

# **Warehouse Receipt System in Malawi**

## **a strategy - a solution**

(January 2012)

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### **Proposed Actions**

- 1) The Reserve Bank of Malawi to finalise the Export Development Fund modalities and documentation.
- 2) The Reserve Bank of Malawi and the financial institutions to finalise the finance component and modalities.
- 3) Each participating financial institution to develop a warehouse receipt finance procedure and sign up with ACE.
- 4) National Food Reserve Agency has approved the warehouse receipt strategy in principle, but final due diligence to be completed.
- 5) ACE to finalise financing amendment to the ACE Warehouse Receipt Rules
- 6) ACE to register and certify the storage capacity pending registration.
- 7) Storage owners and operators to agree in writing to the ACE Warehouse Receipts Rules.



## 1. Warehouse Receipts in Context

The Agricultural Commodity Exchange for Africa (ACE) has advocated for a Warehouse Receipt System (WRS) as an integral part of agricultural trade and financing since its incorporation in 2005. There is a substantial need in the market for a system that will reduce risk of contract/performance defaults in agricultural trade and also facilitate competitive financing with agricultural commodities as collateral. Malawi does not have a regulatory framework for warehouse receipts, so the system has to be built on a contractual relationship between depositors, storage operators, financial institutions, and ACE. The success of the WRS is very much dependent on the active involvement from all participants and this is why it took 6 years before the first warehouse receipt (WR) was issued, financed and traded in Malawi.

In 2011 ACE registered the GSL silos in Kanengo, Lilongwe as the first WRS storage facility. The GSL facility has a capacity of 12000 MT and it was open to deposits from any interested third party. OIBM was the first bank to confirm that they were willing to finance a WR. OIBM proposed to finance 60% of the value at 20% pa or 70% at 22% pa. These rates are very attractive to the small scale sector and ACE promoted this opportunity, as a way for them to receive financing, retain ownership of the maize and thereby enable them to sell the maize at a time when the market is more attractive than it is immediately after harvest.

### Life of a Warehouse Receipt

- 1) A Commodity is deposited in a WRS registered storage facility, certified to store that commodity
- 2) The storage operator issues a WR and thereby guaranteeing the quantity and quality.
- 3) The Depositor requests financing from a preferred bank and immediately receives the funds
- 4) The Depositor follows the prices and may put the receipt for sale on ACE.
- 5) A buyer accepts the offer and ACE generates a contract.
- 6) The Buyer deposits fund into the ACE settlement account.
- 7) ACE settles the finance and storage cost and transfers ownership of the WR
- 8) ACE transfers the balance to the seller
- 9) The new owner can either collect the commodity or request new financing from a preferred bank.
- 10) The WR is cancelled in the Registry if the commodity is collected. If not, the sequence starts again.

High moisture content made it difficult for GSL to take early deposits, but many of the sensitised depositors could not wait and unfortunately sold their maize before it could be deposited. Only on the 2<sup>nd</sup> of August 2011, was GSL able to issue the first WR to Mr Chikasu of Bucow investment, Mchinji. The deposit was 14.5 MT, Maize, ACE Grade 1 (same as NFRA grade). Mr Chikasu was later to make more deposits and increased the WR to 44 MT. With the WR Mr Chikasu accessed financing and later split the WR in 2, one was sold to WFP and the other to a trader. Mr Chikasu could market his WR from a position of strength because GSL was guaranteeing the quantity and quality.

When Mr Chikasu sold his WR, the buyer deposited the contract value to the ACE settlement account. ACE settled the outstanding financing and storage cost, transferred ownership of the WR to the buyer and gave Mr Chikasu the balance. On that deal Mr Chikasu received a 72% increased income after all



cost were deducted, compared to the market price prevailing when he deposited the maize. The buyer later went to pick up the maize at GSL and the WR was cancelled.

The benefit for the small scale sector is obvious and ACE anticipates that available third party storage capacity will soon become scarce as more depositors look to utilise space to improve their incomes. But the WRS will also add value to the large commercial operator. As the volume increases the WRS will become a very attractive vehicle for the flow of easy accessible competitive agricultural financing. Also, WR's from Malawi can be promoted regionally and internationally as a secure instrument, attracting more buyers and perhaps even agricultural investors and speculators that will ensure better prices of Malawian commodities secured on WRs.

The agricultural markets will experience an increased flow of more reliable and relevant market information available to all. The Government of Malawi (GoM) can use this information to better manage agricultural policies. As the registered storage capacity is utilized after harvest the GoM will know exactly what commodities are available and where. If export and export financing is done through the WRS, the GoM will know what tonnages are being exported and more significantly which commodities are meant for export, and thereby be in a much better position to introduce appropriate export/import policies.

## **2. Mechanisms of the Warehouse Receipt System**

### **Legal framework**

The WRS is a contractual relationship between the participants. The main pillar governing the relationship is the ACE warehouse receipt rules. The rules regulate all parts of the WRS; registration of storage facilities; operational requirements; insurance and safety measures: rules, requirements and procedures for finance; audit and inspection requirements and requirements to issue, transfer/trade and cancel WRs.

The WR is in effect a standard storage and collateral management contract between the depositor and the storage operator. When the WR is issued the underlying contracts enter into force by binding both the depositor and storage operator to the terms and conditions in the ACE warehouse receipt rules.

The WR will also in effect become a financing agreement between the depositor and the financial institution if finance is requested. The commodity will be collateralised to secure the financial institution's position. The owner retains title to the commodity, but cannot access, move or dispose of it until all liens on the WR have been cleared. The owner can, however, offer the WR for sale on ACE, but the ACE trading system will only allow a WR to be sold if the contract value is sufficient to clear all outstanding cost on the receipt (finance, storage etc.). The financial intuitions can at any time request ACE to send a collateral management and/or financial auditors to do a stock count and/or quality check, to ensure that the physical stocks match the issued WR from that storage site.



The WRS is subject to the ACE Arbitration rules, and any dispute arising between the parties has to be referred to ACE Arbitration for a speedy resolution.

### Storage Capacity

The central component of any WRS is the storage capacity available. The system is dependent on storage operators being willing to register their capacity with ACE and apply/integrate the terms and conditions in their storage operations. The two main conditions are that stock on WRs is subject to inspection and audit and that commodity information (what is in store and where) will be public information. Ownership of a WR and underlying commodity will only be public information if the owner agrees to it.

The best WRS will have a good mix of commercial operators, Government/PPP and farmer organisations operating the storage facilities in both rural and urban areas. In Malawi, ACE has received expression of interest and will, in the coming months, look to register 114,400 MT storage capacity operated by commercial operators and National Small Holder Farmer's Association of Malawi (NASFAM). ACE anticipates that the total registered capacity for the WRS will reach 200,000 MT before the 2012 season starts.

Location	Capacity	Commodities	Open to third party storage
[location of storage facility]	[MT]	[Commodities that can be stored in the facility]	[capacity that could be promoted to third party against storage fees - MT]
Lilongwe	54000	Maize, Soya, Pigeon Peas, Ground Nuts, Sunflower	25000
Blantyre	52000	Maize, Soya, Pigeon Peas, Ground Nuts, Sunflower	11000
Mitundu	6400	Ground Nuts	Only excess capacity
Kafulu	500	Maize, Soya, Groundnuts	500
Mchinji	500	Ground Nuts	N/A
Balaka	500	Maize, Soya, Groundnuts	500
Natenje	500	Maize, Soya, Groundnuts	500

Additionally, the National Food Reserve Agency (NFRA) has confirmed participation in the WRS. They will open the Kanengo Silos for third party storage and issue WRs to the depositors. NFRA has for some years now actually been the pivotal element in an unstructured WRS. Large operators have had some access to the silos and NFRA would, on request, confirm the deposits to the financial institutions which would enable finance to the depositor. A structured WRS, as described in the paper will ease the procedure and include more depositors. The vision is to include all NFRA storage sites, but this season operational procedures will be tested at the Kanengo silos.



ACE will seek a dialogue with ADMARC to investigate whether modalities for inclusion of some ADMARC storage facilities could be developed. ADMARC has ownership of a fine net of storage sites throughout the country. It is clear from the table above that registration of rural storage is much needed. It could really benefit the rural population if they could access secure storage, WRs and financing through commercial operated ADMARC sites.

### The Registry

The Registry is an electronic database containing all information about all WRs issued. The two main functions are to manage ownership, including transfers of ownership and to calculate all outstanding finance and storage costs. The Registry is integrated into the ACE trading system and all information is public and available through the ACE website. The public can see how many WRs have been issued; in what locations; and, if they are offered for sale, at what price. By selecting a specific receipt all information about this receipts will be available, except ownership if the owner wishes to remain anonymous. The information would include all commodity details; specified storage and financing outstanding on that WR to that date; and a full audit trail history of the WR from the time it was first issued.

A WR is a transferable document. This means that ownership can be transferred but it has to be recorded and approved by the Registry to have legitimacy. The only restriction in relation to transfer of ownership is that all outstanding costs are settled before ownership is transferred. A WR cannot be traded for less than the value of outstanding costs. A WR is a very flexible document; the owner can decide to split, merge, refinance, transfer and cancel the WR.

The Registry is fully integrated with the ACE bid (to buy)/offer (to sell) matching engine and the ACE Bid Volume Only (BVO) auction system. This means that it is very easy to offer the WR for sale or participate in the BVO auctions. The Registry/trade system is designed to facilitate trade and transfer of ownership so it becomes as risk free as possible for all parties involved, including banks and storage operators.

### Performance Guarantee

A significant characteristic of a WR is the security it provides a buyer. When a WR is offered for sale the buyer knows that the underlying commodity is in secure storage, being managed professionally. The buyer knows that he will get the quantity and quality stated on the WR and that it is guaranteed by the storage facility operator. The storage operator is liable in case of a default and the WRS requires that the storage facilities are comprehensively insured.

The WRS will be audited and certified by a reputable accounting firm; a certification that will be used to promote the WRS to large regional and international buyers. ACE is in dialogue with the Zambian Agricultural Commodity Exchange (ZAMACE) and the Ugandan Commodity Exchange (UCE) to harmonise WRS rules and integrate exchange operations to jointly promote WRs to both the regional and international markets. The potential to attract more buyers, to improve competition and to obtain



better prices are increased and the WRS is the mean to achieve this, mainly due to the performance guarantees it comes with.

### Financing

It is not only the buyer that the WR protects; it also protects the financial institution financing the WR. Financing of a WR is a competitive process; the depositor is free to choose the financial institution offering the best terms suited to that depositor's operations. The financial institutions are free to set these terms and ACE will make all details of these terms available to the public. The financial institutions will typically compete on levels of finance, i.e. 60% or 80% of the value of the commodity. The value of the commodity will be determined by ACE based on market activity and actual trades. (The financial institutions can object if they believe ACEs value assessment does not reflect the market). They will also compete on the interest rates and method of making the financing available. The last is particularly important in the rural areas where ACE would like to see smartcard and mobile banking introduced on a significantly a larger scale.

There is a risk to financing WR as there is with any financing. The market may drop below the level of financing eroding the value of the commodity and the collateral. The financial institutions must make their own risk assessments and set the level of finance accordingly. The WRS does have an in-built mechanism to prevent loss of collateral. The financial institutions determine a level of notification and level of recovery, e.g, level finance could be 80% of the value; level of notification could be 90%; and level of recovery 85%. If the market value of the underlying commodity drops to 90% of the value, a notification is send to the depositor, stating that the commodity is losing value and request that margin deposits be made to bring level of finance back to 80%. The depositor will also be notified that the financial institution will offer the WR for sale should the market drop further and reach the level of recovery at 85% of the original value.

This mechanism is essential for the financial institutions; enabling them to manage their risk exposure in a declining market. It is also the only scenario where the depositor can be forced to sell a WR and this will only happen if the depositor fails to deposit margin calls to bring finance levels to agreed levels.

ACE will keep an audit and inspection log of all registered storage facilities where financial institutions (and others) can verify that the physical stock in store match the information on the issued WRs. The financial institutions can at any time request that ACE send collateral managers and/or auditors to inspect a specific storage facility. ACE will facilitate this and update the audit inspection log with the result.

### Settlement Account

The ACE settlement account offers a guarantee to the seller ensuring the buyer's financial performance. The buyer will deposit the full contract value before taking delivery of the commodity



(on normal contracts) or transfer of ownership if it is a WR being traded. Margin deposits can also be deposited to serve as performance bonds etc.

The Reserve Bank of Malawi has been continuously briefed on ACE operations and in 2010 the RBM approved the ACE settlement account in foreign currency. This enables ACE to freely transfer foreign currency to settle regional/international contracts and to forward foreign currency to a Malawian exporter on export contracts. This truly cemented the fact that ACE is the only operating spot and forward market cross border exchange in Africa.

### **3. Integration with the Reserve Bank of Malawi's Export Development Fund**

The Reserve Bank of Malawi (RBM) is conceptualising an Export Development Fund (EDF), capitalised with 80 billion Malawi Kwacha aimed at increasing Malawi's export and foreign currency earnings. The RBM has shown interest in the WRS because the structure can be used to incentivise and promote export, on the large scale needed to significantly increase foreign currency earnings.

Three very significant incentives will be given to the exporters:

- 1) The RBM and financial institutions make very competitive financing available to finance commodities on WR for export. The level of interest rates has not been determined yet, but it will be below the current lending rate.
- 2) Any commodity financed under the EDF must be exported. If GoM implement an export ban or other restrictive policies on a commodity it will not affect the export of a WR financed under the EDF. If the commodity for some reason is not exported, then a penalty will be imposed on the WR owner. ACE proposes that the penalty should be to increase the cost of financing to equal that of a similar WR not financed under the EDF.
- 3) The foreign currency generated by export of a WR financed under the EDF will 100% benefit the exporter. The 40/60 will not apply. The Buyer will deposit the contract value into the ACE settlement account. When ACE has confirmed that all outstanding finance and storage costs have been settled, all the foreign currency will be transferred to the exporters FCDA account with the financial institution who financed the WR.

#### **How to access EDF financing, export permits and 100% foreign currency from export earnings**

- 1) Request ACE to register a storage facility for one or more commodities.
- 2) Meet the conditions in the ACE Warehouse Receipt Rules and sign the certification paper provided by ACE.
- 3) Senior staff at the storage facility will be trained in the WRS and get access to the ACE trade system where they can issue WR.
- 4) Deposit the commodity in the registered storage facility.
- 5) Issue a WR and request EDF financing from a preferred financial institution.
- 6) Promote the WR for export on ACE or sell it to a traditional off taker.
- 7) The buyer will deposit into the ACE settlement account and ACE will transfer ownership of the WR to the buyer.
- 8) ACE will confirm that all finance and storage costs have been settled and transfer all the foreign currency to the exporter's FCDA account with the financing institution.
- 9) The commodity is either collected and exported (transport can still be done by the seller) or refinanced.



The EDF does not only benefit the exporter; there are three significant benefits for GoM and the RBM.

- 1) The GoM will know very early in the season exactly what commodities and in what quantities are aimed for export. This information will be essential to any planning of GoM agricultural policies and the processing of applications for export permits. In effect, financing of a commodity under the EDF becomes a de facto export permit for that WR. Should the GoM wish to restrict the export they must stop financing on a certain commodity.
- 2) The RBM can, from very early in the season forecast foreign currency earnings. Indications are already that the WRS could export substantial quantities and ensure foreign currency. An average foreign currency earning can be estimated at  $200,000 \text{ MT} * 400 \text{ USD/MT} = \text{USD } 80,000,000$
- 3) The RBM can monitor the flow of foreign currency and the WRS will ensure that all export earnings will be deposited in Malawian FCDA accounts. The EDF will bring significant benefits to the exporters and in return achieve a much needed transparency in the flow of foreign currency.

