized by donors. This system has proved beneficial because it allows for access by smallholder farmers. However, its sustainability is often difficult to assure, especially because of the intense supervision provided by the NGOs. This means that the programmes tend to be limited to a few farmer groups. Furthermore, because the warehouse receipts are not transferable, they cannot be used in facilitating trade transactions.

3. Regulated warehouse receipt model

A third model, which has grown in popularity since the late 1990s as a result of pilots by donors such as the Common Fund for Commodities (CFC) and USAID, is a regulated WRS. The distinguishing feature of this model is the creation of a regulatory framework consisting of warehouse legislation and a regulatory body. This system has been piloted in a number of African countries with varying degrees of success. The most notable cases are pilots in Tanzania (Box); Malawi (where its development is supporting the burgeoning commodity exchange); Uganda (where the system is being used to procure grains for relief operations by WFP); and in Zambia. Success has often been achieved where access is open to players of all sizes; smallholder groups are trained and enabled to participate; warehousing services are provided by regulated private entities and capacity building needs of key players is enhanced. It is possible to create these conditions under projects and various initiatives. However, the more challenging prerequisite for success is a supportive policy environment. This has proved to be an Achilles heel in many countries, especially where the focus is on grains which constitute the main staple.

Publication Date: 2013

Name of Event:
Webinar | Structured Trade Finance: Warehouse and Inventory Management in Africa (/event/webinar-structured-trade-finance)