



Asia-Pacific
Economic Cooperation

Advancing Free Trade
for Asia-Pacific Prosperity

GUIDEBOOK ON TRADE AND SUPPLY CHAIN FINANCE

Policy Support Unit



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Economic Cooperation**

Guidebook on Trade and Supply Chain Finance*

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Foreword

In 2014, during China's APEC year, the Senior Finance Officials' Meeting (SFOM) requested the APEC Policy Support Unit (PSU) to prepare a study on regulatory issues affecting trade and supply chain finance. The paper was meant to be an input in the senior finance officials' deliberations on how to improve financial services for the real economy which was one of the key discussion items during the China year, along with infrastructure investment and finance, and fiscal/taxation policies and economic restructuring. The PSU delivered on this request by publishing Issues Paper No. 8 which explores the definitions of supply chain finance and how regulations can promote or stymie its growth.

To write the research report, PSU had to understand trade and supply chain financing in depth, not in theory but in actual practice, to better understand where the role of government policies enter and how. There is no better way to achieve this than to get the knowledge directly from a trade finance practitioner. The report produced gave rise to this Guidebook.

PSU deems that the consultant's report used as reference for the PSU issues paper on trade and supply chain finance contains significant and useful information that can help policymakers as well as young market practitioners understand the rudiments of trade and supply chain financing. It would have been a waste to file this away as just one more background research, hence, the decision to publish it as a Guidebook on Trade and Supply Chain Finance.

The Guidebook describes typical supply chains and which stages need financing and how they are financed. It also discusses risks in the supply chains and various mitigation mechanisms whose availability and use depend on the presence of proper regulatory and legal infrastructures as well as the confidence of the market in them. It talks about financial instruments such as warehouse receipts financing, invoice finance, receivables finance, factoring, forfaiting, and others. Case studies of what had gone wrong in particular actual transactions are presented as examples and provide important insights on regulatory or institutional deficits that need to be bridged and in which, hopefully, APEC can play a role.

PSU thanks the author of this Guidebook for the significant professional experience shared through it. It is our hope that our APEC stakeholders would find in this Guidebook a real guide to navigate the complex nature of trade and supply chain finance.

DENIS HEW

Director, APEC Policy Support Unit

I. Introduction

Supply chain management integrates suppliers, producers, warehouses, distributors, and retailers, so as to make goods available in the right quantity, at the right destination, and in a timely manner to reduce costs. The design, control, operation, information systems, and implementation of a supply chain will not be part of this paper since the supply chain is a complex network.

The basic principles of international trade finance and structured trade finance as well as regulatory issues are woven into supply chain management. At its core, this paper aims to:

- i. Provide an intimate understanding on how goods are financed from procurement until they reach the final buyer, who is at the end of the supply chain.
- ii. Demonstrate specific ways of financing, analyze the risks involved, as well as provide risk mitigations that could be adapted whenever possible, since supply chain and trade finance are inextricably linked.
- iii. Highlight regulatory and security issues where relevant and how some of these issues can be overcome to enable small and medium enterprises (SMEs) to have better access to supply chain finance.

Due to the multi-contractual nature of most import and export transactions, the supply chain will necessarily deal with diverse and complex documentation. For example, an export transaction could involve a sales contract governed by the International Sale of Goods Act, the Bills of Lading Act, if bills of lading are involved for marine shipment, and the International Chamber of Commerce Uniform Customs and Practices if a documentary credit is involved, among others.

From the time the sourcing of raw materials begins, to its production into finished goods, to its storage, to its delivery and receipt of sales proceeds, these all form part of the chain which produces different risks at different points in time, including shifting the burden of such risks to other players in the chain. Whilst financing is an important part of the supply chain, over the years other key players have become involved, including financial and nonfinancial institutions, third parties such as insurance companies, warehouse operators, development banks, government and nongovernment bodies such as the International Finance Corporation (IFC), the United Nations Conference on Trade and Development (UNCTAD), and the Asia-Pacific Economic Cooperation (APEC) forum. Often regulatory bodies provide uniform codes appropriate to different aspects of the supply chain, which are recognized internationally¹ and advocate best practices. However, most of the law governing international trade is not formal or enacted law but conventional and customary law.² The rules, mechanisms, and procedures are worked out over many years until they become customary practice. For example the mechanisms of documentary bills and documentary credits are entirely customary. Documentary credits governed by the International Chamber of

¹ Allen, David E. "Trade financing export transactions". *Financial Review*. 22 November. (1988).

² Ibid.

Commerce and its codes under the Uniform Customs and Practices are universally recognized and employed. In this area, as in many other areas, banking practices tend to make the law. The issue arises as to whether these customary practices apply in the same way as an enacted law or conventional in their application based on agreements of the parties involved.

The role of the law is to provide a framework of rules within which traders in different economies can effectively and confidently deal with one another. The law, therefore, provides uniform codes appropriate to different aspects of the transaction that are recognized internationally by most economies. For example, after many years of work, the Vienna Convention on the International Sale of Goods 1980 established a uniform law on many aspects of the sales contract.³

II. Movement of Goods in the Supply Chain

The supply chain normally starts with the procurement of the goods. These could come from raw materials without any need for further processing and traded in their natural form and therefore classified as commodities (in the sense of unprocessed or semi-processed). These raw materials are usually transported in bulk with shipments calling for one single vessel from a loading port to one discharge port. Shipments are chartered to one charter party and as such would involve charter party bills of lading.

Manufactured goods on the other hand, tend to be shipped in liner shipments calling on various loading ports. These goods call for liner bills of lading, which are usually transported in containers and can have several ports of call. Sometimes, whether in raw material form or manufactured goods, a temporary storage is involved. In such a case, warehousing of the goods enters into the supply chain. Over the last 25 years warehouse receipt financing has evolved into a structured trade finance product that is used by trading companies and producers alike with the collaboration of trade and commodity banks. But today, SMEs have not yet embraced its full benefits. In fact, with more exposure and support from banks, SMEs could gain access to this trade finance product instead of a general working capital line requiring a strong balance sheet with a variety of covenants and at times stringent. Unless the goods stored become the collateral, which is what warehouse receipt financing is about, warehousing is simply a form of storage in the supply chain.

Warehouse receipt financing could begin at the origin of the supply chain or at its destination or both.

The mode of transport is a crucial part in the understanding of the supply chain especially if the goods move from one type of transport to another and from one economy to another. The financing may need to be adjusted according to the risks involved during its transportation since different transport documents are involved and some of them could be considered as securities or collateral.

³ Ibid.

Various transport documents carry different risks depending on whether the financing institution has title or no title to the goods. For example a full set clean on board bills of lading made to the order of the financing bank or endorsed in blank is clearly a title document in contrast to an air waybill or a railway bill which is simply an evidence of carriage. One scenario could be where raw coffee from Viet Nam needs to be warehoused until it can be accumulated in bulk before it can be traded. If the coffee supplier happens to be a medium-sized company or an SME located in Viet Nam, it may be able to attract financiers using warehouse receipt financing and with the coffee beans as collateral. The risks could be reduced once the warehouse receipts are replaced with titled bills of lading when the cargo is loaded on board a vessel.

A state-owned company in Viet Nam, which is the official arm for rice procurement, may need financing during the harvest season. The financing may be extended to the state-owned company to advance money to the farmers during the harvest season. The risk is manageable since it is providing finance to the state-owned entity rather than to the farmers directly. Sugar cane from Brazil could be financed as a pre-crop loan where the farmers are paid in advance for harvesting the sugar. Thereafter, the cane could be brought to a sugar mill to be processed into refined sugar in Brazil. The raw sugar may also be exported to Indonesia for processing into refined sugar and finally sold to ultimate buyers, that is, soft drink manufacturers. Whether the goods stored are for export or import or for further processing, if the financing is done on the basis of the goods stored as collateral, warehouse receipt financing is an alternative way to obtain finance involving the supply chain.

There could also be movement of goods across land borders where the land transport will require railway bills of lading or forwarder certificates of receipt (FCR). Generally speaking, trade finance banks that view the goods as securities may not be keen to take the initial risk at the outset since FCRs or railway bills of lading are considered unsecured as they do not provide title to the goods. Trade finance banks may be interested in financing the part of the supply chain the moment the goods are on board the ship where titled marine bills of lading replace the FCR or railway bill of lading.

Soya beans shipped in bulk from the supplier economy, for example, from Brazil and discharged into a port in China may require a charter party bill of lading rather than a liner bill of lading used for general merchandise.

III. Warehouse Receipt Financing in the Supply Chain

Warehouse receipt financing is financing in which a lending institution provides credit to a seller against the security of goods in an independently controlled warehouse.

III.1 Collateral Management Agreement

Warehousing in the supply chain is not uncommon. It has evolved from just providing storage services, into a form of structured finance⁴ where the commodity stored is offered as collateral. More parties participate such as the warehouse operator, the company in need of financing the stored goods, and the financing bank. This brings to the forefront a form of structured finance that makes use of a three party agreement referred to as a collateral management agreement (CMA). In this form of financing, the security is against the stored goods, divorced from the rest of the balance sheet of the borrower. Because the goods are considered as the basic security, this form of financing has become one of the more common forms of structured trade and commodity finance.

However, regulations regarding warehouse receipt financing have not been uniformly enacted. Existing basic rules govern ownership, transfer of title of the stored goods, and their eventual sale in the event the borrower defaults on the financing.

In a CMA, the financing bank will take the goods as its security which may require the borrower to pledge the goods to the bank, the warehouse operator will take responsibility for the control and release of the goods, and the borrower will continue to be owner of the goods but agrees to relinquish the control of the goods to the warehouse operator.

For instance, banks that want to consider warehouse receipt financing in China will encounter some special legal issues and risks of which they need to be aware. These issues and risks are mainly connected with questions related to the legal nature of documents involved in such transactions; questions related to transfer of title and the availability of security rights over the goods. The relevant Chinese laws and regulations on these topics have evolved over the last few years and are still subject to change and development.

Regulations governing warehouse receipt financing are crucial since the risks and sources of repayment are moved away from the borrower to a third party or to the transaction itself or to the goods themselves.

Examples of third parties could be an insurance company, a forfaiting company, and a warehouse operator. The CMA has a legal framework respected by the three parties involved

⁴ Structured finance is the art of transferring risks in trade finance from parties less able to bear those risks to those more equipped to bear them in a manner that ensures automatic reimbursement of advances from the underlying assets. Such assets include inventory and receivables. Definition from a study prepared by UNCTAD Secretariat "Potential Applications of Structured Commodity Financing Techniques for Banks in Developing Countries". (2001). Downloadable: <http://unctad.org/en/Docs/poitedcomd31.en.pdf>.

so that the rights and duties of each one are clearly marked out. There is no standard CMA. Each CMA has to clearly define the duties and responsibilities of each party in the CMA.

However, warehousing may not necessarily involve a sophisticated third party arrangement if it is a simple lease of a warehouse for temporary storage unrelated to financing.

In warehouse receipt financing, a bank or a trading company or an individual trader mutually rely on goods stored in an independently controlled warehouse to secure financing. The warehouse operator who receives the goods, issues warehouse receipts in one form or another depending on an economy's regulatory system which forms the basis of financing. Rather than relying on the producer's (exporter's) promise that the goods exist and that the proceeds of the sale will be used to reimburse the credit provided, the goods are put under the control of the warehouse operator. The warehouse operator becomes legally liable for the goods he or she stores. If the goods are damaged, stolen, or destroyed, through no fault of the operator, his or her insurance company has to make up for the value lost.⁵ The risk of fraud does exist and is an inherent risk but this risk could be addressed by means of a professional indemnity insurance protecting the warehouse operator. Thus, the warehouse receipt is more than evidence of storage, more than a voucher to collect the goods, but above all, it is an instrument to secure finance more so where structured finance is concerned.

The warehouse operator's integrity is important to the success of this form of financing since the actual possession of the goods is entrusted to him. The use of a warehouse receipt has the added advantage that the goods are no longer in the possession of the borrower, and if the borrower defaults, the lender has a legal recourse to the goods.

Both the bank and the borrower are reliant on the warehouse operator who is more than a storage keeper. He or she assumes the risk and control of the goods the moment the warehouse receipt is issued. The warehouse receipt is a form of acknowledgement and evidence that he or she received the goods for storage and becomes legally liable for the existence of such goods. The borrower surrenders the actual possession of the goods although he or she continues to be the owner. The bank can have a legal right to liquidate these goods according to certain requirements if the borrower fails to pay the warehouse loan. The warehouse operator has however a lien over the goods for fees due to him or her and unpaid.

With regards to regulatory issues, in the United States (US), Canada, and Australia, laws have been enacted which are well developed involving warehouse receipts and the transfer of such receipts. The treatment of warehouse receipts as documents of title vary from jurisdiction to jurisdiction. For example, in Singapore, there is no legislation regulating warehouse receipts.⁶ The lender providing the warehouse receipt financing has to rely on the general law regarding pledges of the goods. In China, warehousing contracts are governed by contract law, whereas the pledges of warehouse receipts are governed by property law.

⁵ Ibid.

⁶ Soon, Choo Hock. "Understanding and Overcoming Title and Security Issues in Asset Based Financing in Asia". Singapore: Rajah and Tann. (2003).

III.2 Warehouse Receipt

The warehouse receipt forms an integral part of warehouse receipt financing and of the CMA. This is because the goods are surrendered to a trusted third party by both the lender and the borrower. Both parties trust that the goods are in safe hands; the warehouse operator upon issuing a warehouse receipt acknowledges that he or she has received the goods and that he or she will only release the goods based on instructions from the lending bank in whose name or to whose order the warehouse receipt is issued. Such instructions need authentication.

The warehouse receipts contain the following information:

- i. The business name and domicile of the depositor of the goods
- ii. The kind, quality, marking, packaging, and number (quantity) of the warehoused goods
- iii. The standard wear and tear according to the nature of the goods
- iv. The place and duration of storage (bonded or nonbonded)
- v. Warehousing fee
- vi. If the goods are properly insured, the insured amount, period of coverage, name of insurer, and the type of insurance
- vii. The issuer, the issuing place, and issuing date

III.3 Title, Security Interest, and Pledge

A security interest is a right that is given to one party over the asset/s of another party in order to secure payment or performance of the party or a third party. The basic reason for taking security in the asset of another party in any financing transaction is to avoid the *pari-passu* principle.⁷

The *pari-passu* principle is a feature of insolvency law in common law jurisdictions like England and Singapore that provides for the equal treatment of all unsecured creditors of the debtor upon insolvency in that unsecured creditors will rank in proportion to their claims. Thus, having security allows the financing bank to avoid equal treatment by obtaining prior rights in the borrower's assets covered by the security interest.⁸

Another purpose of taking security is to obtain rights against a third party who will be responsible if the debtor defaults.⁹

In most cases, a warehouse receipt is not a document of title, hence the bank needs to perfect its security over the goods financed. This can be done by means of requiring the borrower who is still the owner to pledge the goods to the bank. A pledge is a form of security interest.

A pledge arises when a bank, which is the 'pledgee', takes possession of the assets (stored

⁷ Ibid.

⁸ Ibid.

⁹ Ibid.

goods) of the borrower who is the ‘pledgor’ as security until payment of the debt. Having possession of the asset is crucial to the pledge. Even if the lender has no actual possession of the asset, it is sufficient to have what is known as ‘constructive possession’.¹⁰

Constructive possession in modern practice would normally involve the possession of a valid document of title which represents the assets, for example, bill of lading, or warehouse receipt/acknowledgement called ‘attornment’ by a third party, that is, the warehouse operator who holds the goods to the order of, or at the disposition of the lender.

A pledge can be created simply and there is no requirement for documentation although it is good practice to take a written memorandum of the terms of the pledge. In practice, pledges are usually taken of goods and of documentary intangibles such as documents evidencing title to the goods, for example, bills of lading, bills of exchange, or securities such as bearer shares, share warrants, and bearer bonds.¹¹

The pledgee’s security interest is much more than the right to detain the asset in case of default of the borrower. It extends to the right to sell the goods and apply the proceeds in settlement of the debt. The pledgor still has the right to redeem the goods by paying the debt owed and cancel the pledge.

Since the pledge is based on possession of the goods or documents of title, it follows that the rights of the pledgee arise from possession and not from the security documents. The fact that the pledge is based on possession also means that the value of the pledge as a security is limited by the extent of the pledgee’s possession. Thus security is lost, if possession is lost.¹²

In summary, warehouse receipt financing can be used to:

- i. Obtain financing against the stored goods (CMA).
- ii. Store the goods in the warehouse for further processing and sell the finished goods either locally or for export and continue the financing.
- iii. Store the goods pending the appearance of a final buyer.
- iv. Buy in bulk and store them and sell them retail to improve profit margins.
- v. Store the goods in expectation of higher prices or when the market is tight and sell them at the desired price (more common for goods which have a terminal market or commodity exchange).
- vi. Advance money to farmers for loans and use the goods as collateral during harvest season (rice for example). Farmers may not be able to avail of warehouse financing in the same way as large or state-owned companies.

¹⁰ Ibid.

¹¹ Ibid.

¹² Ibid.

III.4 Bonded Warehouse

Goods can be stored in bonded or nonbonded warehouses. Bonded warehousing means warehousing at a bonded area usually at ports along the coast before the goods are cleared by customs (import and export of goods). If the goods have not cleared customs, they are usually stored in a bonded warehouse. The bonded area is under customs supervision and the goods can only be removed under certain conditions, normally after the payment of the import duties. This means that the goods have not entered the economy and are in an offshore territory and can be re-exported. The jurisdiction and type of law that will apply if the goods are in a bonded area is critical in the case of the enforcement of the security.

III.5 Import/Export Company

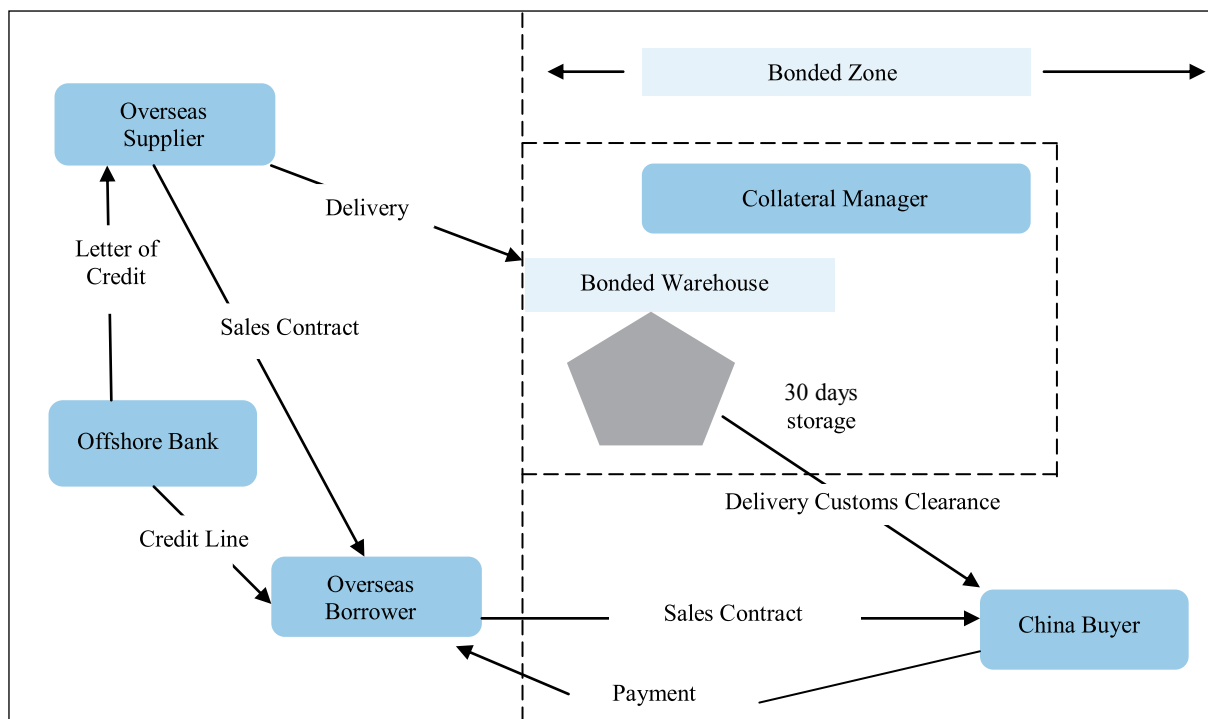
In some jurisdictions like China, the offshore entity needs an import/export company to clear through customs, which has a trading license. Often the offshore entity uses such companies as agents to handle customs formalities.

Companies allowed to own goods in bonded warehouses are offshore companies or authorized trading companies registered in the bonded area.

Should there be a situation where the borrower is in default and the goods are stored in a bonded warehouse, the lending institution with the borrower's cooperation has to go to customs with the pledge document, the facility agreement, and the warehouse receipt to sell the goods through an authorized import/export company. The import/export company may sell the goods domestically after customs clearance or it may also re-export the goods. It is easier to re-export since bonded zones are usually located at the coastal/sea port.

For export bound goods, it is the import/export company that clears the goods and presents the export license, as well as the relevant documents (invoice, inspection certificate, original contract, packing list, among others). Figure 1 shows the flow of the goods from the overseas supplier into the bonded warehouse that need 30 days storage.

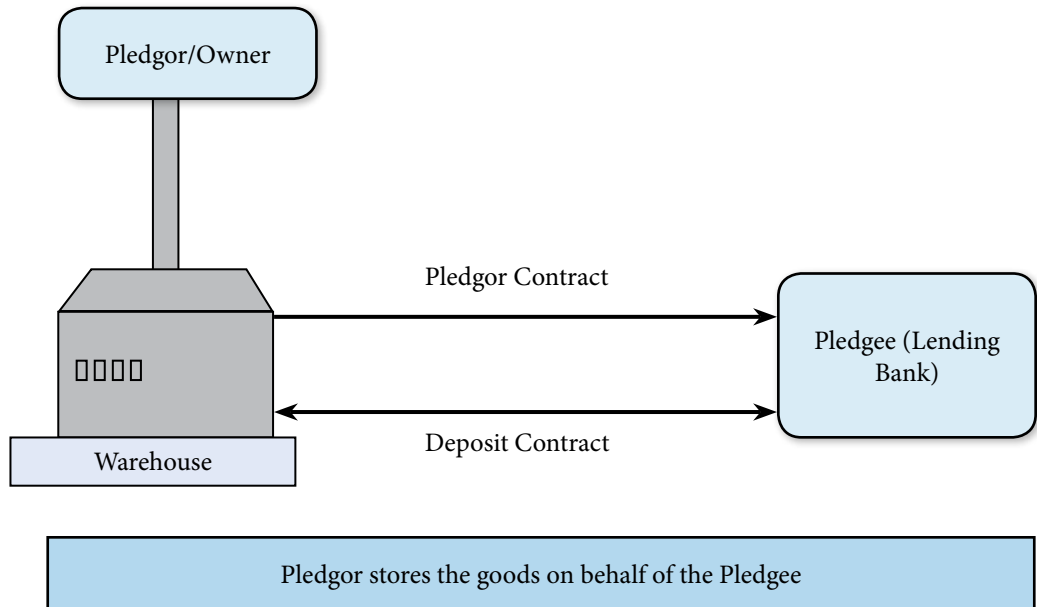
Figure 1: Example of Stock Finance in a Bonded Warehouse



Source: Trade Finance Magazine. "Tackling security on the front line", December-January. (2004).

In China, the warehouse receipt is the voucher for collecting the goods. After the warehouse receipt is issued, Chinese law recognizes that the warehouse operator will only release the goods based on instructions received from the holder of the warehouse receipt. What is of greater importance is the pledge by the borrower to the lender which gives rise to the lender's security interest. The pledgor remains the owner of the goods to make a pledge valid. This is recognized under Chinese property law that governs pledges. However, the borrower cannot create a pledge if the goods remain in the warehouse that is operated by the borrower himself. It is therefore essential to engage the services of an independent warehouse operator. The bank will be the pledgee. The pledge agreement must be under Chinese law otherwise it cannot be enforced. It is advisable to seek a qualified Chinese lawyer for the drafting of the pledge agreement together with a legal opinion. Figure 2 provides an example of the parties involved in a pledge agreement.

Figure 2: Example of the Parties to a Pledge Agreement



Source: Prepared by author.

III.6 Nonbonded Warehouse

Nonbonded warehousing means goods stored at a designated warehouse inside the economy outside the bonded zone and therefore no further customs regulations or duties govern these goods. Goods in nonbonded warehouses are designated for domestic sale. The nonbonded warehouses are usually located in inner cities. China's property law recognizes the financing of goods against pledge of goods in nonbonded warehouses. Customs exert no control over the holding of the title. Imported goods need to be sold domestically for which an import license was granted. A point of caution is goods which have been import cleared may be difficult to re-export since these were imported for specific reasons at specific tax rates.

A lender can decide to dispose of the goods in a nonbonded area in the domestic market or export them with the assistance of an authorized local trading company. The lender by itself cannot sell the goods since it has no trading license. It has to engage the services of a local trading company. The local trading company can convert the renminbi to US dollars since there is an underlying import transaction for which an import license was made available.

III.7 Movement of Goods from Ship to Nonbonded Warehouse and Transport Documents Involved: Example of China

- i. It is assumed here that the bank will finance the importer taking as security the full set bills of lading and replaced by warehouse receipts.
- ii. Upon arrival of the cargo at the destination, the bank will appoint a warehouse operator¹³ to take delivery of the cargo from the shipping company. The shipping company will only release the cargo to whoever presents the full set bills of lading. The financing bank will normally give the full set bills of lading to the warehouse operator to be presented to the shipping company for the cargo release.
- iii. The cargo will be customs cleared by the warehouse operator if this is part of the agreed responsibility of the warehouse operator. The import duties and value-added tax (VAT) will be paid by the importer who is also the borrower, in order for the goods to be taken out of the bonded area.
- iv. Upon customs clearance, the warehouse operator will move the cargo from the port to a nonbonded warehouse that he or she operates.
- v. The warehouse operator will issue warehouse receipts made to the order of the financing bank to evidence receipt of the cargo. The borrower will be required to pledge the goods to the financing bank as security to the financing. A collateral management agreement is usually required with the borrower, lender, and the warehouse operator agreeing on the management of the goods, storage, and release.
- vi. The warehouse operator will release the goods only upon instructions from the bank. The warehouse receipt clearly shows that the lender is the named party to whose order the warehouse receipt is issued.
- vii. The release of the goods will be authorized upon receipt of funds in the account of the financing bank in US dollars. The financing bank is responsible for keeping track that the funds are credited to its account for the sold goods before authorizing the release of the goods to the warehouse operator. Once the buyer credits the funds into the bank's account, the bank will authorize the warehouse operator to release the goods. The warehouse operator will issue a delivery order to the buyer and will cancel the warehouse receipt representing the particular parcel that has been released. The warehouse operator may not always be aware that the goods have been pledged by the borrower to the financing bank and it is good practice to make the warehouse operator aware of the existing pledge by the pledgee (financing bank). This

¹³ The warehouse operator may also be the 'notify party' in the bills of lading so that the shipping company is aware that this operator is authorized to take delivery of the goods.

avoids the possibility of the borrower securing double financing for the same goods. As much as possible, the pledge should be registered.

- viii. The procedure is repeated until the full cargo is released.
- ix. The local buyer of the goods pays in renminbi. However the borrower has to secure prior authorization to convert the renminbi into US dollars, which will then be remitted to the financing bank account. Upon receipt of the sales proceeds, the financing bank then authorizes the warehouse receipt operator to release the goods to the designated buyer.

III.8 Examples of Regulatory Issues for Warehouse Receipt Financing

i. China

Article 66 of the Security Law stipulates that the pledgor and the pledgee may not agree under the pledge contract for the ownership of the pledged goods to be transferred to the pledgee in the event that the warehouse receipt finance is not repaid in full upon the expiration of the time period for settlement of the relevant indebtedness. However Article 71 of the Security Law stipulates that if the pledgee (financing bank) is not repaid in full upon the expiration of the time for settlement of the relevant indebtedness, the pledgee may enter into an agreement with pledgor to keep the goods to offset the unpaid balance, and the pledgee may realize the pledge by way of auction or sale of the goods which are the subject of pledge in accordance with law. There can be no prior agreement on how to dispose the goods in case of a default, since there is a process on how to dispose the goods. The pledgee cannot seize the goods or confiscate them and pay themselves with the sales proceeds since the pledgee as a financial institution has no trading rights or trading license. It is in the business of lending and not trading.

If the bank (pledgee) keeps the goods to offset the unpaid balance owed by the pledgor (borrower), an agreement is required to be entered into between the bank (pledgee) and the pledgor, and if the bank auctions or sells the goods, the auction or sale shall be conducted in accordance with law and no agreement is required to be reached between the bank and the pledgor. In accordance with law means that if there is a default or non-payment of the loan on the due date, the bank can go for a judicial process (that is, go to court but could be time consuming), or appoint a trading company as an agent to auction the goods or find another buyer for the goods.

The provisions of ‘keep the goods the subject of pledge to offset’ should be included as one of the measures for the bank to exercise its rights against the goods under the pledge contract and no agreement is required to be entered into in case of auction and sale.

The legal title of the pledged goods remains with the pledgor at all times but not the control of the goods since the actual possession of the goods is in the hands of the warehouse operator. The bank still has ‘constructive possession’.

According to China’s import and export tariff rules, promulgated on 7 March 1985 by the State Council and amended on 12 September 1987 and 18 March 1992, imported goods that are subsequently returned for some reason shall be applied for export by the original consignee of the goods or its agents and the original import documents shall be submitted to the customs authority. Upon examination and verification by the customs authority, the export customs duties could be exempted. However, the import customs duties levied will not be refunded.

Unless the bank has been approved with foreign trading rights, then upon default and if no buyer can be located in China for the pledged goods, the bank will have to engage the services of an import and export company in China that has foreign trading rights to export the pledged goods for resale overseas.

Assuming that the import duties and VAT are paid by the borrower, it is possible that the borrower may claim interest in the goods and block subsequent re-exportation of the goods in the event of default. It is essential that the provisions would have to be included in the loan and security documentation to ensure that the borrower waives such interest in the goods.

The bank can dispose of the goods but must seek the consent of the borrower of the bank’s intended transfer. The bank must reach an agreement with the borrower as to the way of the disposal of the goods which is either by auction, sale to a third party through a trading company who is allowed to trade domestically, or to an import/export company or by judicial process. The latter is a complicated one and banks would prefer not to use this channel. Once the goods are sold, the proceeds will be applied to the loan, which must be repaid.

In China, a local warehouse operator must be properly licensed and registered according to Chinese law. If the warehouse operator is a local joint venture or a company without foreign investment, it is obliged to get approval from the State Administration for Exchange Control (SAFE). Current regulations allow foreign banks and branches of foreign banks to operate in China which could lend to:

- i. Partially foreign-invested enterprises
- ii. Wholly foreign-owned enterprises
- iii. Foreign companies

There is also the issue of registration of the pledged assets. Registration may be required for companies registered in China but not for offshore companies.

However, for practical purposes, if the pledgor is an offshore company, registration makes a case stronger since it may protect the bank from third party claims. The registration is done with the State Administration of Industry and Commerce.

ii. Thailand

The physical control of the goods under the CMA remains with the warehouse operator who acts as the custodian. It releases the goods upon instructions of the financing bank. The warehouse operator exercises control of the goods on behalf of the bank, from the time the goods are discharged from the ship and taken up storage and releases them upon the Bank's instructions when payment has been made. This is a standard procedure with regards to CMAs.

Under Thailand's civil and commercial code, ownership of goods could be acquired under conditions stipulated in a contract as in the case of a sales contract. A contract is categorized as a specific contract where rights and duties of the parties to the contract and the essence of the contract are subject to the principles laid down by law. For example, sale is a contract whereby a person, called the seller, transfers to another person, called the buyer, the ownership of property and the buyer agrees to pay the seller the price for it. A sale is an agreement involving only two parties, the seller and the buyer, by which property and ownership is transferred from the seller to the buyer for a fixed price. In this scenario, if the bank is involved since it financed the goods in the warehouse, it cannot automatically seize the goods. It must allow the goods to be sold by the seller and the proceeds to the sale will be given to the financing bank in settlement of the loan.

In Thailand, the ownership of property may be acquired by operation of the law or by contractual transaction as in a sales contract. Under the sales contract, the bank may request the seller who may be the bank's customer to put a condition precedent to the transfer of ownership of the goods. Such a condition is acceptable under Thai law. If a contract of sale is subject to a condition or a time clause, the ownership of the goods is not transferred until the condition is fulfilled, or the time has arrived. Based on this provision, the seller can stipulate a condition under the contract of sale that ownership of the goods shall not transfer unless and until the buyer has made payment for the goods in full. Such a condition is enforceable and allows the bank to indirectly control the passing of the ownership of the goods.

Since the bank does not acquire ownership of the goods, it follows that the bank has no legal authority to force the original importer and/or seller or the first buyer to sell the goods to a third party. If ownership of the goods has not passed to the first buyer due to his or her failure to fulfill payment condition under the sales contract, ownership remains with the seller and the seller can terminate the contract of sale and sell the goods to a third party under a new sales contract. After payment has been made, the bank can instruct the warehouse operator to release the goods to the third party in accordance with the CMA.

iii. Indonesia

Indonesia has a law that regulates the warehouse receipt system covering insurance, transfer, underwriting, and settlement of the warehouse receipt.

Under Indonesian law, warehouse receipt is defined as a document evidencing ownership of goods stored in a warehouse. A warehouse receipt may only be issued by a warehouse manager who has obtained authorization from the supervisory board.

The management of the warehouse receipt shall be carried out by a registration center appointed by the supervisory board. The warehouse receipt shall consist of a name-based receipt and an order-based receipt. Warehouse receipts may be transferred, used as a guarantee, or used as a document of transfer of goods. As a proof of ownership of goods, it can be used as a security without further requirement of other collaterals.

The transfer of a name-based warehouse receipt shall be carried out by an authentic deed of transfer, whereas the transfer of an order-based warehouse receipt shall be carried out by endorsement followed by the relinquishment of the warehouse receipt.

The trading of a warehouse receipt may be carried out within or outside the stock exchange. Should such trading be conducted in the stock exchange, the process of such trade shall comply with the procedures set forth by the exchange where such trading is carried out.

From the above, it can be deduced that to make the warehouse receipt a document of ownership, the commodity must be tradable in the economy's stock exchange.

A security rights agreement shall be considered as an ancillary to the loan agreement, the main agreement, whereby there shall be only one encumbrance for each issued warehouse receipt.

Under Indonesian law, the security rights owned by the recipient may only be removed when the following conditions are met:

- i. The securitized principal loan has been fully repaid
- ii. The recipient of the security rights has released the security rights

Should the beneficiary of security rights be in breach of the terms set forth in the loan agreement, the security rights recipient has the right and discretion to sell the object of security by public auction or direct sale.

The supervisory board shall guide, administer, and supervise all activities concerning the warehouse receipt system. Further regulations governing its organizational structure, appointment, and dismissal shall be set forth under presidential decree.

In terms of warehouse management, a warehouse must comply with specific technical requirements and receive approval from the supervisory board before it is permitted into the warehouse receipt system. A warehouse must be a business

legal entity and must be approved by the supervisory board. A warehouse shall be required to enter into an agreement with the owner of the goods before issuing a warehouse receipt. In Indonesia, the concept of a warehouse receipt is to have a security over the goods stored in a warehouse if the borrower is to avail of financing under a CMA. The financing bank will take security over stocks stored in a warehouse in Indonesia. Indonesian law characterizes all commodities as ‘tangible commodities’. Two distinct forms of security available over tangible movables are the pledge and ‘deed of fiduciary transfer’ or *fidusia*. In both cases, the security can be given either by the borrower or by a third party.

There is also a pledge that is a possessory security, which means that in order for it to take effect, the goods must come into the physical possession either of the bank or of a third party agreed upon by the owner and the bank. The third party can be the company that owns and/or operates the warehouse where the goods are stored.

There is no legal requirement that a pledge be made in writing. It is however, normal and prudent to have a written pledge agreement in cases where the amount to be secured is significant to ensure that there is proof of the parties’ intention. The pledge agreement can be made either in English or Bahasa Indonesia and is perfected by handing over the pledged goods to the pledgee or a third party approved by the pledgor and the pledgee. By taking a pledge of the goods, the bank will be in a strong position in that it will have physical control over the goods and it will have the right to sell the goods and to use the proceeds to repay its loan in the event the borrower is in default of its obligations under the financing agreement.

In order to give more protection to the bank, the bank may at the same time also take a *fidusia* security if the goods were not intended to pass into the possession of the bank or warehouse operator. Technically, a *fidusia* agreement granted over the goods that remain in the possession of the party granting the *fidusia* is invalid. The party granting the *fidusia* transfer could be the borrower who has surrendered the goods to the warehouse operator. However, the advantage of taking the *fidusia* and registering it, is that it will prevent the owner granting a first ranking *fidusia* to any other third party. The risk of that third party succeeding in a court action to recover the goods from the possession of the warehouseman is remote, a *fidusia* ranks below the pledge, but even an attempt to do so could cause the bank inconvenience and expense. A point to note is the deed of fiduciary transfer is not effective as a security until it has been registered at the fiduciary registration office where the fiduciary transferor has legal domicile.

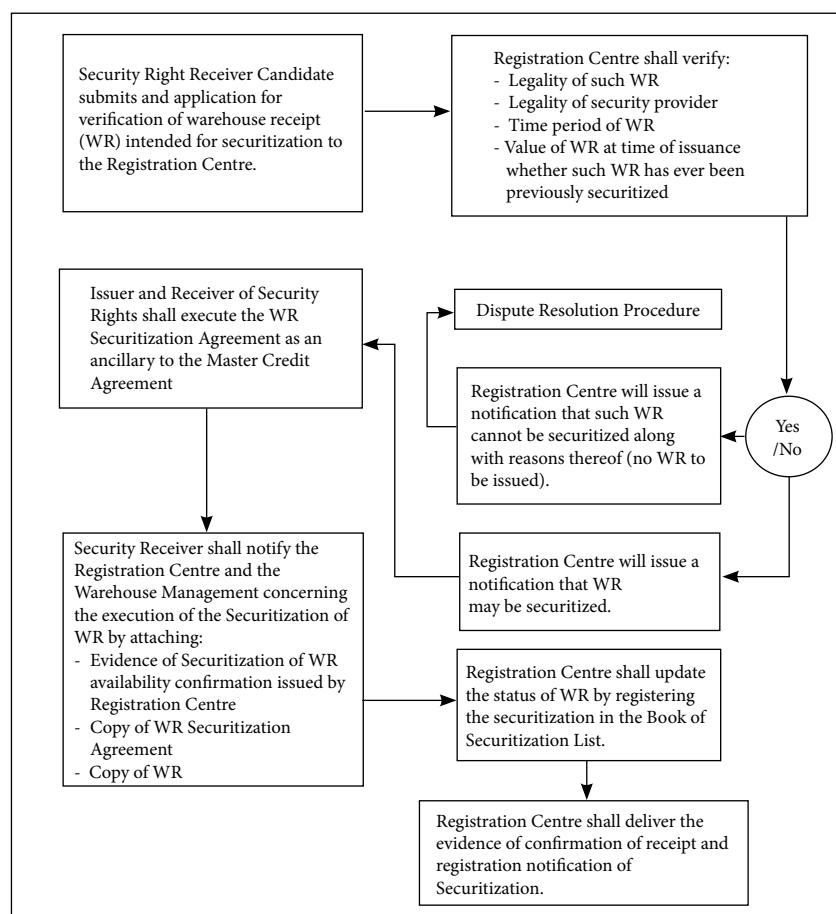
In Indonesia’s civil code, in the event of default by the debtor, the pledgee (bank) has the right to sell the pledged object by a ‘public sale in accordance with local customs and usual conditions.’ In practice, this means that the goods must be sold through the state auction agency that will generally be unwilling to act in the sale unless there has been a court order that the sale should be made.

There are exceptions to this. (1) The parties agree to another form of sale. It is not clear however, whether it is sufficient that the pledgor has given his or her

agreement to another form of sale at the time of entering the pledge, or whether his or her agreement must be obtained at the time of the sale itself. (2) The subject matter of the pledge consists of ‘commodities or instruments that can be traded on a market or bourse.’ In that case, the pledgee can sell the goods into the market, provided he or she does so through the mediation of two qualified brokers. There is, however, no formal or organized market for certain goods. An example would be for the sale of vegetable oil in Indonesia where no qualified broker for this commodity exists within the economy. Thus, this exception from the requirement for a public sale may not apply for certain goods.

As a matter of practice it will not be necessary for a bank to sell the goods through a public sale, provided it is possible to determine the market price for the goods in Indonesia at any particular time. For example, if the bank is able to make a private sale, and the owner was to bring court action to restrain the bank from doing so, the bank could answer by pleading the borrower’s noncompliance with the terms of the financing agreement and requesting an order either by permitting the bank to make a private sale, or authorizing a public auction.

Figure 3: Securitization and Notification of Securitization of Security Rights in Indonesia



Source: Indonesian Summary of Law Number 9 of Year 2009 Regarding Warehouse Receipt System

III.9 Types of Warehouses¹⁴

i. Private Warehouse

In a private warehouse, the production and storage is in the same place. For example, a steel mill can have a private warehouse on its premises. The primary business of the company is not warehousing but manufacturing or trading and the warehouse is part of its business. There is a close relation between the warehouse and the owner of the stored merchandise. The ownership of the goods and that of possession is by one person, which is against the concept of warehouse financing. For warehouse financing to be possible, the depositor, also the borrower whilst retaining ownership of the goods, relinquishes the actual possession of the goods to a third party, which is the warehouse operator who assumes custody and control of the goods.

ii. Public Warehouse

An independent warehousing company whose main line of business is providing storage services for a fee operates a public warehouse. It does not obtain title to the goods stored but only actual possession. The depositor retains ownership.

There are two types of public warehouses:

- a. A terminal warehouse that is separate and distinct from the physical production facilities or companies owning the goods stored in the warehouse. It is usually a dedicated storage area and can be located at a port for easy loading or discharge owned and operated by an independent warehousing company. It may entail additional transport from the warehouse to the production facilities if these are located in land.
- b. A field warehouse is near the premises of the firm depositing the commodities.

In both the terminal and field warehouses, which are independent companies, it is possible to arrange a collateral management agreement between the depositor, the financing company, and the warehouse operator to obtain credit facilities. The stored goods will be the subject of collateral. In principle, only public warehouses can provide warehouse receipts for use as collateral in international trade. In private warehouses, which are for storage purposes only and not linked to international trade finance, there is no control of the commodities against which the receipts are issued.

III.10 Selection of Reputable, Independent Warehouse Operator

The key to warehouse financing is the reliability of the warehouse operator and how its operations are structured. A warehouse receipt is only as good as the company

¹⁴ UNCTAD Secretariat. *Potential Applications of Structured Commodity Financing Techniques For Banks in Developing Countries*. (2001). Available: <http://unctad.org/en/Docs/poitcdcomd31.en.pdf>.

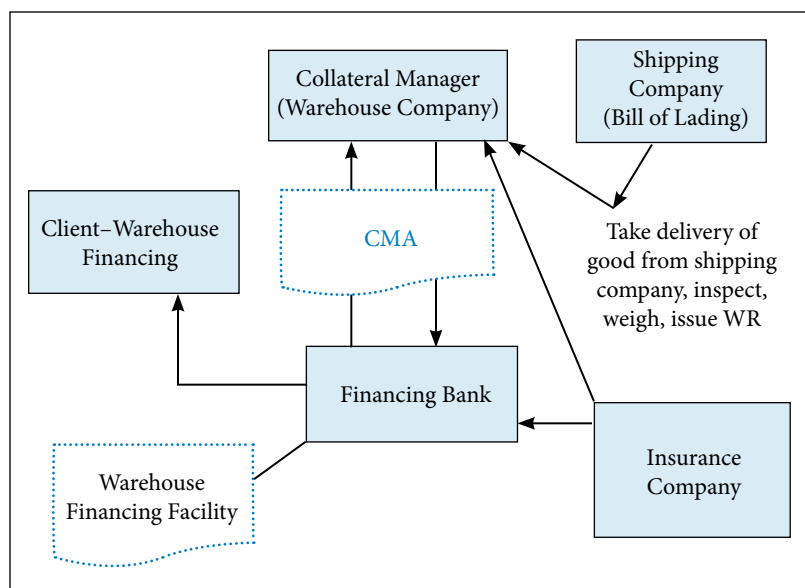
issuing it. It must have the proper structure in place including foreseeable risk. Insurance is a risk transfer mechanism but does not reduce the occurrence of a loss or the disappearance of the goods.

Warehouse receipt financing can help a developing economy by assisting in its overall export program. The marketing of primary commodities of developing economies could be promoted through improved warehousing and financing structures. UNCTAD¹⁵ and the European Bank for Reconstruction and Development¹⁶ are actively supporting projects involved in warehouse financing and free trade in general. This form of financing could be explored by SMEs and training programs could be made available to them as a way of familiarization.

III.11 Basic Structure of Warehouse Receipt Financing

Warehouse receipt financing is available to any company who is able to collateralize the financing with the goods that are being financed. Figure 4 shows the basic structure of warehouse finance; the flow of warehouse receipt from delivery of goods by a shipping company to a warehouse in a CMA, with storage provided by a warehouse company and financing facility by a bank with insurance cover.

Figure 4: Basic Structure of Warehouse Finance



CMA = collateral management agreement; WR = warehouse receipt.

Source: Prepared by author.

¹⁵ Ibid.

¹⁶ European Bank for Reconstruction and Development. *Study on Grain Receipts Programme (Regional)* (2004). London: European Bank for Reconstruction and Development.

III.12 Place of Jurisdiction

As the legal issues concerning warehouse receipt financing vary from one economy to another, the place of jurisdiction is of primary importance. It is the place where in the event a legal case is brought to court, it has to be brought to the agreed jurisdiction between the parties. A legal dispute involving Hong Kong, China and Singapore should be decided by a court in the agreed jurisdiction. The applicable law should also be specified, for example, English law.

For instance, if a transaction involves a Chinese company and an entity from Hong Kong, China, the judgment that is rendered by a court in Hong Kong, China may not necessarily be enforced by a court in China and therefore, before proceeding, parties in the transaction have to seek an update of regulations and seek if necessary a legal opinion.

III.13 Application of Regulatory Issues

There is not a uniform approach to the ownership or transfer of ownership of goods when the goods enter the warehouse and when ownership is or could be transferred in the event that the loan that financed these goods goes into default.

If SMEs, especially those in emerging markets, could benefit from this type of financing, it is worthwhile to address the financial institutions' concern as to the issue of title or non-title to the goods in storage. The backbone of warehouse receipt financing is that the banks providing this type of finance are able to have a valid security which may be enforceable with the established documentation, that is, the pledge, the CMA, and warehouse receipts. It is possible to have a valid security but an imperfect one.

IV. Insurance – Warehouse Receipt Financing

Insurance can mitigate the credit risk on goods that are the subject to warehouse finance since it can shift the risk to the insurance company while the goods are in storage. The rating of the insurance company affects the quality of the security. As much as possible, the rating of the insurance company should be known. Credit ratings of insurance companies are publicly known based on Standard and Poor's, Moody's, or Fitch.

IV.1 Property Insurance (Storage of Goods)

If the financing is securitized by the goods in the warehouse, it is essential that stored goods have to be insured (property or storage insurance). This should cover risks against theft, fire, war, or all risks. The policy should cover the validity (how

long the goods will be in storage), the location of the warehouse, port of loading or port of discharge, the payment of premium, and the percentage of cover.

Sometimes insurance companies are only licensed to operate in a particular jurisdiction so that they are prevented from insuring goods in some locations where the goods are stored. The borrower, in addition to arranging property insurance, should arrange for additional cover for risks such as civil riots, commotion, strife, and strikes depending on the local political environment. Some economies may be susceptible to floods, typhoons, and cyclones, in which case the property insurance should also cover such risks.

IV.2 Fidelity/Professional Indemnity Insurance

This insurance is bought by the warehouse operator to protect himself or herself from unexplained disappearance of the goods, which could be caused by error or by his or her own employees.

IV.3 Property Insurance (an Extension of Marine Cargo Insurance)

Although properly speaking, this applies to insurance of goods whilst at sea, it could extend to the insurance of goods in storage for an agreed number of days in the event that there is a limitation of the insurance company insuring storage at a particular jurisdiction. Figure 5 shows a sample from a marine insurance company that includes insurance for the storage of goods for a specified number of days.

Figure 5: Sample from a Marine Insurance Company that Includes Storage for a Specified Number of Days

Mitsui Sumitomo Insurance Co. HK Ltd.	
<u>ATTACHING TO AND FORMING PART OF POLICY</u>	
Open Policy Number	: CA0004948001-00
Assured	: ABC Ltd. held to the order of Financing Bank in HK
Period of Insurance	: Always Open as from 07 th April 2009 Until cancelled subject to policy Cancellation Clause
Subject Matter Insured	: Silicon Manganese/Ferro Silicon/Manganese Ore & Alloy And the like (packing in bags or in bulk)
Conveyance	: By approved vessels as per Institute Classification Clause as attached not less than 1,000 gross tons, & other means of Conveyance held covered at rates and terms to be agreed.
Voyage	: Refer to Appendix (and all other voyages held covered at rates and terms to be Agreed)
Named locations for storage	
If any	: Refer to Appendix
Terms and Conditions	: Subject to the following Clauses: 1. Institute Cargo Clauses (A) 1/1/82 2. Institute War Clauses (Cargo) 1/1/82 3. Institute Strike Clauses (Cargo) 1/1/82
All of the above are subject to a maximum of 150 days storage after the arrival there at and exact locations to be advised prior to risks attached.	

In general, all insurance policies should be assessed in terms of credit rating, insurance coverage in terms of amount, scope of coverage, beneficiary designation, and payment of premium, and if a warehouse is involved (warehouse reliance, control efficacy, adequacy of contractual undertaking, that is a CMA).

V. Risks Spectrum of Warehouse Receipt Financing

V.1 Quality Risk: Deterioration of Quality

The status of the goods in storage may be at risk whilst in storage as certain commodities have a different shelf life. Suitable precautions need to be taken to ensure that the collateral held by the bank is sold in time to recover the advances. In the case of goods that are not sold within the prescribed time limit, it is prudent to call for an inspection with the aid of the warehouse manager and if necessary take steps to sell the goods.

V.2 Quantity and Weight Risk

The goods stored are subject to inspection to determine the quantity and weight as received. The possibility of the quantity stored not matching the information stated in the warehouse receipt exists and if it happens, the bank has the benefit of the professional indemnity insurance for ‘unexplained loss’ on the goods held in storage.

V.3 Transport Risk

The risk of transport related to warehouse financing includes logistics problems such as port congestion, a tight freight market that could delay the transport or shipment of the goods from the warehouse and hence cause a delay in repayment.

V.4 Performance Risk

The reputation and integrity of the warehouse operator is paramount in handling the storage of the goods in whose hands the goods are entrusted. The bank in whose name the warehouse receipt is held, relies on the warehouse operator to release the goods to the lawful buyer after the bank has received payment for the goods.

V.5 Administration Risk: Wrong Delivery of the Cargo

The shipping company on arrival at the discharge port wrongfully delivers the cargo to a party that is not part of the CMA. This can happen if a third party takes hold even of only one set of bills of lading. Shipping companies will deliver the cargo to whoever is the notify party in the bills of lading. Thus, if a third party happens to take hold of only one set of a blank bill of lading, it could take delivery of the cargo by filling its name as the notify party instead of the warehouse operator.

V.6 Cargo not Insured by the Seller

The insurance is purchased either by the seller or by the buyer according to the International Commercial Terms, commonly known as INCO terms. If the contract of sale is under free on board (FOB), the seller will not get involved in insuring the cargo. It will be the responsibility of the buyer. In case the cargo sinks in transit, the seller may not be paid by the buyer and the seller will be unable to repay its financing bank.

The bank does not get involved in marine insurance which is arranged between the buyer and the seller. At best, the bank will ask for an assignment of the insurance proceeds.

V.7 Price Risk

The seller is waiting for a buyer to surface but meanwhile the goods are shipped. In this case, it may require warehouse financing. The need for warehouse financing is agreed from the outset with its banker, who will provide financing, taking the goods as security, from the time they are loaded on board, put in storage, and finally sold to the ultimate buyer.

So far, so good. The seller is able to ship the goods to the port of destination. His or her banker will deliver the bills of lading to the warehouse company which will take delivery of the goods from the shipping company, surrender the bills of lading, and upon storing the goods, issue a warehouse receipt to the order of the bank. The bank is not the owner of the goods, but will require a security interest by way of having the goods pledged. The pledged agreement is executed by the seller and the bank is happy with it. Meantime, the goods are in storage. However, the seller is still unable to find a buyer. The bank continues to take the goods as security. In the meantime, the price of the goods has fallen so that if they were sold, the value of the sales proceeds is much less than the financing involved. If no agreement is reached at this stage, the bank will force the seller to liquidate. This could be a complicated situation, since under warehouse financing, the bank has no right to seize the goods and unilaterally sell them without the consent of the seller.

V.8 Lien on the Cargo by the Warehouse Operator

The cargo is placed in storage. Warehouse receipts are properly executed. However, it is discovered that the seller has not paid the warehousing fees or is not in a position to pay. The warehouse operator will not release the cargo since he or she has a lien on the cargo by way of the unpaid warehousing fee. Alarm bells ring. If the seller is not able to pay the fee, the bank will receive a signal that the seller's financial condition is in a precarious situation. The cargo will not be released unless the bank pays these fees.

V.9 Credit Rating of the Insurance Company (Reputation Risk)

The cargo is properly stored and goods are held to the order of the bank. The goods in the meantime disappear. The warehouse operator has bought fidelity insurance from an insurance company familiar with this kind of financing. The bank is notified that its claim from the warehouse operator is honored under the fidelity insurance. However, when the time comes for the insurance company to pay, it is unable to do so because it has gone into receivership, in preparation for bankruptcy.

V.10 Fidelity Insurance

Although the bank may have bought property insurance for its own protection, this insurance covers, fire, war, riots, and theft (if it can be proven, such as an obvious breakage of locks). Otherwise, if the goods disappear – it may be a case of theft by employees of the warehouse operator – the disappearance can be covered under the insurer's fidelity insurance.

Box 1. Case Study involving Financial Risk

XYZ Thai Company Ltd is a local processor of soya bean oil for domestic sale. It is highly leveraged and is unable to have regular bank lines to import soya beans for further processing. A local bank approaches the company for CMA financing, which will involve the issue of letters of credit. In addition, the bank requires a 20 percent cash deposit as margin for any decline in the price of soya beans whilst it is in the warehouse. The company is prepared to execute a pledge of the soya beans to the bank as security interest. The import of soya beans goes smoothly for several shipments. One of its banks, unrelated to the CMA financing, applies for a court injunction to seize and dispose of the soya beans in the warehouse, which are the only assets of the company.

Assessment: It is assumed that the bank did its due diligence on XYZ Thai Company before granting the CMA as well as the legal issues related to the importation of the soya beans into Thailand. The company assumed that it has title to the cargo. The bank leased the warehouse where the cargo was stored which was pledged to the bank. The latter also was aware that warehouse was mortgaged but the bank could not get the consent of the mortgager to lease. With the shipments having taken place, the bank seemed to have been complacent. There was no intention of XYZ Thai Company to defraud the bank.

The collateral manager had to release the cargo under court order.

What could have been done: The bank providing the CMA financing should have tried to get the consent of the mortgagor of the warehouse where the cargo was stored and pledged to the CMA bank. In this instance, the mortgagor would have been aware of the new debts incurred by XYZ Thai Company, which were intended to sustain its business. The banks handling such cases, through internal and external legal advisers, should get constant updates of the bankruptcy courts for any pending lawsuits against companies that are highly leveraged as these are available publicly. This would allow the financing bank to take necessary action in case it decides to go ahead with the CMA.

Source: Author

Box 2. Case Study involving Operational Risk

A collateral manager, ABC Warehousing Company, managed and controlled stocks of palm oil in several tanks for a CMA financing bank. During one of the releases instructed by the bank, the physical quantity released fell short of the quantity appearing in the release instructions of the bank. The bank sued the warehousing company for operational negligence. There was negligence in verifying the quantity of the palm oil that was received.

Assessment: The professionalism of the persons hired by the warehouse operator is crucial for this type of financing. The field operators were not alert since the release of the palm oil requires skill. The valves are always locked and sealed under their control. At the time of the delivery of the palm oil they have to dip-measure the truck tanks or the ground tanks, take the quantity stated on the delivery order, and sign receipt for the full quantity. The experience of the warehouse staff is to be assessed to ensure compliance with the operational rules for receiving and releasing the palm oil in and from the tanks which the field operators follow as to the quantity received, verify that the truck tanks are empty before leaving, and apply random audits.

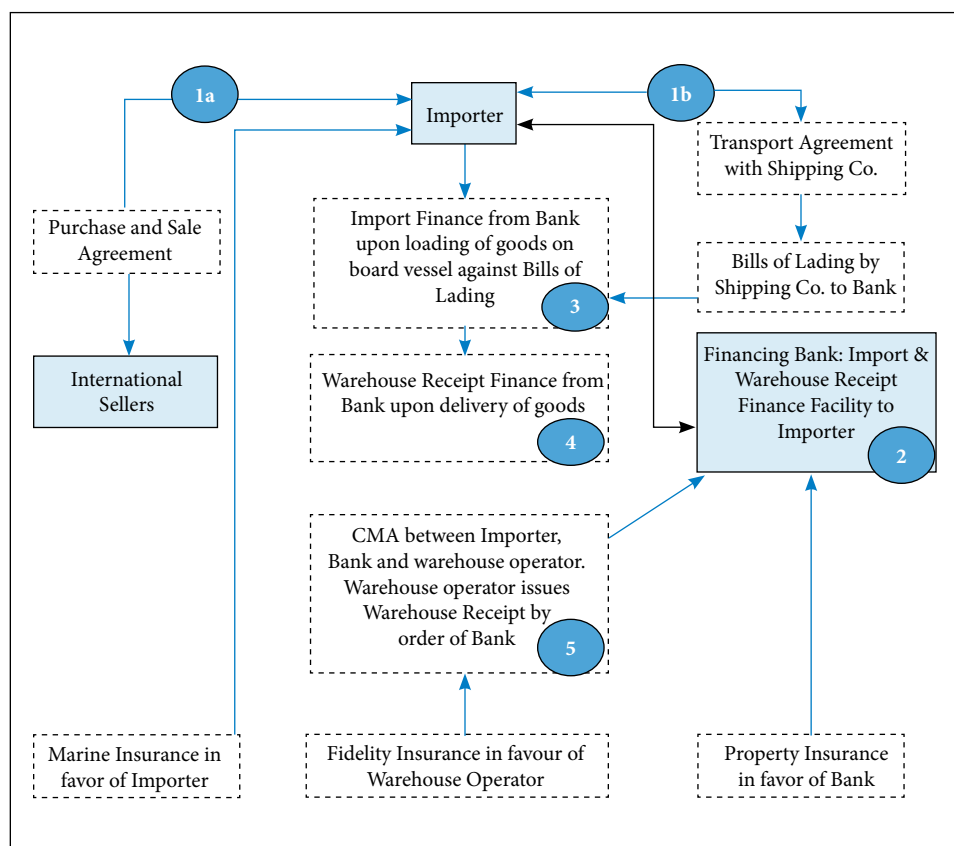
Source: Author

VI. Basic Supply Chain Finance

VI.1 Import Finance

Import finance is an extension of or could precede warehouse receipt financing. Import finance in this report focuses on the transport and shipping leg of the import trade. The importer who is financed by his or her banker sources the goods, which are then transported by sea and subsequently stored in a warehouse at destination. The warehouse is pre-approved both by the importer and his or her banker.

- i. Buyer and seller enter into a purchase and sales contract also known as the sales agreement. It is assumed that in this instance, the borrower (importer) has the intention of importing the goods, which will subsequently be warehoused.
- ii. The sales terms require a letter of credit issued by the importer's bank in favor of the seller where payment conditions will be stipulated, such as the type of documents to be delivered, before payment can be effected.
- iii. The importer may appoint a warehouse manager (collateral manager) to oversee the import process at the port of discharge, verify the weight and quality, among other matters. In this case, the collateral manager also acts as an inspection company, making a survey report and issuing quality and weight certificates.
- iv. The collateral manager is responsible for the suitability of the warehouse for storing the type of goods involved.
- v. If the collateral manager does not own the storage facility, he or she will enter into a lease agreement with the landlord including a waiver of lien from the landlord over the commodity financed and stored.
- vi. When the goods arrive at the discharge port, the collateral manager will verify the quantity and quality of the goods before accepting them for storage and before issuing the warehouse receipt.
- vii. The warehouse receipt will evidence the weight, type, grade, quality, and location of the commodity.
- viii. Once the goods enter the warehouse, warehouse receipt finance takes over the import finance. The bills of lading will be replaced by warehouse receipts. It is assumed that the warehouse operator is designated by the financing bank to take delivery of the cargo and store it in his or her warehouse, and issue the relevant warehouse receipts (Figure 6).

Figure 6: Transaction Flow of Import Finance Leading to Warehouse Finance


Source: Prepared by author.

VI.2 Export Finance

Just like import finance, export finance can be linked to warehouse receipt financing. This involves the export, shipping, and transport leg of the transaction. This is the case of an exporter who sells the goods to international buyers who are in need of warehouse finance.

The goods, in a pre-approved warehouse meant for exports, follow this general procedure:

- i. The exporter enters into a purchase and sales agreement with an international buyer or buyers.
- ii. The goods are transported by sea and stored in a pre-approved warehouse at the destination.
- iii. A collateral management agreement is arranged as a condition for the bank financing the exports.

- iv. When the goods arrive at destination, the collateral manager will inspect, verify the goods at the discharge port, and issues a warehouse receipt to the order of the bank.
- v. The bank will finance the exporter based on the warehouse receipts.
- vi. The international buyers may issue letters of credit to the exporter that will stipulate the type of documents required and the mode of payment. The letter of credit will be channeled to the exporter's bank.
- vii. The exporter will arrange shipment of the goods that are stored in the warehouse for shipment. The warehouse receipts will be released in exchange of the bills of lading when the goods are shipped on board. The export finance will come into effect when the bank pays the exporter. The bank will take as security the goods loaded onto the ship backed by bills of lading, and will follow through the supply chain until the bank is paid by the international buyers.

The supply chain for export finance starts with the goods stored in the warehouse and the journey continues from the warehouse to the ship and finally to the final buyers. In export finance, there is a forward sales agreement in place with final buyers.

In import finance on the other hand, the supply chain starts from the international suppliers shipping the goods and the bank finances the importer with the discharge of the goods into a warehouse for storage involving a warehouse receipt that replaces the bill of lading.

VI.3 Invoice Finance

Supply chain finance can be divided into:

- i. Production finance that covers raw materials procurement for production into finished goods.
- ii. Stock finance that covers goods stored in a pre-approved warehouse (either for import or export).
- iii. Trade finance does not necessarily involve warehousing but general credit lines provided by the bank. The bank is taking a clean credit risk on the borrower's balance sheet. This happens when the bank relinquishes its security on the goods, which may be released for further processing.
- iv. Invoice finance happens when the bank takes as security the invoices that the borrower has issued to its buyers as evidence of sale. This is treated as clean financing and relies heavily on the strength of the credit standing of the buyers who may be buying the goods on open account terms. This is more a balance sheet driven financing.

VI.4 Receivables Finance

Financing receivables refers to the funding of sales on credit terms where the customer has a receivable on its books. The bank will provide a short-term advance against the underlying security, which is the export receivables in connection with the goods sold to the client on open account sales. This is also called financing of book debts. There could also be export documentary bills involved. This banking product represents some sort of working capital for the seller as he or she may approach his or her banker to finance these documentary bills pending payment by the buyer. This is referred to as bills finance or receivables finance. The bills purchased may also be in the form of bills of exchange or bank draft. At times, some financial institutions provide a guarantee to these bills.

Banks which extend this finance retain a right of recourse to the exporter, that is to say, in the event the invoice is purchased or discounted by a banker, the latter will have the right of recovering the bill amount with interest and charges from the exporter.

The main risk of receivables finance is the risk of non-payment by the buyer. Depending on the credit standing and reputation of the buyer, the exporter needs to obtain suitable trade credit risk insurance cover to at least 85 percent of the invoice value. This helps to limit the loss on account of nonpayment to a maximum of 15 percent. At other times, the banker would require cash margins to cover this shortfall. If the transaction is on a non-recourse basis, the bank cannot go back to the seller in the event the buyer fails to honor the bills purchased.

Box 3. Case Study involving Guaranteed Bills of Exchange

The case involved a trader from an Asian economy residing in the United Kingdom (UK) and exporting commercial goods to Nigeria and the United States. The trader knew that he could get insurance from export credit agencies (ECA) against the risk of non-payment by the foreign buyer. Banks may sometimes purchase bills of exchange from the exporter against the guarantee of an ECA, for example, the Export Credit Guarantee Department (ECGD) of the UK and the foreign buyer would pay for the goods in due course according to the sales contract. The trader involved created imaginary contracts for the sale of goods supported by fraudulent bills of exchange with forged acceptances by the imaginary buyers. He obtained money from the bank by selling these accepted bills of exchange. The ECGD guarantees to assist UK exporters. The guarantees were intended that in the event of default by the overseas buyer, the exporter would be paid 90 percent of the purchase price. This is a valuable source of working capital for the exporter and makes it easier for the trader/

exporter to obtain finance. The foreign buyer usually accepts the bills of exchange payable at a future date. The ECGD issued a series of guarantees to the bank in relation to purchases from this Asian trader drawn in respect of fictitious export transactions entered into by companies in which this Asian trader owned or controlled. Initially the guarantees were in the form of a comprehensive banker's guarantee (CBG). The CBGs provided cover and altogether nine CBGs were issued in a span of 2 years. A number of bills of exchange and promissory notes were purchased by the bank under each CBG. Some of the bills and notes were honored and some were paid later without any substantial loss to the bank. Subsequently, the ECGD issued guarantees in the form of specific banker's guarantees (SBG). The SBGs guaranteed bills relating to specific contracts for capital goods. This case concerns four SBGs that were issued in respect of four imaginary export transactions.

A senior underwriter of the ECGD, although a junior civil servant, was involved with the issue of the four SBGs. He authorized their issue but was aware that the bills of exchange were fraudulent. The bank that bought the bills of exchange made a claim on the ECGD against its guarantee, which secured the payment of the bills. The bills of exchange were forged. The supposed buyers existed and were highly respected but the contractual documents and the bills of exchange accepted by the buyers were forged and the buyers knew nothing of the supposed transactions executed in their names.

The ECGD employee had not forged any document and the court held that there was nothing unlawful in issuing the SBGs. But it would not have been within the course of his employment or the scope of his authority to do acts by which the purchasing bank of the bills of exchange was deceived. The employee signed letters on ECGD note paper indicating that the transactions were acceptable to the ECGD. But the employee had no authority to write these letters and the letters were not written within the scope of his employment.

The bank that purchased the bills of exchange was also at fault, which was crucial to its claim for payment. The SBGs guaranteed payment of the principal element of the sum on the face of the bill, provided the bill remained unpaid 3 months after the due date of payment. However the guarantees were confined to bills 'in connection with which the bank had taken all reasonable steps to satisfy itself as to its validity and enforceability in the buyer's country...' As the bank had not taken those steps, the ECGD was not liable under the guarantees.

The case was decided not on the basis of the acts of the ECGD employee, but the loss was caused by the bank's recklessness in its dealings with the Asian trader and his companies. If the purchasing bank had taken action, which it should have done to protect itself, the ECGD would have suffered the loss and not the bank as a result of the guarantees being issued, since the ECGD would have had to honor the guarantees.

Source: Export Credit Guarantee Department Case, based on publications in the internet judgment. House of Lords. Generale Bank vs. ECGD session, 1998–1999.

VI.5 Retention of Title (ROT) Clause

Sometimes borrowers may have to send export documents including bills of lading directly to the buyers for payment. The trade flow may require such arrangements since the buyer needs to take delivery of the cargo early, avoiding demurrages at the discharge port. This is seen in interrelated companies with good track records. In these instances, the sales contract, the seller's invoice, and the remittance schedule of the financing bank should contain a proper retention of title clauses. A sample clause is: 'The property in the goods shall not pass to the buyer until he has completed payment of the price in full.'

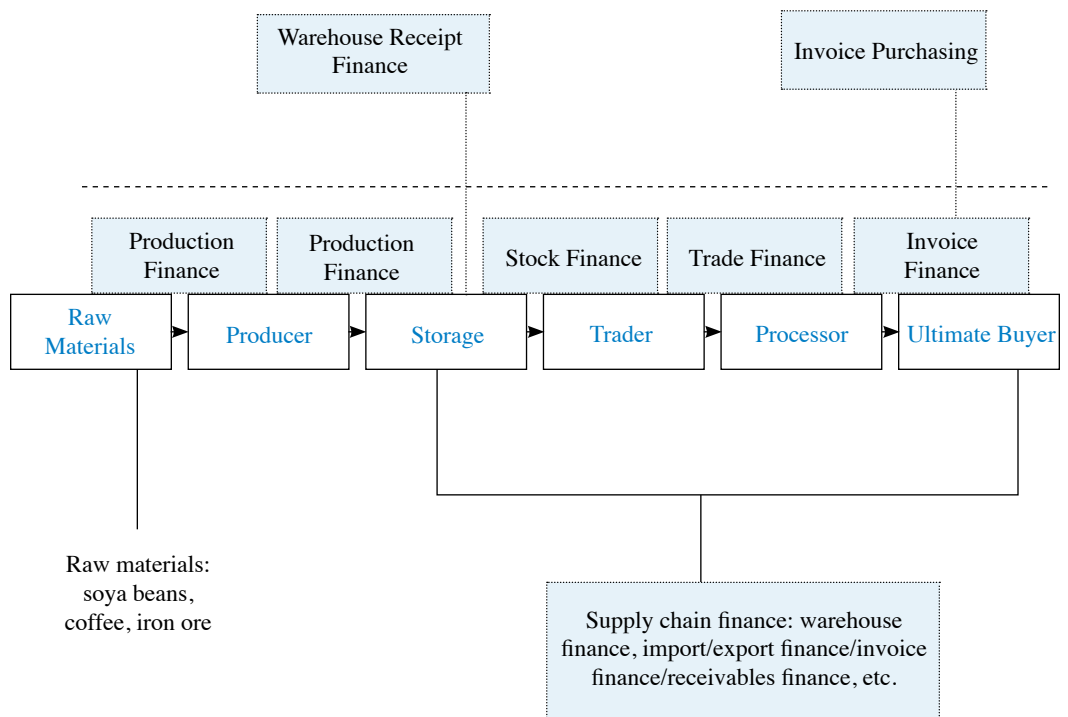
VI.6 Credit Risk Insurance

When the bank discounts the export bills, it appraises the financial standing and reputation of the buyer. It may also arrange for credit risk insurance from an acceptable insurance company to cover possible nonpayment of the buyer on maturity date of the bill. Credit risk insurance normally covers up to 85 percent to 90 percent of the non-payment depending on the standing and reputation of the buyer. This will help limit the loss on account of nonpayment risk to a maximum of 15 percent or 10 percent. Many insurance companies provide credit risk insurance on buyers.

VII. Total Spectrum of Supply Chain Finance

Supply chain finance involves a variety of financing forms which accompanies every step of the chain, from procurement of the raw materials, to warehousing, conversion into finished goods to trading to final delivery of the goods and the corresponding receipt of payment. The stages of financing are traced in the diagram below (Figure 7).

Figure 7: Financing the Supply Chain from Raw Materials to Ultimate Buyer

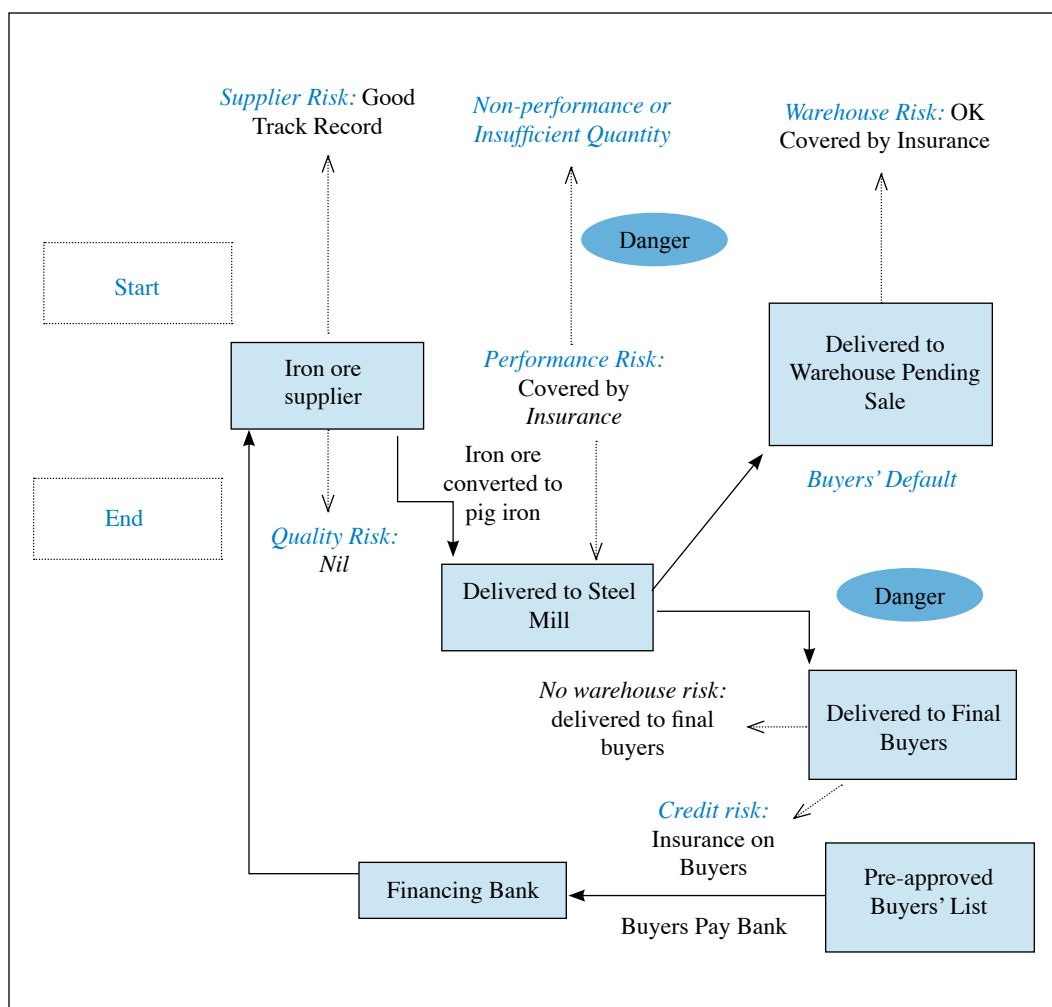


Source: Prepared by author.

VII.1 Risk Spectrum

One phase of the supply chain is the production of raw materials into finished goods, since not all raw materials or commodities are traded in their raw form. When production is involved, a new spectrum of risks appear, the most crucial being the performance or delivery risk from the producer (Figure 8). Nevertheless, production finance may also involve warehouse finance.

Figure 8: Risk Identification and Risk Mitigation



Source: Prepared by author.

VII.2 Key Risks in the Supply Chain and the Corresponding Risk Mitigants

Table 1 shows the degree of risks, their impact on the transaction's profitability and the possible risk mitigation.

Table 1: Risk Differentiation, Impact, and Mitigation

	Probability	Impact	Risk Mitigant
1. Iron Ore delivery risk	Low	High	Letter of credit (LC) payment
2. Quality, off specification risk	Low	High	Quality inspection certificate
3. Steel mill production risk	Medium	Very High	Check track record
4. Steel mills credit risk	Low	Very High	Check balance sheet
5. Sales diversion risk	Low	Very High	Contractual relationship with client
6. Warehouse reputation risk	Low	Low	Fidelity insurance
7. Buyer credit risk	Low	High	LC terms; buyer credit risk insurance: AA rating
8. Political risk affecting payment	Low	High	Update situation of economy, political risk insurance if necessary
9. Transportation risk	Medium	High	Insurance
10. Economy risk	Low	Medium	Political risk insurance

Source: Prepared by author.

Box 4. Case Study involving Performance/Delivery Risk/Price Risk

This involves the case of prepayment financing through a Hong Kong, China company for the production of zinc ingots in China. The funds were paid to the wholly owned Hong Kong, China subsidiary of a China zinc smelter and passed on to its parent company to purchase local zinc concentrates and convert them into London Metals Exchange (LME) zinc ingots. The LME zinc ingots were pre-sold to a zinc trader in Australia with payment on letters of credit (LC) terms and delivery over a 12-month period under an offtake agreement. The transaction was insured for non-performance for 90 percent of the financed amount including the non-payment risk. The insurer had an A minus credit rating. The Australian buyer usually buys from small traders and medium-sized smelters in China and is considered familiar with this type of sourcing. Market checks in China were also done for this smelter, which were favorable.

The local concentrates will be sourced from the shareholders' own mines as well as from third parties. The smelter has a capacity of 20,000 metric tons of zinc ingots per year or 1,667 tons a month. Due to a lack of funding, the smelter

could only produce 800 tons a month. The smelter only sells to domestic buyers and this transaction is the first time the company is exporting the ingots. At the time the deal was entertained, zinc prices were booming and expected to remain high. Notwithstanding, the deal required a 150 percent market value of the zinc ingots to be shipped which gives a margin of 50 percent over the principal and interest amount to be paid during the month of shipment.

The transaction, which required delivery of 2,880 tons of zinc ingots, is well within the smelter's capacity of 20,000 metric tons. The smelter, being one of the largest taxpayers of the province, enjoyed good provincial support.

When the transaction was considered, it passed the basic risk assessment in terms of:

Performance Risk: Covered by insurance cover of 90 percent, and the required ingots were well within the smelter's capacity to produce.

Buyer's Risk: No issue since the purchases were on letter of credit terms.

Price Risk: Zinc ingots to be delivered should have a market value of 50 percent above the amount of principal and interest to be paid. Zinc ingots could have been hedged as they were of LME grade, but this was not done. Price risk was on a mark to market basis.

At the time the financing commenced, the zinc ingots had the following historical LME 3-month and Shanghai Futures zinc price:

	<u>Domestic Price</u>	<u>LME Price</u>
2005	USD 1,703	USD 1,393
Jan 2006	USD 2,378	USD 2,102
Feb 2006	USD 2,531	USD 2,238
Mar 2006	USD 2,812	USD 2,423
Apr 2006	USD 3,391	USD 3,039
May 2006	USD 4,137	USD 3,489
June 2006	USD 3,464	USD 3,181
July 2006	USD 3,329	USD 3,328
Aug 2006	USD 3,568	USD 3,364
Sept 2006	USD 3,778	USD 3,408
Oct 2006	USD 4,025	USD 3,805

LME = London Metal Exchange.

Notes: LME = London Metal Exchange for LME prices and Shanghai Futures Exchange for domestic prices. Conversion rate renminbi in US dollars based on State Administration for Foreign Exchange (SAFE), People's Bank of China at the prevailing month.

In terms of price, the outlook for zinc at that time was strong, given that it had risen from USD 1,000 to around USD 4,025 by the end of October 2006. The demand for the metal was strong and it was forecast that demand would outstrip supply, given China's economic growth. The fundamental driver was the shortage of zinc. The smelter decided to switch from domestic sales to the international market.

Post mortem and what went wrong

The pre-payment facility was fully drawn in May 2007. The loan was supposed to be paid in 12 monthly installments from export proceeds from the Australian buyer.

After two payments in June and July, the smelter could not pay the August installments and asked for a 3-month extension from the financing bank and concurred by the insurer. There was a very large fall in international zinc prices and it became more economical to sell domestically. Taking into consideration the high cost of production that could not be covered at prevailing zinc prices, the smelter decided to reduce production and wait until zinc prices rebounded, which never happened. Repayment, which was due in August, was only done in November and another one in December. The smelter could only produce a minimal amount of zinc in order not to close the plant. The international zinc price plunged to USD 2,500 by December 2008. The supply chain was severely disrupted and the smelter had to pay for expensive overdue interest failing which, it will be sued.

There was an expectation of the cancellation of the 5 percent export rebate tax, which would have induced the smelter to sell into the overseas market, but again this did not happen and exports continued to decline. After several extensions, the financing bank decided to make a claim on the insurance policy for non-performance, which also covered non-payment. After a waiting period of 6 months, the insurance company paid the 90 percent of whatever loan was outstanding.

The client was a marginal one in the zinc industry, which produced only 20,000 metric tons of zinc where the average capacity for smelters was over 100,000 tons. This should have signaled that the smelter would not be able to produce at full capacity should prices drop due to absence of working capital.

Once zinc prices started to fall, the smelter reduced production in the hope that when prices rebounded, it could resume normal production. The smelter did not have a hedge mechanism to lock in the prices, which was possible given that the zinc ingots were of LME grade.

The insurance policy was carefully studied to include non-payment that was caused by non-delivery.

Foreign banks are not allowed to lend to domestic companies. They are allowed to lend to joint ventures or foreign companies in China. For foreign banks to lend to domestic companies, they must seek a renminbi license to do so. However they can still lend to domestic entities for pre-export finance. The financing will be done on the basis of a pre-payment for exports and not for domestic sale. In this structure, the foreign bank had a SAFE approval to do a pre-export finance since from the outset the zinc ingots were to be sold to an Australian buyer.

The deal failed to pass the price risk, which was crucial given the volatility of zinc prices even if over the past 5 years the indicators showed an all time high.

The financing bank managed to recoup its financing for 90 percent which justified taking a risk on a marginal smelter.

Source of zinc price is Antaike Lead & Zinc & Tin Monthly, 121. (December 2006).

VII.3 Performance Risk

In a supply chain, when production is involved, a variety of things may go wrong, starting with the capability of the plant to produce the required finished product. As mentioned, the most critical risk is the performance risk on the producer.

- i. In the assessment of the performance risk of a plant, one most basic risk mitigation is to do an actual plant visit. Many things could be observed during a plant visit, for example, its physical condition, its road infrastructure including access and dependence of logistical and transport infrastructure, and its proneness to external threats such as floods, hurricanes, strikes, and pollution. The operational aspect of the plant could also be backed by independent technical reports. (In the case study above, two plant visits were conducted and it was found that the plant infrastructure was basic and some workers were doing manual operations that could have been automated. The plant did not appear to have the necessary capital to invest in machinery.)
- ii. The track record of the producer can be gauged based on statistics such as the ratio of production to its exports, the profile of its customers, and the track record of its counterparties. (In the case study, the smelter had no experience in exporting. It was its first attempt.)
- iii. It is important to assess the ability and willingness of the producer to deliver. (In the case study, the smelter was not willing to produce more zinc knowing that they would be sold below production costs. It also did not hedge against the falling zinc prices since it did not have the background on hedging.)
- iv. A payment default could be triggered by non-delivery. One should examine the causes of the non-delivery, whether it was caused by the producer delivering

products that did not meet the specified requirements, or by the trader who did not provide a ship at the port of loading on time (if the agreement was one where the trader was responsible for nominating a vessel).

VII.4 How to Mitigate Performance Risk through Limited Recourse Financing

Often, financing can be given directly to a trader who takes a risk on the producer. In this instance, the performance risk could be a shared risk between the financing bank and the borrower who acts as the intermediary/trader. The latter could be a large trading company with a proven track record with the producer and with the economy involved. It would also be more attractive to a lending bank to lend to a trader who happens to be an Organisation of Economic Co-operation and Development (OECD) economy, rather than to lend to a borrower in an emerging economy. The trader will be more equipped to evaluate the risks in the transaction since it can leverage on its trading track record. The problem of jurisdiction and enforcement of security is also overcome if the enforcement is in an OECD economy.

i. Risk Sharing Assessment

Repayment of the financing will necessarily be linked to the performance of delivery obligations of a contractual nature by the producer and will enable the financing institution to evaluate the transaction as a commercial performance risk rather than an economy risk, especially if the producer happens to be in a less developed economy.

- a. A starting point is to begin with one-off transactions that involve several shipments and test the waters. In a limited recourse pre-payment finance, the performance risk is solely the performance of the producer.
- b. The first issue is the allocation of risk between the financing bank and the trader should the producer fail to deliver. Risk sharing is that portion of the loss that is retained by the trader, say for example 80-20 of the loaned amount. In this case, the trader becomes a participant to the non-payment of the loan up to 20 percent. At the same time, the trader will continue to be a commercial counter party to the producer.
- c. Another issue is to define the events that will trigger the non-performance of the producer, and to look at what is caused by whom. For example, contract cancellation is always a key risk but the question is what causes the cancellation and for what reasons. Some reasons could be:
 - the producer delivered off-specification or defective goods
 - the producer delayed delivery thereby causing the trader to lose market share

- the producer unilaterally increased the costs
- the trader, not the producer, was supposed to provide a ship under the contract but did not do so

The allocation of risks has to be clear and precise as well as the events that might trigger them in the drafting of the loan documents.

ii. Compliance with Regulatory Issues and Covenants

The trader may be required to comply with local regulations of which he or she may have limited control such as the taxes and export duties that may be ambiguous or reach confiscatory levels. The supply chain may involve duties imposed that may be expensive or changed without warning.

iii. Security Issues

Sometimes, a large producer in an emerging economy may not cooperate or submit to foreign law. In this case, the mitigant is to include arbitration in case of dispute.

iv. Unilateral Cancellation of the Contract

This depends on the commercial relationship between the trader and the producer. If a good relationship exists, this is not a major risk. However, if there is only a fragile relationship, the trader may want to limit future dealings with the producer until the loan is fully repaid or allocate future deliveries under subsequent contracts for repayment. The commercial relationship should not be underestimated and could be a key negotiating point.

In limited recourse risk sharing, the banks and the traders are not only providing specialized financing techniques but are also creating regulatory and evolving procedures that could be applied to a much larger geographical area. This limited recourse risk sharing could also include trading companies or SMEs which could be marginalized due to lack of awareness of sophisticated financial techniques and risk mitigants like political insurance and trade credit insurance.

VII.5 Key Risks that could be Shared and Insured

The following risks can be subject of political risk insurance:

i. Cancellation of export authorization

Limited recourse risk sharing normally includes risk involving the inability to export due to cancellation or invalidity of export license. In some cases, the financing bank may be willing to share the risk of inability to obtain an export license which might be conditioned upon showing that a license was

in fact available at the time that the advances were given, but subsequently repudiated due to new government regulations.

- ii. Government interference with the performance of the producer who is also the exporter. This interference is usually in the form of a law, order, or regulation that may have a direct impact on the ability of the producer to perform.
- iii. Confiscation or expropriation of the goods by the government.
- iv. Contract repudiation by the producer is a shared risk. However, if the contract repudiation is justified and is caused by the trader, this cannot be a shared risk.
- v. War, revolution, strike, or civil commotion – the inability to export due to any of these causes is usually included as a shared risk. But the loss due to nuclear contamination or explosion is almost always excluded. The reason behind this exclusion is that such risks are not insurable under Lloyd’s political risks policies and there is no pressure on the banks to participate in such risks.
- vi. Transfer risk arises from non-convertibility of the local currency and remitting the repayment in foreign currency.

Box 5. Case Illustration of a Limited Recourse Financing

A coke trader in Hong Kong, China had provided an advance payment for the production of coke to a coke supplier. Subsequently, the trader approached one of its bankers for the refinancing of its advance as it needed more liquidity to entertain other structured deals.

The bank, which has considerable credit facilities to this trader, agreed to this refinancing on condition that the trader would participate in the non-performance risk of the coke supplier up to 20 percent. It assumes, for the sake of example, that the coke supplier after repaying USD 1,000,000 is no longer able to deliver, leaving a total loan outstanding of USD 4,000,000 of a pre-financing of USD 5,000,000. This loss will be shared by the trader for USD 800,000 and the remainder of USD 3,200,000 by the lender.

On the other hand, if the failure of the coke supplier to produce is caused by the trader, the bank will have full recourse on the trader, that is, the trader will have to reimburse the bank for the full amount of USD 4,000,000 outstanding.

Source: Author

VIII. Key Issues in Taking Security

There are a few basic issues that need to be addressed when taking security.

VIII.1 Governing Law and Jurisdiction

Attention has to be paid to the governing law of the security document. If the security involves tangible assets, the security must be in conformity and be governed by the laws of the economy in which the asset is domiciled.

In the case of contractual rights and intangibles, the governing law should be the law of the place where they are enforceable. There may be formal requirements of the governing law or the place where the document is executed as to the form of documentation, which must be strictly adhered to.

VIII.2 Legal Capacity and Authority

It must be ascertained that the party providing the security has the necessary legal power under its constitutional documents or under the laws of the economy in which it is incorporated to grant the security. Even if the party giving the security is empowered to do so, the question may arise whether the specific security is enforceable against it as being a proper exercise of its powers. For example, a company in China may give its corporate guarantee to a transaction in Hong Kong, China, but the lender must check whether that company is allowed to provide such a guarantee under common law jurisdictions, otherwise, it would be unenforceable.

VIII.3 Authorization and Execution

If a company or government body is providing the security, the lender would have to ascertain whether the officials of that body have authorized the execution of such security document. This is crucial in emerging economies. The security document must be executed according to the company's constitution and the laws of the economy in which the document is executed.

VIII.4 Consents

The lender must check whether the type of financing structure together with the corresponding facility and security documents require government approval, for example, if it involves a foreign currency loan to an entity in China, a question could arise whether this entity is allowed to seek foreign currency loans and if so, if it has the necessary approval for currency convertibility from the economy.

The lender cannot risk the non-enforceability of the security document especially if the security document involves the underlying asset as the main collateral. If in doubt, it is better to seek legal opinions.

If they are poorly drafted and lack precision, or do not reflect the intent of one of the parties, these documents will have very little value as far as enforcement is concerned. Vague wording could amount to significant losses. For example, if it is a limited recourse sharing, what is viewed as accepted risk and what is not, may amount to disputes that could entail huge legal fees. This vague wording can be interpreted in either way in favor of the trader or the financing bank.

Box 6. Case Study involving Jurisdiction

During 1999 and 2000, Tradigrain shipped various quantities of vegetable oil to India with a view to the oil being stored after discharge in tanks hired by Tradigrain's customers' payment of sums due to Tradigrain under a series of sale contracts. An independent company managed the storage facilities but in 2000, the customers succeeded in obtaining delivery of significant quantities of the oil without paying. Tradigrain sought to recover part of its losses from the 29 insurers which had subscribed to an open cover policy of marine insurance, effected by brokers in Germany, which had been specially extended to cover storage risks, including misappropriation and loss resulting from the negligence or unauthorized conduct of the managers of the storage tanks.

The Italian insurer S.I.A.T. was the leading insurer involved and only one of their 28 co-insurers was a UK company.

Tradigrain, a UK company commenced proceedings in the Commercial Court, arguing that insurance certificates relating to the shipments provided that any proceedings on the policy should be brought in the English Courts (in circumstances where the underlying sales contracts were entered into on the standard terms of FOSFA 54)¹⁷. The insurers challenged the English court's jurisdiction to determine the policy dispute, arguing that the open cover policy was subject to German law and Hamburg jurisdiction. (Thus, for example, only the Italian courts could deal with the claim against S.I.A.T.)

In considering this objection to English jurisdiction, the judge Colman J. concluded that, as a matter of construction, the jurisdictional provisions in the open cover policy did not prevent Tradigrain from commencing proceedings in courts other than those of Hamburg. In any event, it was his view that those

¹⁷ FOSFA is the Federation of Oils, Seeds, and Fats, which is a professional body concerned with oil trade in oilseeds, oils, and fats. It issues contracts covering various types of trade such as CIF, C&F, and FOB, and contracts linked to price settlement or deficit delivery. It is based in the United Kingdom.

provisions had not been effectively incorporated into the special extension covering post-discharge storage risks, for which separate declarations were required. However, the judge also concluded that none of the insurers was bound by the jurisdiction clause inserted in the certificates – since the marine cover to which they related did not extend to the subsequent storage of the cargo. Nevertheless, it was necessary to have regard to the Lugano Convention on jurisdiction in civil and commercial matters. In circumstances where the judge decided that there was no binding jurisdiction agreement of any kind, this Convention required Tradigrain to bring proceedings against any of its insurers only in the courts of the economy in which that insurer was domiciled. (Thus, for example, only the Italian courts could deal with the claim against S.I.A.T.)

In the end, Colman J. granted a declaration that the court had no jurisdiction as against the 28 non-English defendant underwriters but refused to stay the proceedings brought against the English insurer.

The English Courts will usually try to avoid parallel litigation in different jurisdictions relating to the same dispute. However, international conventions that regulate jurisdictional matters may operate to prevent this. For this reason, Colman J. concluded his judgment with an exhortation to ‘Tradigrain, the leading underwriters and the (following) market urgently to make a serious effort at least to resolve the jurisdictional position by an ad hoc agreement so as to minimize cost and further delay.’

Source: Tradigrain Case. January 2002.

IX. General Trade Finance

The absence of trade finance infrastructure is a barrier to the supply chain. Limited access, high interest costs, and absence of insurance are likely to affect SMEs that wish to participate in the trade flow. Securing trade finance, that is usually short term and recurring in nature, is among the challenges faced by SMEs. Importers need working capital to purchase raw materials, process them into finished goods, and sell to the international market. Policymakers need to create an economic strategy that ensures trade development and support in terms of trade finance and an efficient financial infrastructure.

General trade finance involves the provision of credit by a financial intermediary to buyers and sellers of goods to sell the goods domestically or internationally. This is distinguished from general working capital finance. The credit is extended to a specific and underlying trade transaction or transactions that have a specific time scale, usually no more than 360 days and financing ends with the conclusion of the supply chain through the sale of the goods to the final buyer.

IX.1 Documentary Credit

i. Letters of Credit

This is a payment term used in international trade transactions that allows the buyer to offer a secure term through the intervention of the banking system. The issuing bank of the letter of credit will make payment immediately or at a prescribed date upon presentation of stipulated documents usually shipping and insurance documents and commercial invoices representing the goods and makes possible the transfer of title to those goods. It involves a legally binding obligation by the issuing bank to pay the seller as long as documents presented under the letter of credit conform to the terms and conditions set out in the letter of credit. The issuing bank assumes responsibility in paying the exporter. This offers security to the seller.

A refinement of the payment mechanism under the letter of credit is the bill of exchange. The bill of exchange is also referred to as a bank draft where the signature of the issuing bank is added to the bill of exchange, which then transfers the obligation to pay the seller to the bank itself. Thus, the seller is exposed to a bank risk rather than to a buyer's risk. If the seller does not wish to hold the bill of exchange to maturity, it can get it discounted by another bank that provides immediate cash payment. The discounting bank then assumes the payment risk of the transaction. If the importer's bank defaults on payment, there is typically no recourse to the exporters or sellers, that is, they are not obliged to reimburse the discounting bank.

ii. Documents Against Payment (DP)

In this payment mode, the seller retains control of the goods until they are paid for. The seller will deliver the documents providing control of the goods to his or her bank, which is then instructed to release the documents only upon receiving payment from the buyer. The most important among these documents is the bill of lading, which entitles any holder in whose name it is made, to take delivery of the goods from the shipping company. The bill of lading is also a proof of shipment. The seller is protected since no release of the documents will be made until payment is made and the buyer is protected since no payment is made until the goods have arrived.

iii. Documents Against Acceptance (DA)

The bank, just like in documents against payment (DP), plays a supervisory and intermediary role. In this method, the buyer accepts the documents presented including a bill of exchange, and is obliged to pay at a later or maturity date. Under this mechanism, the seller loses control of the goods released to the buyer, and is relying to be paid at maturity.

In DP terms, there is no 100 percent guarantee of payment as the buyer may refuse to show up to pick up the documents (DP), and the seller has no option but to warehouse the goods. In documents against acceptance (DA) terms, which are riskier, the buyer may not show up for payment at maturity of the bill of exchange.

Collection of DP or DA documents is far riskier than a documentary letter of credit. Collections are documentary evidence of a commercial transaction, and commercial practices and legal systems vary from economy to economy. It is good practice for SMEs to keep up-to-date with the latest provisions of the International Chamber of Commerce governing uniform rules for collections.

IX.2 International Factoring

International Factoring involves cross-border sales to a variety of international buyers where receivables are created. These receivables are then purchased through a mechanism called factoring. This is the outright purchase of receivables by a factor from a seller. The factor buys all the outstanding invoices from a seller and takes over the subsequent dealings with the buyer/importer. In receivables factoring, the seller effectively is offered prepayment finance. The seller's invoice must state that the receivables have been sold to a factor, who then becomes the new owner of the debt.

IX.3 Forfaiting

Forfaiting is the purchase without recourse of debt instruments due to mature at some time in the future arising from the finance of goods and services. The risks of non-payment are transferred to the forfaiter who pays the exporter the cash after deducting an interest charge, the discount that is charged at the agreed rate for the credit period covered by the debt instrument. The forfaiter will hold the debt instrument as an investment or sell it in the secondary market to other forfaiters. The most common debt instruments for forfaiters are the bills of exchange and the promissory note. For an exporter, the advantage of forfaiting is immediate cash payment. It is also non-recourse that frees the exporter from all the risks related to international trade. Since forfaiting is a non-recourse to the exporter, the forfaiter needs some form of protection, which is called aval. This is a form of guarantee that the payment obligation will be honored.

A bank in the importer's economy usually gives the guarantee. The guarantor is called the avalor. The avalor must be the one to assess the credit worthiness of the importer. The forfaiter looks into the credit risk of the avalor more than the credit risk of the importer.

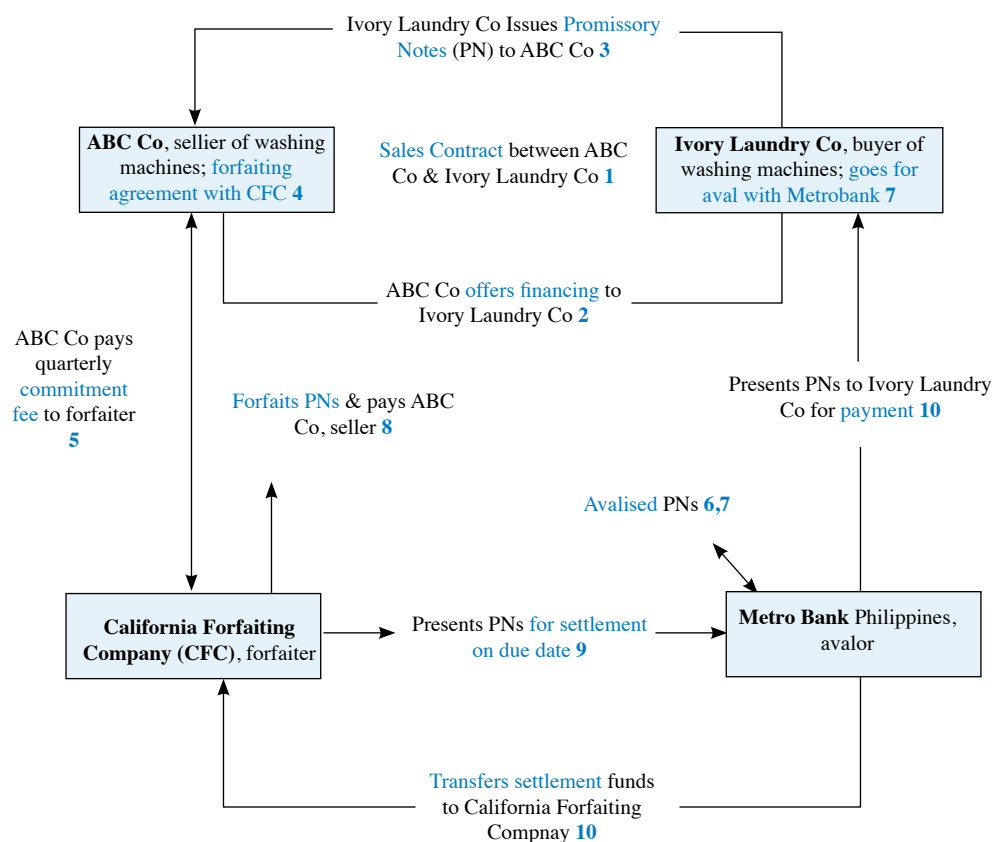
Another feature of forfaiting is the discount rate. This covers the period the credit is extended, which is equivalent to the forfaiter's cost of funds. The discount rate reflects the assessment by the forfaiter of the risks involved.

Besides the discount rate, additional fees charged by the forfaiter include days of grace to cover interest losses arising from possible delays before funds due to the forfaiter are credited to him or her, and the commitment fee for the forfaiter's agreement to finance the transaction and fix the discount rate for the agreed period. Please refer to an example of forfaiting provided below and which is depicted diagrammatically in Figure 9.

Box 7. Forfaiting Example

1. ABC Company, a seller of washing machines in the US, has an interested buyer in the Philippines, Ivory Laundry Company for a total of USD 1,000,000 and needs credit for the whole transaction.
2. Financing is offered by ABC Co (US) to Ivory Laundry Co (PHL). Ivory Laundry after securing an aval (guarantee) from Metro Bank Philippines agrees to the financing offered by ABC Co. With this, Ivory Laundry and ABC Co sign a commercial contract.
3. Ivory Laundry issues Promissory Notes payable to ABC Co (US).
4. ABC Co and California Forfaiting Company commit to forfaiting terms and California Forfaiting sends a commitment letter to ABC Co. This letter contains the details of buyer, goods involved, total amount to be forfeited, credit period, payment instrument, delivery dates of goods, documents involved, and the avalising bank.
5. With the Forfaiting Agreement, ABC Co is obliged to pay the quarterly commitment fee in advance to California Forfaiting Company.
6. ABC Co ships the goods to Ivory Laundry Co (PHL). Ivory Laundry Co delivers its promissory notes to Metro Bank, the avalising bank.
7. Metro Bank after examining promissory notes, signs an aval at the back of the promissory notes. Ivory Laundry Co is now liable to pay for the aval fee to Metro Bank.
8. The promissory notes and other documents are sent to ABC Co and upon receiving them, hands them over to California Forfaiting Company, which adds its endorsement. California Forfaiting Company pays ABC Co the discounted proceeds of the promissory note.
9. When each note falls due, California Forfaiting Company presents the notes to Metro Bank for settlement.
10. Metro Bank then presents the notes to Ivory Laundry Co for payment and transfers the funds to California Forfaiting Company.

Figure 9: Diagram of a Forfaiting Transaction



Source: Prepared by author. Note: Aval is a guarantee added to a debt obligation.

X. Transport Documents in the Supply Chain

The goods from the warehouse can be transported by land for domestic sale or by air or sea when they are traded internationally, crossing national borders. Once the goods leave the warehouse, the factory, or the steel mill, a variety of transportation methods are available including containers, road haulage, conventional general cargo, shipping, rail, and air. With the growth of global trade, the maritime bill of lading is by far the most common transport document for import and export. The type of shipping document is often incorporated as part of the sales contract and often as part of documentary requirements. In structured commodity finance, title bills of lading could be the most important security. If the marine bill of lading is a document of title where the named holder is the financing bank or endorsed to its order, most likely the bank will consider financing the goods.

X.1 Marine Bill of Lading (Based on UK Carriage of Goods Act 1992)

A marine bill of lading is:

- i. A receipt for the goods shipped and provides certain details as to their condition when placed on board the ship. In the event of the goods being damaged, missing, stained, or inadequately packed, the bill of lading is regarded as unclean, foul, or dirty. Goods that are placed on board without defect are regarded as a clean shipped bill of lading.
- ii. Evidence of the terms of contract of affreightment between either the exporter or importer and a shipping company to transport the goods by sea.
- iii. A document of title which empowers the party named on the bill of lading to the right to own the goods. In trade finance, this could constitute an important security.
- iv. A negotiable instrument whose title can be transferred to another by endorsement. Even during transit time, the holder of the bills of lading may sell the goods by simple endorsement and delivery of the bills of lading.

X.2 Regulatory Issues Related to Bills of Lading

i. Evolution of Regulations Regarding Bills of Lading

a. Hague Rules

These were agreed at an international convention in Brussels in 1924 and govern liability for loss or damage to goods carried by sea. They are officially known as the International Convention for the Unification of Certain Rules relating to Bills of Lading signed in Brussels on 25 August 1924, and given effect in the United Kingdom by the Carriage of Goods by Sea Act 1924.

The rules were designed to apply to all exports from any economy which ratified the rules and this is how they are applied, which is almost universally, wherever they have not been superseded by the Hague-Visby Rules or the Hamburg Rules, either by application of law or by contractual incorporation into the terms and conditions of the relevant bill of lading.

b. Hague-Visby Rules

In 1968, an international conference adopted some revisions to the Hague Rules, officially known as the Brussels Protocol, signed on 23 February 1968. They were called the Hague-Visby Rules and given effect in the United Kingdom by the Carriage of Goods by Sea Act 1971.

The 1968 convention provided that the Hague-Visby Rules amendments would come into effect after the convention had been ratified by 10 economies. These requirements were satisfied in June 1977 and by September 1997, some 34 economies had adopted them. A further six economies have enacted legislation broadly in line with the rules.

c. Hamburg Rules

In March 1978, an international conference in Hamburg adopted a new set of rules called the Hamburg Rules, which were to radically alter the liability shipowners had to bear for loss or damage to goods.

The main differences between the new rules and the Hague-Visby Rules are:

- The carrier will be liable for loss, damage, or delay to the goods occurring whilst in his or her charge unless he or she proves that ‘he, his servants or his agents took all measures that could reasonably be required to avoid the occurrence and its consequences.’
- The carrier is liable for delay in delivery if the goods have not been delivered at the port of discharge provided for under the contract of carriage within the time expressly agreed upon or, in the absence of such agreement, within the time which it could be reasonable to require of a diligent carrier having regard to the circumstances of the case.
- The dual system for calculating the limit of liability, either by reference to the package or by weight as set out in the Hague-Visby Rules has been re-adopted.
- The Hamburg Rules cover all contracts for the carriage by sea other than charter parties, whereas the Hague-Visby Rules only apply mandatorily where a bill of lading is issued.
- They will apply to both imports and exports to and from a signatory economy whereas Hague and /Hague-Visby rules apply to exports only.

ii. ***Existing Regulations Governing Bills of Lading (Carriage of Goods Act 1992)***

Under the Hague-Visby Rules, a bill of lading is only a *prima facie* evidence of receipt. The UK Carriage of Goods by Sea Act 1992 is the existing document regulating bills of lading, which provides that a bill of lading is conclusive evidence of receipt of goods, besides being an evidence of contract of carriage, a document of title, and as a negotiable instrument.

X.3 Charter Party

This is a contract of carriage for an entire vessel leased to a charterer for the conveyance of commodities on a determined voyage (voyage charter party) or until the expiration of a specified period (time charter party).

A charter party governs the relationship between the shipowner and the charterer whereas the bills of lading govern the relationship between the shipper and the carrier (who will be either a shipowner or a charterer).

The voyage or time charterer (also known as disponent owner) may in turn sub-charter the vessel to another sub-charterer when allowed under the head charter. Whether or not he or she does, bills of lading for goods shipped on the chartered vessel will be issued to particular shippers, who may or may not themselves be sub-charterers. These bills of lading are said to be issued 'subject to the charter party'. Effectively, the charterer becomes a commercial intermediary between the shipowner and the ultimate receiver of the bill of lading. The holder of the bill of lading (for example, endorsee, consignee, bearer, or bank) needs to know who to sue if the goods are lost or are delivered in damaged condition.

i. Voyage Charter/Freight

A voyage charter/freight is a contract to carry specified goods on a defined voyage and the freight is usually calculated based on the quantity of cargo carried. A lender who finances the deal has to know if the borrower intends to include financing the freight besides financing the goods. Therefore, he or she will need to examine the charter party for the freight payment clause that shows the amount payable, by whom, when, and to whom payable.

- a. By whom payable: Charterer and bill of lading holder
- b. By when payable:
 - At port of loading; at time of loading or few days after loading
 - On delivery of mate's receipt or 'freight collect' bill of lading evidencing shipment based on fax copy
 - On delivery of freight invoice based on fax copy
 - On return of 'freight prepaid' bill of lading
- c. To whom payable, which depends on the charter party:
 - The shipowner
 - The agent of the shipowner, for example, shipbroker or ship manager representing the shipowner.
 - The disponent owner/time or voyage charterer.

If the freight is not paid, the shipowner or the disponent owner can have a lien on the cargo.

ii. Time Charter/Hire

In a time charter/hire, the ownership and possession of the ship (that is, master and crew under the shipowner's control) remain with the shipowner whose charter hire is generally calculated at a monthly rate on the tonnage of the vessel.

Operational management includes:

- a. Examine the charter party for the hire payment clause, which is usually payable every 30 days in advance
- b. As a rule, banks do not finance charter hire
- c. Any hire payment is treated like freight payment under a voyage charter that is evidenced by:
 - copy of freight collect bill of lading or mate's receipt evidencing shipment
 - copy of freight invoice

There is a risk of lien on a cargo by the ultimate shipowner if hire is paid to the disponent owner or the appointed agent and the latter does not pay the ultimate shipowner.

It is good advice to have a copy of the charter party if the borrower is purchasing on cost and freight (CFR) and cost, insurance, and freight (CIF) conditions from his or her supplier so as to ensure that the contract of carriage is in conformity with the contract of sale. If the purchase is on free on board (FOB) conditions, the borrower would have chartered the vessel himself and a copy of the charter party can be produced.

What to look for in a charter party:

- In a CFR or CIF purchase, the seller charters the vessel.
- In a FOB purchase, the buyer charters the vessel.
- Vessel's details: flag, age, owners, classification, protection and indemnity (P&I)¹⁸ club, and previous voyages.
- Issuance of bill of lading, letter of indemnity (LOI) for missing bill of lading.
- Countercheck such details with insurance broker engaged by the borrower or Lloyd's Register of Ships.

iii. Charter Party Bill of Lading

The bill of lading is the receipt given to the seller by the shipping company for goods accepted for carriage by sea. It identifies the shipper of the goods (seller) and

¹⁸ Protection and indemnity (P&I) relates to third party liability insurance for the shipowner, charterer, or operator.

the consignee (usually on the reverse), either in blank, which means that whoever holds the document holds title to the goods, or endorsed to the order of a named party. The bills of lading are issued in full sets with one, two, or three originals to a set. Although only one original is needed to obtain delivery of the goods, it is necessary to possess the full set of originals in order to exercise complete control over the goods. Non-negotiable copies, which are consigned, are not documents of title and are used only for record purposes. Banks, if they are interested in financing the supply chain, and a documentary credit is called for, would require a full set of originals, held or endorsed to their order as a pre-condition to the financing.

The International Chamber of Commerce has endorsed the bill of lading as acceptable within the Uniform Customs and Practice for Documentary Credits.

Charter party bills of lading do not contain the full conditions of carriage. These are detailed in a separate charter party agreement. Since commodity finance requires one single vessel, it usually will involve charter party shipments and banks have accepted charter party bills of lading even if the bills of lading do not contain the full conditions of carriage. However, the bill of lading has to be a title document.

There are many types of bills of lading as follows:

- Bearer bill of lading. A bill of lading that does not identify a consignee but is merely marked 'to order'. When a bearer bill is transferred to a third party, possession can be transferred without the need for endorsement of the bill.
- Order bill of lading. A bill of lading that names a consignee, for example, 'to Hong Kong, China Bank or order'. The consignee must endorse the bill of lading by signing the reverse of the bill when it transfers the document to a third party.
- Straight bill of lading. A bill of lading that names a consignee without the words such as 'to order'. It is a non-negotiable bill of lading; the consignee needs to identify himself to take delivery of the goods. Hence, it is not a document of title.
- Received for shipment bill of lading. A bill of lading that records receipt of the goods by the carrier at a time prior to when they are loaded onto the carrying vessel.
- Shipped bill of lading. A bill of lading which records receipt of the goods by the carrier at the time when they are loaded onto the carrying vessel.
- Freight collect bill of lading. A bill of lading showing freight is to be collected from the charterer/bill of lading holder in an FOB shipment.
- Freight prepaid bill of lading. A bill of lading marked in this manner will generally prevent the carrier from claiming freight from the bill of lading holder or from exercising a lien over its cargo.

iv. Shipowner as legal and actual carrier

A carrier is the party that is contractually liable under a bill of lading for the carriage of goods. A legal carrier is one who contracts directly with the charterer or sub-charterer and could be a:

- Shipowner's agent: at load and discharge port, or
- Shipowner's shipbroker: one who engages charterer for the shipowner

v. Disponent owner

Time charterer/voyage charterer who charters vessel from the shipowner and could be a:

- Charterer's agent: at load and discharge port, or
- Charterer's shipbroker: one who engages shipowner for a vessel

vi. Master/Captain

A master/captain is one who is in charge of the crew and the vessel.

vii. Authority to sign bill of lading

Only the shipowner or the master has the authority to appoint an agent to sign the bill of lading.

Sometimes, a sea waybill is also used. Unlike a marine bill of lading, the sea waybill does not confer title of the goods to the bearer, and as a result there is no need for the physical document to be presented for the goods to be released. The carrier will automatically release the goods to the consignee once the import formalities have been completed. This results in a much smoother flow of trade, and has allowed shipping lines to move toward 'electronic document interchange', which may ease the flow of global trade.

Nevertheless, for letter of credit and documentary collection transactions, it is important to retain title to the goods until the transaction is completed. This means that the bill of lading still remains a vital document in international trade.

If the bill of lading is declared to be non-negotiable, then it is not a true bill of lading and instead will be treated as a sea waybill.

Box 8. Case Study involving Shipowners' Non Compliance to Discharge Cargo at Specified Discharge Port

Glencore International AG, an international commodity trader, were buyers of 4 parcels of oil carried on three separate vessels a) Cherry from Kuwait to Fujairah and discharged in Fujairah, b) Epic from Kuwait and partially discharged in Fujairah, and c) Addax from Kuwait to Fujairah but never discharged at all, and d) oil transshipped from 'Hyperion' to Cherry at Fujairah and carried by Cherry to Singapore.

Glencore, owners of the bills of lading sued the owners for not discharging all of the cargo at Fujairah, the destination. Glencore also sued the owner of Cherry for transshipment, that is, discharging the cargo from Hyperion to Cherry and carrying it to Singapore. Glencore was the voyage charterer and bill of lading holder for the three cargoes. It did not have a contract with Cherry for the Hyperion cargo. Glencore claimed that the cargoes should have been completely discharged at Fujairah. Glencore sued the owners of Cherry, Epic, and Addax for the undischarged portion of the oil for breach of the bills of lading contract. Glencore sued the owners of Hyperion for conversion for lack of a contractual relationship.

The immediate seller of the cargoes was Metro who owned a floating storage in Fujairah. Metro was also the time charterer of the vessels. Glencore had an agreement to sell back the cargo to Metro once it arrived at Fujairah and the latter was free to re-sell the cargo. The shipowners followed the instructions of Metro. Glencore had instructed Metro to discharge the cargoes fully at Fujairah. These instructions were not communicated by Metro to the shipowners. The shipowners did not discharge all of the cargo in Fujairah, and against Metro's indemnity carried part of the cargo to Singapore and there disposed of it. The shipowners argued that a) Metro was acting as Glencore's agent in giving instructions to dispose of the cargo, b) the shipowners did not cause Glencore's loss as Metro would have sold all of the cargo if it was discharged and would not have paid Glencore anyway – Metro subsequently collapsed, and c) Glencore did not have the immediate right of possession of the Hyperion necessary to sue for its conversion. Glencore won this case for the three cargoes and the fourth cargo was appealed.

Court Judgment in Singapore:

- i. The rule that a carrier who delivers cargo without surrender of the original bills of lading does so at his own peril is long established. Neither the owner of the cargo nor anyone else can insist on the delivery of the cargo being made to him if he is unable to produce the bill of lading. The shipowners acted on instructions from Metro in full knowledge that Metro could not produce the bills at that stage. The shipowners knowingly committed acts that were in breach of contract

and to escape liability for doing so they would have to establish that Glencore had given the instructions on which they acted or could be deemed to have done so.

- ii. The Court of Appeal agreed with the trial judge that Glencore's instructions to Metro required full discharge of the cargo from the ships into the Fujairah facilities.
- iii. In the UK proceedings to which Metro, Glencore, and the shipowners were parties, the judgment of the English court had confirmed that Metro had no actual authority to dispose of the oil and were not entitled to use the oil as though it was their own from the moment of its arrival at Fujairah. This finding bound the shipowners in the Singapore proceedings.
- iv. The falsification of documents, like the ship's documents and telexes showing that the cargoes had been discharged in full when they had not, showed that the shipowners knew that Metro did not have authority to order the vessels not to discharge nor to deal with the cargoes as though they belonged to Metro.
- v. Metro invoked the time charter party clause in requesting discharge and delivery without production of the bills of lading. The shipowners therefore knew that they would be acting on the instructions of Metro as time charterers. Metro's instructions could not have constituted them Glencore's agents, let alone Glencore's agents for taking delivery of the cargoes.
- vi. The principles relating to implied actual authority did not assist the shipowners as the extent of Metro's actual authority as evidenced by Glencore's instructions to them was to arrange for the cargoes to be discharged at Fujairah and stored there. The authority was specific, not general.
- vii. The most relevant fact was that the oil was not put into the tanks. It was taken away. There was no evidence that had all the oil been put into the tanks in Fujairah, it or most of it would not have been there when Metro collapsed in a couple of months. As long as the oil or part of it was still in the facility when Metro collapsed, Glencore could have reclaimed it since contractually they retained title until payment. Even if they had transferred title, the remaining oil could have been the subject of execution proceedings.

In the case of the Hyperion cargo, a person has the right to sue for conversion if and only if he had, at the time of the conversion, either actual possession of, or the immediate right to possess, the goods converted. Being the owner of the goods allegedly converted is not always sufficient to entitle that person to immediate possession.

Source: Glencore Intl AG vs. owners of Cherry, Epic, and Addax. Singapore Supreme Court Case. April 2002 and November 2002.

X.4 Other Types of Bill of Lading

- i. A combined transport bill of lading is a document issued by an operator for the carriage of goods by at least two modes of transport, such as road/sea/road or rail/sea/road. It is used especially in container shipments.

Under the terms of the combined transport bill of lading, the carrier accepts ‘through liability’ for the contracts that he or she makes with subcontractors. The carrier is liable as soon as his or her subcontractor has received the goods from the shipper. The bill of lading provides for the carrier or shipowner to accept responsibility from the place of the goods acceptance to the place of the goods’ destination after discharge of the goods from the carrying vessel. This may involve a road/rail/canal transit to the departure port. The actual voyage(s) may involve a transshipment, and a journey from the final destination port embracing road, rail, or canal.

- ii. A transshipment bill of lading permits cargo to be transhipped from one vessel to another en route to reach the final destination, such as the UK to Singapore or Singapore to Bangkok under one document through freight rate.

X.5 Backdating Bills of Lading

A liner bill of lading is a negotiable document that embodies the Hague-Visby Rules and is found in the liner cargo trades. Antedating or backdating a bill of lading is:

- i. Where a sales contract or letter of credit provides for an express stipulation as to the time, time would usually be the essence of the contract of sale between the buyer and the seller. If the seller is unable to meet the shipment date, the buyer is entitled to rescind the contract.
- ii. The shipowner is liable for the consequences arising from antedating the bill of lading.
- iii. Antedating the bill of lading can be a basis for a claim in tort for fraudulent misrepresentation.
- iv. A letter of indemnity by the seller-shipper to the shipowner for issuing an antedated bill of lading is unenforceable.

Box 9. Backdating Bills of Lading Case

- i. Mr. Mehra was the managing director of Oakprime Ltd., a beneficiary under a letter of credit that had been issued by Incombank, a bank in Viet Nam, confirmed by Standard Chartered Bank (SCB), London. The credit was issued in connection with a CIF sale of Iranian bitumen by Oakprime to Vietranscimex, an organization in Viet Nam. A condition of the credit was ‘shipment must be effected not later than 25 October 1993’. The last date for negotiation was 10 November 1993.
- ii. Loading was delayed and Oakprime was unable to ship the goods before 25 October 1993. But the shipping company agents and shipowners (Pakistan National Shipping Corporation (PNSC) agreed with Mr. Mehra to issue bills of lading dated 25 October 1993 and did so on 8 November 1993, before the goods had been shipped. On 9 October, Oakprime presented the bill of lading and other documents to SCB under cover of a letter of credit signed by Mr. Mehra stating that (with one omission) the documents were all those required by the credit. This statement was false, a fact that was known by Mr. Mehra because he had arranged for the backdating of the bill of lading. The false statement was made to obtain payment under the letter of credit and it was agreed that if there had been no bill of lading or SCB had known that it was falsely dated, payment would not have been made. The omitted document was presented a few days later and certain other documents that had shown discrepancies from the terms of the credit were re-submitted after the final date for negotiation of the credit had passed. Notwithstanding that SCB knew that these documents had been presented late, it decided to waive late presentation. It authorized payment of USD 1,155,772.77 on 15 November 1993.
- iii. Then SCB sought reimbursement from Incombank. SCB sent a standard form letter that included a statement that the documents had been presented before the expiry date. A relevant employee of SCB knew this statement was false. Incombank, although unaware of both Mr. Mehra’s false dating of the bill of lading and SCB’s false dating of the presentation of the documents, rejected the documents on account of other discrepancies that SCB had not noticed. Despite further requests, SCB was unable to obtain reimbursement.
- iv. SCB then sued PNSC, the shipping agents, and Oakprime, and Mr. Mehta for deceit. They had all joined in issuing a false bill of lading intending it to be used to obtain payment from SCB under the credit. The judge ruled that they were all liable for damages to be assessed.
- v. PNSC appealed on the ground that the loss suffered by SCB had been partly the result of its own ‘fault’ and its damages should therefore be

reduced to such an extent as the court thought just and equitable. The judge would have accepted this argument, and reduced the damages by 25 percent. But the majority of the court held that SCB's conduct was not at fault because it was not in common law a defense to an action in deceit.

- vi. Mr. Mehra appealed on the ground that he made the fraudulent representation on behalf of Oakprime and not personally. The court unanimously upheld this ground of appeal. It ordered SCB to pay Mr. Mehra's costs before that court and three quarters of his costs at trial.
- vii. PNSC appealed against the decision that the damages could not be reduced and SCB appealed against the decision that Mr. Mehra was not personally liable. Shortly before the hearing, PNSC agreed to pay SCB USD 1,700,000, in full and final settlement of its claims to damages, interests, and costs.
- viii. At the end, counsel for SCB stated in open court that they were not seeking to enter judgment against Oakprime. But judgment was entered against the managing director, Mr. Mehra for having authorized, directed, and procured the deceit of SCB. Mr. Mehra was personally liable for tendering false bills of lading as constituting a representation that the contents of the bills were true and accurate. SCB also relied on the tendering of the shipping advice stating that the estimated time of arrival of the vessel was 15 November 1993.

Source: Standard Chartered Bank vs. Pakistan National Shipping Company, House of Lords. 6 November 2002.

Box 10. Case Study: Delivery by Carrier without Presentation of the Original Bills of Lading

This was an appeal by P&O Nedloyd and Maersk Line (the carriers). In February 2002 they had been adjudged liable to Utaniko and East West Corporation (the claimants) in consequence of container loads, which the claimants had shipped from Hong Kong, China and delivered to San Antonio to a Chilean company, Gold Crown, without presentation of the relevant bills of lading.

In those bills of lading, the claimants were named as shippers, Gold Crown was named as the notify party, and the goods were consigned to the order of certain Chilean banks to which the bills of lading were to be passed to enable them, as the shippers' agents, to collect the purchase price payable by Gold Crown.

The bills of lading were endorsed by the claimants (shippers) and sent to the banks in Chile. However, the goods remained as the claimants' property at all material times. None of the banks involved had any security interest in the bills of lading, which were held by them to the order of the claimants.

When the loaded containers arrived in San Antonio, the carriers' local agents placed them in licensed customs warehouses. Having paid the customs duty, Gold Crown's customs agent was able to obtain delivery, without having to present the original bills of lading (which remained in the possession of the Chilean banks). Gold Crown paid the claimants for some of the goods supplied, but failed to pay for seven container loads shipped with Maersk Line for two of the P&O container loads.

Ultimately, the bills were re-delivered (but not endorsed) back to the claimants by the banks.

The Court of Appeals dealt with the principal issues raised in the proceedings as follows:

i. Title to Sue

The bills of lading were governed by English law. The effect of Sections 2 and 5 of the Carriage of Goods by Sea Act of 1992 was that, by identifying the Chilean banks as consignees in the bills of lading and delivering the bills so that the banks for the purpose of collecting the purchase price, the claimants transferred all contractual rights of action against the carriers to the banks. Moreover, the claimants acquired no contractual rights of suit when the bills were re-delivered to them by the banks, because of the banks' failure to endorse the bills back to the claimants.

Nevertheless, the court agreed with the trial judge that the claimants' inability to claim in contract under the bills of lading was not fatal to their claims. The correct analysis was that the claimants were the original bailors of the goods to the carriers, and that bailment continued despite the delivery of the bills of lading and the transfer of contractual rights under the bills of lading to the banks. The claimants retained the right to the immediate possession of the goods at all material times, and were on that basis entitled to hold the carriers responsible in bailment for any loss or damage resulting from the carriers' breach of duty as bailees.

ii. Carriers' Breach of Duty

The carriers were in breach of duty as bailees because of their failure either to deliver the goods to a person entitled to them against presentation of original bills of lading, or when parting with possession

of the goods to warehousemen, to arrange for such third parties to be under similar obligations regarding delivery. Such breach was causative of the claimants' loss of their goods.

The judgment of the Commercial Court in favor of the claimants was upheld.

Source: Waltsons and More. Carriage of Goods by Sea. P&O Nedloyd vs. Utaniko. February 2003.

X.6 Mate's Receipt

This is a document issued immediately by an authorized official of the ship, to the shipper for cargo loaded on board the vessel. The receipt is called a mate's receipt, an interim document until the bill of lading is issued. It is a declaration of the receipt of the goods by the ship for shipment or receipt of goods on board. It is later exchanged for a bill of lading at the land office of the shipping company.

Mate's receipts have the same information as bills of lading.

X.7 Forwarders Certificate of Receipt (FCR)

This is a shipping document or a land transport document that a freight forwarder issues. The purpose of an FCR is to certify that the freight forwarder had taken possession of the goods with irrevocable instructions to deliver them to the named consignee or to his or her order. This is principally used when the supplier sells the goods ex works (EXW) or when the goods are being dispatched via a freight forwarder's groupage service and a recognized document is needed to prove that the goods are no longer in the control of the seller. This is a non-title document and banks normally would not accept such a document unless the borrower is a large company and is creditworthy.

Since the FCR is not a title document, it offers very little or no security. However, it is a commonly used transport document particularly when the goods need to be transported over land as in EXW. Banks cannot change the way the traders deal with for example, steel mills who would like to be paid upon loading their cargo on trucks or trains, but at least, banks try to control and mitigate these in land risks. One mitigation is by way of insurance during land transport.

Whenever a company asks for financing under FCR documents, the goods as much as possible should be at the port awaiting shipment. Once the freight forwarder has delivered the goods at the port for shipment, the beneficiary to the letter of credit can draw on the letter of credit that normally calls for simple documentation such as a commercial invoice and the FCR.

The company can deliver the goods at the port through a freight forwarder and can use the FCR to draw on the letter of credit and ease its cash flow with an earlier drawing.

The financing bank may feel more secure if the goods are at port awaiting shipment and properly insured. The company could provide the bank with a side letter with wording to the effect that:

... the letter of credit is negotiated with a forwarder certificate of receipt (FCR) instead of full set bills of lading made out to the order of the financing bank and that the company hereby confirms that the goods covered under the above mentioned letter of credit which are stored at port in the place of origin, are the property of the bank until such time as shipment takes place and bills of lading in compliance with the above letter of credit's terms are in the possession of the bank.

Furthermore, the company also undertakes to insure the goods at port in the place of origin and hereby confirms that the interest of the bank is noted on the relevant insurance policy.

X.8 Air Transport Documents – Air Waybill

Some goods in the supply chain are transported by air. The great majority of the goods conveyed by air are on scheduled airline services as distinct from chartered services.

An air waybill is a transport document issued confirming the acceptance of goods for carriage and accompanies goods conveyed by the airline throughout the transit. It is an air consignment note. It is not a negotiable instrument or document of title to goods. Overall, it is a receipt for the goods for dispatch and is *prima facie* evidence of the conditions of carriage. The main functions of the air waybill are a contract of carriage and a receipt of goods. At destination airports, the air waybill serves as a basic document for verification to the consignee, customs clearance, and delivery to consignee. The air waybill is ratified by almost every economy in the world. This permits interchangeability of the document throughout the transit, thereby permitting cargo transported by air.

House Air Waybill. This is an airway bill issued by forwarding agents for air freight consolidated shipments. It is equivalent to the air waybill in documentary operations as long as it is clear that the issuer assumes liability as the carrier or acts as agent of the named carrier. It is issued by the forwarder and countersigned by the carrier airline.

X.9 Land Transport Document

Railway Receipt

When cargo is transported by land using railway receipts, these transport documents are not documents of title. This is usual for delivered at frontier (DAF) or free carrier (FCA) when cargo has to be transported by land across the frontier or until it reaches the port.

XI. Commonly Used Documents in the Supply Chain

XI.1 Commercial Documents

i. Sales Contract

Whenever a seller and a buyer enter into an agreement detailing the goods to be bought or sold between them and the terms in which the sale and purchase will be performed by the parties, this arrangement is a sales contract. Usually, the sales contract contains the following:

- a. Names and address of the buyer and seller
- b. Description and quantity of the commodity
- c. Time and place of delivery (port of shipment)
- d. INCO Terms (CIF, CFR, FOB, among others)
- e. Unit price
- f. Time and place of destination
- g. Terms of payment – letter of credit, documents against payment, documents against acceptance, open account
- h. Details of shipment
- i. Documentary requirement
- j. Jurisdiction, governing law and arbitration clause, among others

The contents of the contract, especially the terms of sale, will have to be matched with the terms and conditions of the letter of credit. If the seller is not comfortable with the buyer's economy due to political risks, it may on its own, separate from the sales contract, obtain political insurance which can cover incidents of confiscation by customs officials. The political risks should be assessed and suitable political insurance cover should be obtained if necessary.

The place of jurisdiction, governing law, and arbitration clauses should be stated in the sales contract for resolving disputes that may arise.

Besides the contract of sale, other commercial contracts could include supply contract, offtake contract, tolling contract, which are part of the commercial considerations into which the parties enter.

Box 11. Case Study on Arbitration Issue

Concordia Trading had entered into a warehousing agreement with Cornelder Hoogewerff to provide warehousing services. It was provided in the agreement based on clause 8.3 that the liability of Cornelder Hoogewerff to Concordia Trading in respect to claims for loss or damages, or expenses arising from the commodities or in respect to the warehousing management operations shall be subject to the Cornelder's warehousing and forwarding conditions to the extent not specified in the agreement.

It was also provided in the warehousing conditions of clause 38 that all disputes which may arise between Concordia and Cornelder Hoogewerff shall be referred to Arbitration under and in accordance with the Arbitration Act.

Concordia made a claim to arbitration over an alleged shortfall and deterioration of the goods. Cornelder Hoogewerff declined arbitration and took no steps to appoint arbitrators. Concordia applied to appoint arbitrators but was not successful.

On appeal to the High Court, Concordia argued that clause 8.3 of the Agreement, incorporated, by reference, the warehousing conditions, including clause 38 which provided for arbitration.

The appeal was dismissed by the High Court.

The decision: The correct construction of Clause 8.3 'that it would only be the 'liability' to the 'extent not specified by the Agreement' that would be 'subjected to' warehousing conditions and 'liability' does not include settlement of disputes.

Clause 8.3 referring to 'liability' should have been one of extended meaning, one which includes resolving disputes. The clause should have been constructed as follows: The liability of the parties shall be subject to warehousing conditions including the arbitration clause.

Source: Singapore Law Reports. Concordia Trading Pte Ltd. vs. Cornelder Hoogewerff Singapore Pte Ltd. 1999.

ii. Supply contract

This is an agreement between a seller to sell and deliver and the purchaser to buy the products specified. It forms part of commercial documents.

iii. Offtake contract

This is an agreement entered into between a producer and a buyer to buy/sell a certain amount for future production. This agreement is common when production is involved and forms part of commercial documents.

iv. Tolling contract

A tolling contract involves the provision of raw materials for conversion into finished goods where the party providing the raw materials commits to take back the finished goods from the producer and pays the producer a fee, called tolling fee. The finished product remains the property of the owner of the raw material.

XI.2 Transport Documents

Please refer to section X for a brief description of the following transport documents.

- i. Marine Transport – bill of lading, mate’s receipt, FCR
- ii. Land Transport – FCR, railway receipt
- iii. Air Transport – air waybill

XI.3 Financial Documents

i. Offer letter

This letter is a letter that is given by a bank to a prospective customer outlining the terms and conditions that the bank is willing to provide for the customer to consider but is non-binding and is for indication purposes only.

ii. Facility/loan agreement

The facility or loan agreement is a binding agreement in which the bank is prepared to provide a loan facility according to the terms and conditions mutually agreed between the bank and the customer.

iii. Insurance policies

Insurance policies which are required before the lender commits to grant a facility which may include marine insurance, property insurance, trade credit insurance, non-performance risk insurance which are the typical insurance related to supply chain and trade finance.

XI.4 Security Documents and Security Interest

i. Collateral Management Agreement/Fiduciary Deed of Transfer

This document is used in warehouse receipt financing, which is an agreement between three parties: the bank, the borrower, and the warehouse operator. This three party agreement defines the duties and responsibilities of each of the parties.

ii. Trust Receipts

When a bank releases the bills of lading which are title documents, it does so based on the trust it places on the borrower and against an execution of a document where the borrower undertakes to hold the proceeds of the sale of the goods ‘in trust’ for the financing bank. This document is called the ‘trust receipt’ and gives the financing bank the right to initiate action against the borrower to recover the amounts due in the event of the borrower’s default.

This trust receipt is essential to monitor and maintain continuing security.

iii. Pledge Agreement

This involves the physical or constructive possession of an asset by a creditor by way of security. Ownership remains with the pledgor (primary obligor or depositor of the goods) but the pledgee (bank who is the beneficiary of the pledge) will enjoy the right to liquidation of the asset in case of default of the pledgor according to procedure of disposal or sale. However, the rule may vary in each jurisdiction as to whether you can sell at arms length or whether the sale has to be a public auctioned sale or judiciary sale.

iv. Assignment

Assignments are intangible assets such as debts and rights under contracts (sales contract, offtake contract) and can take the form of a security. It is not concerned with fixed assets or goods. It is the immediate transfer of an existing right from the assignor to the assignee. Only the benefits under a contract can be assigned. In the case of a trade debt, the party who is entitled to sue a debtor for payment, transfers this right to sue the debtor in his or her place by means of an assignment. The term to describe the transfer of ownership of a right of action is called assignment. If the assignment is in writing, it is a legal assignment; otherwise it is an equitable assignment.

v. Charge

A charge does not depend on either a transfer of ownership or the delivery of possession. It does not constitute a transfer of ownership. A charge retains both the possession and title to the asset that is the subject of charge so that if the customer defaults, the bank has the right to seize the charged property and sell it in satisfaction of the debt. The critical consideration of charge is the degree of

freedom the chargor company has in dealing with the charged asset in the normal course of business. If the charge is a fixed charge, the bank has sufficient control of the charge property to prevent the chargor company in dealing with them in the normal course of business.

There are two types of charges:

- a. A fixed charge is granted over one or more specific assets. If an asset is subject to a fixed charge, the customer cannot deal with or sell the asset. The asset is said to be encumbered to the bank. Fixed charge is usually used over factory premises or machinery and/or equipment.
- b. A floating charge is granted over an asset but ‘floats’ over a class of assets generally. This is the case of inventory that is used in the ordinary course of business in order to generate income and is unencumbered. The bank has a floating charge over a class of assets that are constantly changing in nature, as the inventory is sold or replenished. The floating charge becomes fixed to specific assets when the charge is ‘crystallized’ and this happens when an event triggers the floating charge to settle on a particular asset or assets.

The following events may result in the crystallization of a floating charge:

- appointment of receiver over borrower’s assets
- borrower goes into liquidation or ceases to carry on business
- borrower attempts to create any other encumbrance over its assets which would have priority over the floating charge

The above charges need to be registered with the relevant authorities (for example, land registry for legal mortgage and registrar of companies) within 30 days. Any person dealing with a company is deemed to have constructive notice of all charges created over the company’s assets. The failure to register a charge may render the charge void against the liquidator (although the underlying debt may still be valid and rank the creditor as an unsecured creditor). The priority of competing charges also depends on the date and time when the charge is registered. The floating charge is invariably accompanied by a negative pledge clause that precludes the borrower from creating later charges with priority to, or ranking *pari passu* with, the floating charge. In addition to registering the floating charge, the bank will also register the negative pledge.

For all these security documents, what is crucial is the jurisdiction where these documents can be enforced and whether they are in fact enforceable.

XII. Insurance

XII.1 Marine Insurance

Cargo insurance, involving the maritime transport of goods from one economy to another, is indispensable to international trade as well as to protect the interests of those involved in the transport of these goods. Banks may decline to finance goods in transit if the cargo is not protected by insurance.

Most marine insurance is handled through the intermediary of an insurance broker. He or she is the agent of the insured party.

- i. Who insures the goods will depend on the shipping (INCO) terms:
 - For cost, insurance, freight (CIF), it is the seller's responsibility to insure the cargo.
 - For free on board (FOB) and cost and freight (CFR), it is the buyer's responsibility to insure the cargo.
- ii. Types of marine insurance:
 - Institute of Cargo Clause A covers 'all risks' except for express inclusions, for example, war and strikes, and is established on a voyage basis defined in the transit clause, as extending from warehouse to warehouse.
 - Institute of Cargo Clauses B and C are nominated perils cover subject to express exclusions. The nominated perils in the C clauses are more limited than in the B clauses.

War and strikes clauses are usually added and give cover against risk of war, strikes, riots, and civil commotion with the payment of an additional premium.

Box 12. Case involving Cargo Insurance

This involves the financing of a small edible oil trading house by an international bank on a transactional and secured basis. Unfortunately, the company got into financial difficulties and could not repay the balance of the loan outstanding. As security, the bank had full set bills of lading for goods shipped from Malaysia to India. The bank took action against the shipping company who agreed to release the cargo against a letter of indemnity (LOI) countersigned by a prime bank in India.

Although the vessel was insured with the UK P&I Club, the borrower stated that they could not provide security on behalf of the shipping company since delivery of the cargo without the bills of lading was a breach of their P&I cover. The prime bank informed that the employee who countersigned on

the LOI was not authorized and they could not refute the bank stamp. The financing bank engaged the services of Maritime Services to track down the movement of the vessel so that the bank could obtain security for the loan. However, Lloyd's was not able to provide the timely information. The financing bank realized that it had cargo insurance in blank (as co-insured) so that the bank had the authority to execute the policy by typing its name on the back of the policy. As such, it was able to file cargo claim insurance through a broker for the loss of the cargo. Twelve months later the financing bank was able to recover the money owed including interests and legal costs.

Source: Author (actual case but unable to disclose the parties)

Box 13. Case involving Loan Insurance

The financing bank participated in a transaction behind an international trading company in the pre-financing of edible oil from Indonesia to be delivered over a year. The bank's participation together with two other banks was for the insured portion with the international trading company taking up the uninsured portion. Due to falling prices and the money being siphoned to the Cook Islands, the borrower defaulted and could not pay.

A claim was made to the underwriters, one of them being HIH, Australia's second largest insurance company, which later went into liquidation. Six months after the claim was made, the financing bank recovered the whole amount of loan outstanding from the insolvent underwriter.

Source: Author (actual case but unable to disclose the parties)

Lessons could be learned from these two cases. Secured lending means that when traders have difficulties, they can rely on their securities, insurance being one of them and an important one, even if it takes a long time, except when it is pure fraud. The time spent to recover the money should not be discounted. Not only is the reputation of the insurance company important, but also the reputation of the broker, who is the link between the ultimate insurance company and the insured party.

XII.2 Trade Credit Risk Insurance

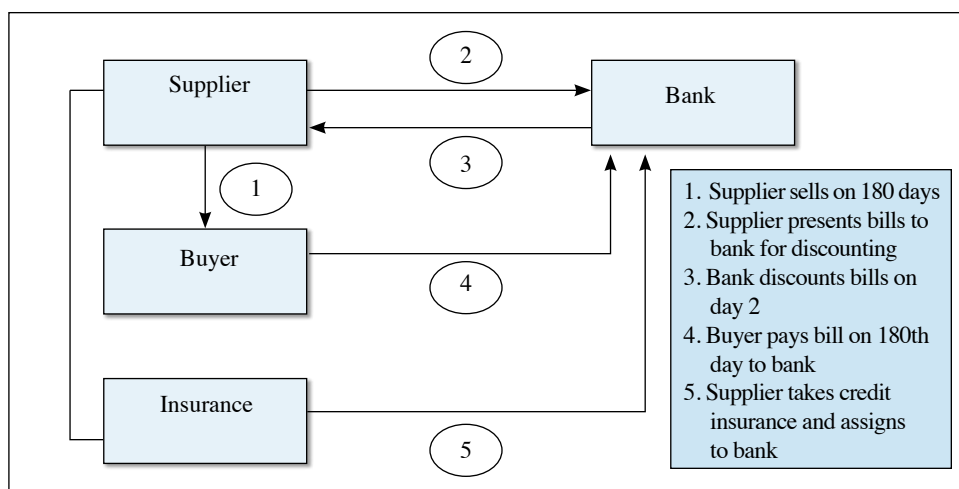
Credit insurance is to provide protection to exporters of goods and services who sell their goods on credit terms. The exporter is insured against losses arising from a wide spectrum of risk, which could either be commercial or political.

- i. Features of trade credit insurance (commercial cover)
 - a. Insolvency of buyer
 - b. Non-payment of goods
 - c. Non-acceptance of goods

Usually the indemnity is for 90 percent cover. It could include pre- and post-shipment cover.

- ii. Features of political insurance:
 - a. Confiscation, expropriation, nationalization
 - b. Currency inconvertibility/exchange transfer
 - c. Cancellation of import/export license
 - d. Political violence, war, riots
 - e. Breach of contract
- iii. Application of trade credit insurance
 - a. Bills discounting
 - b. Working capital
 - c. Advance payment guarantee. Figure 10 illustrates how SMEs can avail of trade credit insurance to obtain financing.

Figure 10: Example of Trade Credit Insurance for Bills Discounting



Source: AON. "Trade and Political Insurance". Presentation at Singapore Business Federation conference. (2004).

XII.3 Property Insurance and Fidelity Insurance

These types of insurance usually are appropriate for warehouse receipt financing.

XII.4 Export Credit Insurance

When it is applied to trade finance, this is usually short term and covers a period of not more than 180 days. Protection includes pre-shipment and post-shipment risks. It can also be covered against commercial and political risks.

There are specialized institutions that provide export credit insurance. There are also export credit guarantees that are instruments to safeguard export financing banks from losses that may occur from providing funds to exporters. While export credit insurance protects exporters, guarantees protect banks offering the loans. They do not involve the actual provision of funds, but the exporters' access to financing is facilitated. These instruments are useful to SMEs that are exporting to economies where there is a lack of knowledge on the creditworthiness of the buyer.

The role of government in trade financing is crucial particularly to emerging economies. Governments can play a direct role in the provision of credit guarantees.

XIII. Type of Traded Products

XIII.1 Oil and Petroleum Products

Oil, one of the main sources of energy, is the most stringently controlled seaborne cargo. Due to its unique features, the classic supply chain may not necessarily apply to oil since it has different ways of transporting the commodity according to the purposes for which it is to be used or the relevant legal requirements governing it. It has its own special characteristics that are reflected in the terms of sale, transport, and insurance contracts.

Oil has several markets – wet (physical), derivatives, paper (non physical), and electronic. Sale transactions have developed unique forms of trading. It may be bought and sold in the 'spot market' and may change hands to form a 'string' or a 'daisy chain'. Paper barrels are used in 'futures' and 'options' and so the seller does not need to come up with the oil.

Many political and economic factors have left their mark on oil trading and were instrumental in creating and liberating the markets. Oil enjoys diverse sources of supply as a result of the use of production sharing agreements, joint ventures, the appearance of independent oil companies and traders. However, some large oil traders that exist today started out as SMEs.

- i. The novel feature of oil trading is the incorporation of undertakings and indemnities deriving from international conventions. The contract of sale combines commercial and international law principles. Some of these

international law principles for oil include laws governing oil pollution and protection of the marine environment and these laws could include comprehensive pieces of legislation.

- ii. Frequently, traders and oil companies buy and sell oil several times at various prices in a series of matched contracts. The string of transactions is referred to as daisy chain. The name of a trader or the oil company may appear more than once in the chain and thus a circle would be set up.

The string or circle is a series of transactions in which each of the parties, except the first and the last, is both a buyer and seller. Each contract involved in the string must be for a commodity of the same description, for delivery at the same port(s), governed by the same standard terms and with compatible quantities and delivery periods. The only difference will be in the price. Each contract stands on its own. When a party becomes bankrupt, he or she will not be disregarded in circle settlement.

Thus in a FOB sale (the buyer nominates the vessel), after the vessel's nomination reaches the seller, he or she will designate the loading port/berth. This information will be transmitted through the string to the last buyer. As soon as the oil is loaded on board the ship, a delivery notice will be sent by the seller and will go through the string to the last buyer.

- iii. Payment Undertaking

The payment undertaking does not impose any additional burden on the buyer over and above that already agreed in the purchase/sales contract. It is however a separate formal irrevocable document addressed directly to the designated bank by the seller. This payment undertaking is usually involved when the trader sells a cargo to a highly creditworthy oil company which will not provide a letter of credit due to its excellent rating. The oil financing bank will ask the oil major to issue an irrevocable payment undertaking to pay for the cargo if it is delivered as agreed in the purchase/sales contract. In addition, the payment is routed to the account of the trader at the specific bank.

With this payment instrument, the seller can fully and flexibly use its lines of credit without having to issue a documentary credit, while the buyer's reputation can be enhanced by building a history of prompt payments with international banks. Today, the irrevocable payment undertaking has been widely accepted and is used.

- iv. Letter of Indemnity (LOI)

The LOI has evolved as a practical solution when goods are sold while still at sea. When the cargo is at sea, it is difficult to have credit documents processed through the commercial chain at the same speed. The seller of the cargo will have to declare that he or she is the owner of the goods, that he or she is

entitled to sell them, and that he or she is prepared to bear all the consequences of missing bills of lading. The issue is that bills of lading do not always travel quickly or by the most direct route. The buyer's bank will have to pay against this LOI. Hence, the mechanism to secure payment has been devised and has been widely accepted.

The LOI is issued by oil majors, first class oil trading companies, or prominent producers. The buyer may request the seller's bank to countersign the LOI as additional security if the supplier is of less prominence than the oil majors. Although the LOI cannot replace a fine instrument such as the bill of lading, practitioners in the oil trade, both bankers and traders, have long used this payment instrument that today it is internationally accepted. Nearly all letters of credit allow the option to draw against bills of lading or LOI.

XIII.2 Raw Materials (Raw or Semi-processed Form)

These products are usually agricultural crops such as grains and metal products, which have yet to be converted into finished goods and are traded in their natural form.

The transport and financing of raw materials can take various stages as follows:

- i. Pre-crop loan
- ii. Storage at the place of production
- iii. Transport towards the loading port
- iv. Temporary storage at the port
- v. Transport towards an independent warehouse for long term storage awaiting sale

XIII.3 Raw Materials on Land

These are usually at a fixed place before and after transport. They can be stored provisionally at the loading or discharge port awaiting further transport as they are part of a re-sale of the chain or separated from the chain as for instance, medium- or long-term storage at the destination for progressive sale or strategic stocks.

The storage will be part of the supply chain in the context of subsequent resale or further processing of finished goods for further sale.

- i. Mark to market. Raw materials/stocks on land which are placed in storage will have to be subject to market valuation on a regular basis, referred to as mark to market, which means that the value of the stocks in storage shall be valued at an agreed percentage of its market value in relation to its financing. Thus if the financing is based on 80 percent of its market valuation, should the market value of the stocks fall below this agreed ratio, the customer is obliged to put

more stocks in storage. This is applicable when the financing requires mark to market monitoring.

- ii. Source of repayment. If stocks are meant for further sale, there is also a repayment monitoring such that the stocks at a certain point in time, should be ready for further shipment to a final buyer, and the proceeds of this sale will be used to settle the stock financing.
- iii. Collateral management agreement. If stocks are to be held in storage for an indefinite period of time, the storage should be subject to a collateral management agreement.

XIII.4 Floating Stocks

This refers to raw materials that are in transit, on board a vessel on their way to a discharge port. The stocks will be used as a security for financing and the security is the bills of lading held to the order of the financing bank.

XIII.5 General Trade Merchandise (Manufactured Goods)

This refers to general merchandise that does not require any specific form of finance apart from general credit facilities. The security is not the underlying cargo, but the financial condition of the trader's balance sheet.

XIV. Structured Trade Finance in the Supply Chain

XIV.1 Structured Trade Finance

Structured trade finance moves beyond traditional trade finance wherein it makes use of commercially viable financing and finances products around the basic trade flow. It usually deals with cross-border trade where the beneficiary of the financing is usually in a high-risk economy and where the repayment is the liquidation or the sale of the commodity. It is a structure where pre-financing or post-financing may be involved. It focuses on financing the commodity rather than the borrower or trader especially if the trader does not have sufficient financial strength to obtain traditional banking facilities. The transaction comes from isolating the trader from the commodities that are used as security for repayment.

Whether it is production, processing, or simple trading, the credit risks could be mitigated in various ways; security can be taken on the commodity financed as the collateral. The title to the goods is crucial since the commodity is the source of collateral. The enforcement of the security with regards to the governing law is

emphasized and the jurisdiction where the transaction is taking place has to be well defined.

Risks can be mitigated through the use of credit enhancements such as insurance contracts, hedging, or demand guarantees. The finance is usually in two phases, namely: (1) to structure the deal with an appropriate credit facility with a repayment schedule; and (2) to find a security for the risk exposure. There is no fixed structure but a matter of finding specific credit enhancements to reduce the risk and using generic banking products.

Structured trade finance is usually related to goods being financed prior to production, and sold in a progressive stage that will form the resulting cash flow. Every structure is unique, although there are some commonly seen structures.

Structured finance is useful when the borrower is located in a risky economy. It could be relevant for SMEs without a track record since the transaction is self liquidating and not reliant on a historical balance sheet. The focus that matters is the ability of the trader to perform his or her obligations in the transaction. In structured finance, the main obstacles are the lack of understanding and awareness of the financing techniques, legal and regulatory issues that could pose barriers (for example, restrictions on escrow accounts, the inability to execute a proper pledge, the uncertainty of enforcement of a security, and the ambiguity of title to the goods). The range of alternatives available to finance SMEs via structured finance could widen with government support since most transactions are designed on an ad hoc basis.

XIV.2 Basic Structuring Techniques

The creation of structured finance depends on a broad spectrum of factors but could also be systematic.

- i. Identification of the source of repayment since the structure is self liquidating. Are the goods pre-sold? Is the payment going into a dedicated collection or escrow account? Are the payments going to an overseas account in case the borrower happens to be in a risky economy?
- ii. Creation of a flow chart from the time the funds are disbursed, to the time the repayment is received. Which part of the chain has the heaviest risk? Which risk could be mitigated and which risks could be absorbed? Could these risks be shifted to other parties, for example, the insurer, or hedger, or warehouse manager?
- iii. What is the rationale of the financing request? Is it disguised working capital or is it for a specific financing need, such as for procurement of raw materials?
- iv. What are the transportation risks involved? Which part of the supply chain could be secured in terms of controlling the goods? What documents of title

could be obtained during the transportation flow from the point of origin to the point of discharge? A flow chart may be needed to trace the documents flow, the goods flow, and the payment flow.

- v. If the amount is significant, can this be shared to other financiers by means of club deals or syndications? How much over collateralization is needed if the commodity has an inherent price risk?

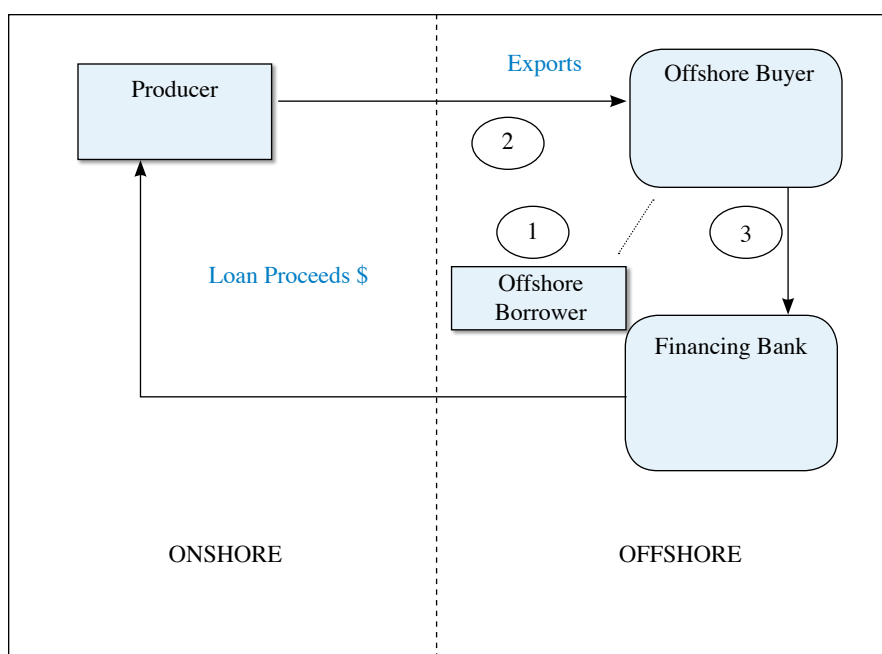
The answers to the above questions may determine whether it is worthwhile to proceed with the structure, revise the structure, and close the deal. As it appears, it may be something for SMEs to start with, especially if traditional working capital is not accessible.

XIV.3 Common Forms of Structured Finance

i. Pre-Export Finance

Pre-export finance is a form of structured finance using self-liquidating offshore cash flows generated from the exports of commodities to mitigate credit and transfer risks. The borrower is the exporter who needs to sell the finished goods after they have been produced. This is a combination of the performance risk of the producer who is located onshore (perhaps in a high-risk economy), and the payment risk of the overseas buyer (offshore) (Figure 11).

Figure 11: Pre-export Finance



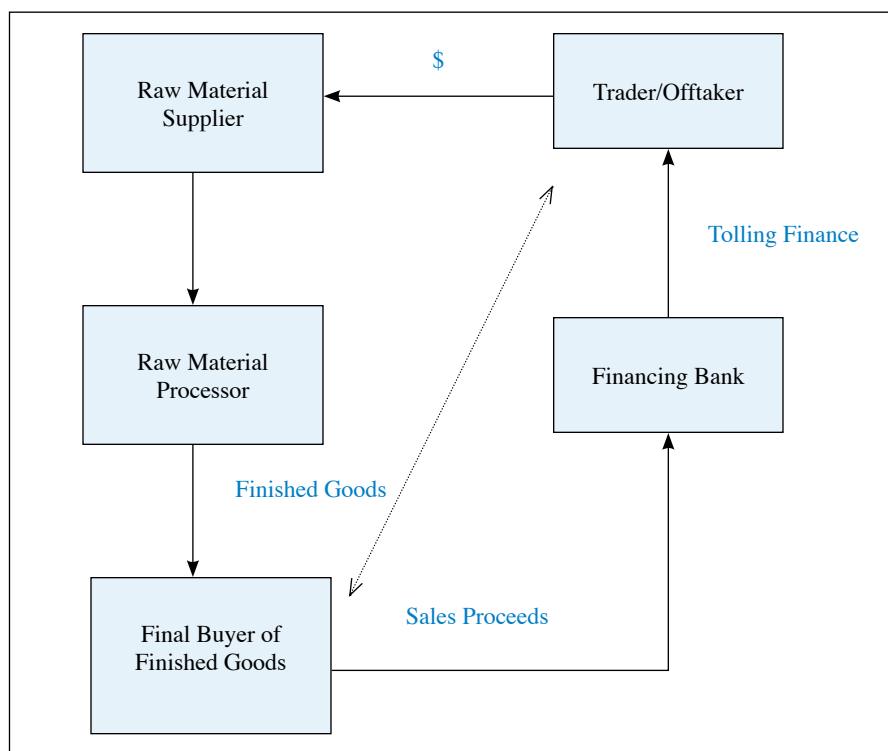
Source: Prepared by author.

ii. Tolling Finance

Tolling finance involves financing the conversion of raw materials into finished products where the borrower delivers raw materials to an emerging market processor secured by cash flows from the delivery of finished goods. The borrower is usually the offtaker of the finished goods and sells them to a final buyer overseas.

The processor receives a tolling fee for his or her services. The supplier of raw materials takes a performance risk on the processor. The bank usually assumes the performance risk on the processor. In tolling finance there is more control of the use of funds, which are directly tied to the processing of the raw materials (Figure 12).

Figure 12: Tolling Finance



Source: Prepared by author.

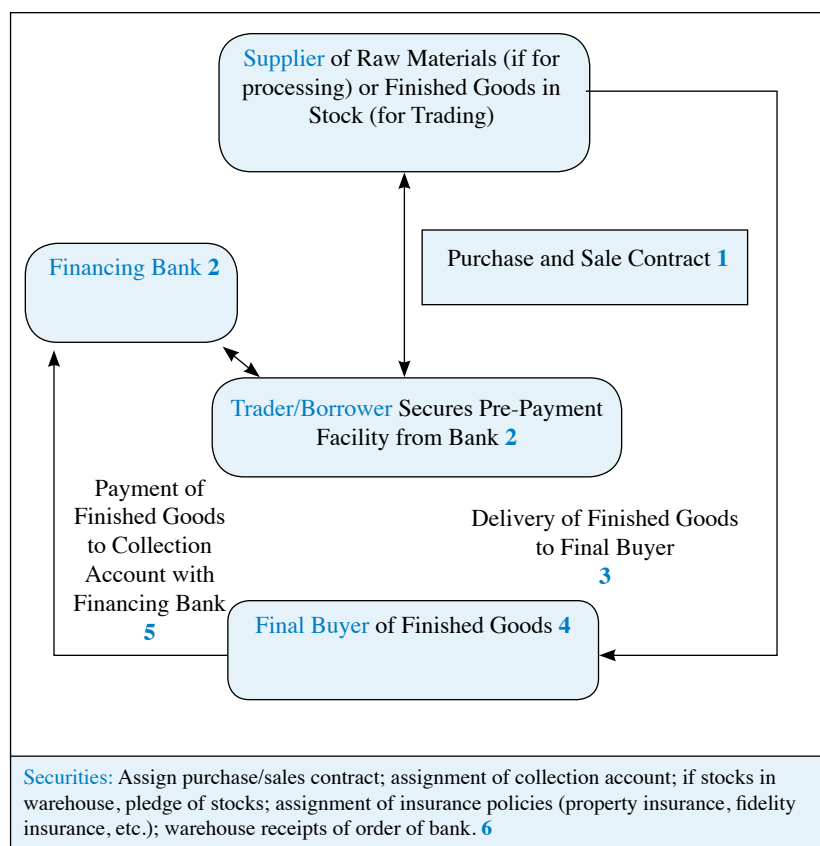
iii. Pre-payment Finance

This is a payment in advance to a borrower who may or may not be linked to exports. The borrower is the customer of the financing bank who is seeking finance in order to make some advances to a producer. The funds could be for working capital, or for machinery, or others, and may not necessarily be for the procurement of raw materials. This is of a higher risk than pre-export finance where the use of funds is clearly for raw materials to be processed into finished goods and exported. Pre-payment can also be used for plant expansion but the repayment source comes from sales of the underlying products to be sold.

Another example of pre-payment is the form of advance payment to an international trader to make payments to local companies, for example, Indonesia, Viet Nam, and China for the purchase of raw materials. These could be already stored in a warehouse or to be procured from farmers. In this case, the borrower can have the title to the goods he or she has purchased. If the goods are pre-sold, the borrower can assign the pre-sold contracts to his or her banker. Pre-payment can also be a form of limited recourse finance as discussed earlier (Figure 13). The flow is as follows:

1. Purchase and sale contract between the supplier of raw materials and the borrower, assuming production is involved
2. Borrower (trader) seeks a pre-payment finance facility from a bank for the production of finished goods
3. Finished goods are delivered to the final buyer
- 4-5. Final buyer pays into a designated collection account with the borrower's bank
6. Basic securities: Assignment of Purchase Contract, Sales Contract, Collection Account, Insurance policies, Pledge of Stocks (warehouse receipt finance)

Figure 13: Generic Structure of Pre-payment Finance



Source: Prepared by author.

iv. Inventory Finance by Means of Warehouse Receipts

This was discussed at length in Section 3 of this report. This type of financing eliminates performance risk as the goods are physically stored in the warehouse, but the political risks remain as the goods need to get out of the economy. Moreover, the banks need a good back office since the goods, which are the subject of collateral, need to be monitored and re-valued based on their market value. Transport risks are real in their own right. A good collateral manager on the ground is essential, otherwise the lenders are susceptible to fraud.

Other key questions to be raised when doing structured inventory finance are: a) Are the goods easily convertible into cash in case they are not pre-sold? b) Are the goods exportable if the domestic buyer refuses to honor the contract of purchase and can an export license be easily obtained? c) Can they be protected from price erosion through hedging? d) If they are insured, where is the place to make a claim – offshore or onshore?

v. Finance against Cash Flow

In this type of structure, the emphasis is ringfencing the cash flow sufficiently so that no other creditor can break it open and divert the cash. The funds that are used as repayment will be placed in a dedicated collection account that will have to be assigned to the lender. This is connected to the assignment of the export or sales contract if the repayment is coming from the exports. The assignment of the export contract is a means to prevent third parties from attaching that particular cash flow by a court order and it allows the lender to take the position of the offtaker to collect the goods and liquidate the assigned contract itself.

vi. Offshore cash flow

If the sales proceeds are remitted to an offshore cash flow, it immediately eliminates the foreign exchange and transfer risk. It may happen that economies may want repatriation of export proceeds, but this is not usually the case. This can be structured as a pre-payment instead of as a pre-export, thus eliminating the export angle of the transaction.

Offshore cash flows where the sales proceeds are remitted eliminate political risk in terms of funds transfer and currency convertibility.

Onshore cash flows are suitable provided there is pre-approved currency convertibility so that when the time to settle the principal and interest arrives, there is no problem of foreign exchange transfer offshore.

XIV.4 Enhancement to the Structure/Credit Enhancement

The evaluation of the risks will dictate the type of structure to be created. The structure will revolve around the available risk mitigants, the payment instrument, the repayment schedule, the securities available, application of regulatory issues,

the duration of the risks, and the ringfencing of the cash flows from export proceeds. This is an exercise of matching the financing needs with a specific structured solution.

i. Insurance

Besides the usual property marine insurance, structured trade can be built upon third party credit enhancements such as export credit backing or political insurance, fidelity insurance or property insurance. The insurance, which can be procured from the private insurance market, can cover non-honoring of debt, insolvency, delayed payment also known as protracted default, expropriation, non-honoring of contract, contract frustration, and currency inconvertibility.

ii. Collateral Management or Inspection Companies

A reliable creditworthy collateral management company can make a difference with regards to warehouse receipt financing. This is crucial as the control of the goods whilst in storage is in the hands of the collateral manager.

Fraud is a risk that must be considered and there is no better way to mitigate this risk than to use a reputable collateral manager. Regular visits to the warehouse should be done to match stocks in storage against the warehouse receipts that allowed the release of the goods. History has shown that the same goods can be financed many times over by several banks with each bank receiving allegedly warehouse receipts for non-existent goods with the participation of a collateral manager.

iii. Reserve Accounts

This is a specific account that could be domiciled in the bank providing the financing offshore. The reserve account could be built to an amount equivalent to one principal and interest repayment, so that if there is a delay in repayment or a shipment delay, the account could make the repayment current. It buys time on how a repayment delay could be regularized.

XIV.5 Key Elements in Structured Finance

- i. Identify the source of repayment, and if it is coming from offshore, make sure there is a dedicated collection account where the offshore cash flow goes to and this account be assigned to the financing bank. If this is in place, there is no reason why an SME located in an emerging market cannot attract structured finance.
- ii. Performance risk in a high-risk economy can be overcome by performance risk insurance. If there is also a payment risk from a buyer overseas, the insurance could be both for non-performance and non-payment.
- iii. An SME with an offshore buyer can assign the export contracts to the financing bank. If the SME is a trader who is acting as an intermediary, it can assign its

- purchase contract (offtake contract) to the bank, so that there is direct access to the producer or supplier.
- iv. To cover the price risk, an SME can offer sufficient collateral using a mark to market ratio to have some kind of buffer in case the price drops. For example, the value of the goods to be delivered can be priced at 180 percent of the principal and interest to be paid at the month of delivery. This is over collateralization.
 - v. The goods involved must be liquid. They can be readily sold as commodities in contrast to specialized products.
 - vi. It is important to provide a strong structure in terms of securities and the enforcement of these securities, particularly with regards to documents of title and ownership.
 - vii. If collateral is involved, it should not only be controlled and but also monitored as to its market value on a daily basis.

Box 14. Case Illustration on How a Structured Trade Finance Transaction Could Arise

The case involves an SME from Hong Kong, China that needs financing for the production of zinc ingots in China to be subsequently exported.

According to existing regulations, international banks in Hong Kong, China are precluded from lending to domestic entities in China unless such entities are joint ventures. The SME is located in Hong Kong, China and could access funding from international banks in Hong Kong, China and transfer the funds to the zinc producer in China. The China producer needs working capital for the production of the zinc ingots.

According to Chinese regulations, lending for working capital outside Hong Kong, China and transferred to China is not allowed. However, there are instances when a trade related deal could be possible and can be approved by the State Administration for Foreign Exchange (SAFE) that regulates foreign borrowings.

The financing could be structured into a trade finance deal in the form of pre-export finance.

The SME could secure financing from an international bank in Hong Kong, China for a pre-export finance facility. The funds could be remitted to the China zinc producer as advance payment for the production of zinc ingots. At the same time, the SME will have to sign an offtake agreement for the purchase of the zinc ingots that it will subsequently sell to international metal traders.

This structure could benefit the SME since foreign loans are relatively cheaper than renminbi denominated loans, compared to if the China producer were to borrow locally for the working capital it needs for the production.

While this example applies to China, it could also be applied to other emerging economies if the product in question can be exported. The industry would thus be able to survive with the much needed working capital obtained through a structured deal.

Source: Author

XV. Conclusion

This report covers the basic tools and practices of trade finance. It also describes the current approach used by banks to obtain reliable security in circumstances where local laws are not yet well defined.

SMEs, be they local merchants, trading companies, processors, importers or producers, all need financing in one way or another. They can be amply served by banks engaged in structured trade finance as long as the regulatory framework is satisfactorily met, risks adequately mitigated and repayment identified and reasonably assured.

On a broader level, there is a need for the governments to play a more proactive role in alleviating the inadequate financing available to SMEs, especially those located in emerging economies. Currently, the major constraint is the perception of SMEs as the more risky part of the economy as far as trade finance banks are concerned. One solution is to educate SMEs on structured trade finance, which puts emphasis on the self-liquidating nature of transactions rather than on the state of their financial affairs.

The role of the governments as well as other sectors involved in the financing of the supply chain could be made more supportive and may need some adjustments. Among them is the need for a clear and effective legal environment. The regulatory issues highlighted in this report, such as lack of uniformity in interpretation of ownership or title to the goods when warehouse receipt financing is involved, have to be addressed. It is unclear to what extent the lender has perfected his or her title to the goods which are his or her security. Property and contract laws and the commercial codes of the civil law in economies as they apply to supply chain financing are important as well as the choice of the governing law, since supply chain finance is a cross-border operation. In conclusion, an effective legal environment that could be integrated into the financial infrastructure could be a starting point in facilitating the growth of SMEs, the backbone of a vibrant economy.



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