

TECHNICAL SUMMARY



Necessary Conditions for an Effective Warehouse Receipts Activity

by Krassimir D. Kiriakov and the QED Group, LLC, United States Agency for International Development Concept Paper, Washington DC: USAID 2007.



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Introduction

The following is a summary of Kiriakov, Krassimir D. and the QED Group, LLC (2007). *Necessary Conditions for an Effective Warehouse Receipts Activity* (United States Agency for International Development Concept Paper). Washington DC: USAID.

Warehouse Receipts (WHR) system is an alternative solution for commodity producers, processors, and traders to access short-term financing for operations, take advantage of price fluctuations, and secure the storage of their produce. WHR system uses public warehouses to store grains of third parties and issue warehouse receipts. The public warehouse is responsible for technical and financial performance, which assures depositors that their commodities will be stored with guaranteed quality and quantity. The producers, processors and traders determine when to use the commodity as collateral and market it. The financial institutions accept warehouse receipts as collateral since they are highly

liquid and commodities always have clear market prices.

The framework for establishment of a WHR system focuses on structural components, including legislation, registration, licensing and inspection of public warehouses; and development of financial instruments for collateralized loans, insurance, and indemnity funds. This paper describes the necessary conditions of the commodity market infrastructure that enable implementation of successful WHR systems. It begins by looking at legislation followed by financial performance guarantees and financial institutions. In the end it examines the general commodity market conditions needed for a successful WHR system.

Legislation

A reliable legislative framework which protects the rights and interests of depositors in public warehouses, and recognizes claim of collateral is crucial for banks to trust the Warehouse Receipt system. Specialized WHR legislation that takes into account the specifics of the commodity related to storage and marketing is important.

The most common system for providing a regulatory framework for the public warehouses is a Government Regulatory Agency. Banks rely on these agencies for information on warehouses and to obtain market information necessary for negotiation of credit conditions. In countries with weak legislative framework, government agencies are substituted with private survey-

ing companies or collateral management agreements (CMA).

The major functions of the regulatory agency are:

- Organize and implement the licensing process
- Maintain public registers of the public warehouses
- Execute initial, periodical and special exams of the financial, operational and technical condition of public warehouses as well as quality and quantity of the stored grain
- Collect orders for printing of warehouse receipts

The legal framework should also provide a clear definition of the public warehouses and their major licensing requirements (relevant thresholds set by a regulator):

- Minimum required capital
- Minimum storage capacity
- Provide the necessary performance guarantees or participate in indemnity fund
- The public warehouse should not be a creditor or provide guarantees for loans for third parties
- Insurance of assets against fire, flood, and earthquake
- Publicly announced storage fees
- Provide to the regulatory agency information about its business operations

In addition to the above mentioned requirements, the warehouse should have a laboratory for grading of the commodity or have access to one. The producers and the warehouse operators should also have access to an independent laboratory for dispute resolution.

Types of warehouse receipt systems: Warehouse receipts vary in different countries, but they generally provide a simple mechanism for transfer of ownership or initiation of a pledge to be used easily. Warehouse receipts are special security papers issued by a public warehouse that proves that the commodity has been deposited, specify its ownership, and state the obligation of the warehouse to deliver it to the legitimate holder of the receipt.

There are two general types of warehouse receipts: one part receipts and two parts receipts. The difference between the two types is in that the two parts receipts provide opportunity



for trading both in commodity and stock exchanges, as one of the parts is related to the ownership of the commodity and the other to the pledge. Nowadays, electronic warehouse receipts are being introduced in the market. The selection of the type of receipt should again be based on the evaluation of the commodity market situation in each specific case.

Financial Performance Guarantees

Another critical structural component for an effective WHR system is the financial performance guarantee. Financial performance guarantees are used to satisfy potential losses of the depositors in licensed warehouses in cases of bankruptcy, theft or mishandling of the commodity, and they play an important role in the integrity of the WHR system. There are two ways to establish financial performance guarantees: insurance bonds or letter of guarantees, issued on behalf of the licensed public warehouses, or the creation of indemnity funds.

Financial Institutions

As all the components of a Warehouse Receipt system fall into place, financial institutions become more confident about this type of



lending. Banks gradually start to increase the percentage of the commodity value they accept as collateral, decrease interest rates for qualified borrowers, and begin to compete for new clients. For the agricultural producers, obtaining this type of credit becomes a convenient, faster process, with reduced paperwork. Banks that understand commodity-based financing and are open to using warehouse receipts are an important condition for the success of the system, as they develop in-house commodity expertise to follow market trends and properly value the loans.

General Commodity Market Conditions

Many different commodities are appropriate for warehouse receipts, and each has special

features related to storage, price volatility, marketing chains and standards and grades. This section provides only a general framework, and each country-specific case should be evaluated based on collection of sufficient baseline data and analysis of all factors.

1. *Commodity Features*: the commodity needs to be produced in bulk to bear the administrative overhead of using the WHR system. In general, markets that are net exporters are more suitable with the commodity should be appropriate for storage and prices with enough volatility to justify delayed marketing.
2. *Commodity Exchanges*: viable commodity exchanges are important for the overall marketing infrastructure but they are not a necessary precondition. On the contrary, viable warehouse receipts may enhance the development of functional futures commodity exchanges.
3. *Grades and Standards*: local grades and standards should reflect the international markets and be used as a base for negotiation of terms and conditions between the depositor and the warehouse operator. Banks also use them to assess value of the commodity and collateral.
4. *Market Information*: access to reliable data on market conditions and price trends is important for participants in the WHR system, including banks that use it to determine value of the collateral.

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