



MANAGING THE “LOSS GIVEN DEFAULT”: HOW TO AVOID LOSING OUT WHEN A COMMODITY FINANCING TURNS SOUR

When a financier decides on a loan, one of his key considerations should be whether the transaction makes sense for the buyer and seller. If it does, the two will normally be willing to cooperate to sort out any problems, in particular to leave open the possibility for future transactions. Nevertheless, it still is possible that things go wrong, and worse, that the seller is then left in such dire financial straits that he defaults on his payment obligations. If this occurs, the financier may be left with the commodities under collateral control as his major recourse. His ability to convert these commodities into cash determines his “Loss Given Default” (LGD, in the terminology of Basel 2). A loan’s LGD, in turn, is important in deciding on how to provision against the loan and thus, what interest margin to charge for it.

This implies that, even though no financier would of course consider lending against a transaction which may well go wrong, it still makes sense to prepare for the worse, and ensure to the extent possible that the process of liquidation of a stock of commodities (or for that matter, goods) will be a smooth one.

When you are financing against commodities under a collateral management agreement, can you really take possession of this collateral when the borrower fails to meet his obligations? This is a crucial aspect, and the situation differs from country to country, and to a certain extent, from commodity to commodity. There are several risks you have to keep in mind:

Dealing with claims from unpaid suppliers.

Imagine a trader who defaulted on his obligations has deposited commodities into a warehouse, and received an advance against them, but did not pay his suppliers. The latter can then put a lien on the commodities, and local courts may well view their claims favourably. This is not always the case - under many sales contracts, title is transferred even if no payment is made - but in general, it is useful for the financier to check whether goods have actually been paid for.

Restrictions on the ability of the financier to actually access the pledged goods.

The bank may be prevented from actually accessing the warehouse where the goods are stored, let alone moving the goods from the warehouse to sell them. This can be a particular problem for field

How can ACE mitigate this risk?

With ACE’s support (part of ACE’s KYCC procedures), the bank will have confirmation from the seller that the commodities have already been paid; or alternatively, the bank, on the basis of ACE documentation, pays the seller directly.

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ACE KYCC and its market and on the ground information minimize the risk of dealing with unscrupulous borrowers. Furthermore, to prevent access difficulties for the financier, ACE actually leases the warehouse, giving it rights, title and access. This also creates restrictions on the owner. Should the owner use force, ACE’s insurance will cover the resulting losses.

warehousing operations, with the warehouse owner deciding to put a second lock on the warehouse, and ignoring his earlier leasing out of the warehouse to a collateral manager.

The warehouse owner may use force, even armed force, to keep out the financier. Situations like this are very difficult to deal with, and one of the problems for financiers is that insurance may not cover such risk. The goods are (presumably) still there, so under property insurance or cargo insurance, there is no loss -this is not a theft, as recognized under such policies. It could be covered under political risk insurance, but only if local authorities are clearly complicit with the warehouse owner. It could also be covered under a collateral manager's liability insurance, but only if the collateral manager had guaranteed the financier access to the goods in case of borrower default.

Comingled stock. In some warehouses, stocks from various depositors are comingled. *A depositor is thus entitled to delivery of a certain quantity of stock rather than to the actual stock deposited.* This leads to the question of whether the depositor can give effective security interest to a lender in such a situation.

It is quite difficult to provide a definite answer to this question since laws vary from one country to another. In England for example, under the Sale of Goods Act 1979, the purchaser of a specified quantity of a bulk of goods is not deemed to have acquired title until the portion he or she has purchased is actually identified and differentiated from the rest of the bulk. This was remedied only in the mid-1990s, but many Commonwealth countries have not followed the UK example.

The best option therefore is to seek the opinion of a local counsel on what the local law says and hence determine the most appropriate way to deal with the problem. Where possible, the warehouse keeper may be required to differentiate and isolate stocks belonging to the various depositors.

How can ACE mitigate this risk?
ACE's due diligence includes extensive local and international legal opinions to counteract such occurrences.

Dealing with stock rotation. In the case of field warehousing, the borrower would normally like to be able to rotate his stocks, in such a manner that normal, day-to-day business is not negatively affected. This is generally possible under field warehousing arrangements, as long as a certain minimum volume is maintained, and the borrower does not substitute goods by others of an inferior quality.

How can ACE mitigate this risk?
ACE has a broad knowledge of the sector and country, enabling it to evaluate the needs for stock rotation. ACE maintains detailed records, acceptable on a real-time basis to the financier, on stocks in warehouse at all times. It continuously monitors stock movements, in quality and quantity terms, both into and out of the warehouse.

However, the financier needs to verify that local law indeed permits such free substitution of fungible goods. The lender's title to the goods should not be jeopardized by the fact that the goods in stock are not the same as the ones originally pledged. If local law does not permit such fungibility, then a new warehouse receipt needs to be issued upon each new deposit.

Restrictions on the sale of goods. Three possible restrictions on the sale of goods may severely hamper a financier's ability to realize a fair price on goods he possessed and wishes to sell:

- sale of the goods may not be possible as long as any lawsuits are still pending in

How can ACE mitigate this risk?
ACE helps to structure transactions, and its due diligence will highlight such situations prior to the financier actually paying out. ACE will assist the financier in putting into place all the conditions necessary to mitigate these risks, including proper documentation.

court. For perishable commodities, this can seriously degrade their value.

- he may not be able to export the goods, because the export license is still with the defaulting borrower, or the bank is not registered as a commodity trader. This may force the bank to sell the commodities at a discount on the local market, or pay off the borrower to arrange the export.
- The bank may be obliged to sell the goods through a public auction, which can be time-consuming, and prevents sale to possible better clients (e.g., overseas processors).

How can ACE mitigate this risk?

ACE will engage in this form of finance only where the proper legal conditions exist. Then, ACE will put into place a co-owner arrangement under local law, which gives superior protection of ownership to the financier...

Taxation rules. If the transfer of warehouse receipts is treated as a sale (which it is in many countries), the resulting value added tax obligations may sink any potential for use of warehouse receipt finance, use of repo structures, and secondary trade.

How can ACE mitigate this risk?

ACE's due diligence will bring out all taxation issues, and ACE is able to suggest alternative structures and/or solutions to the financier.

Import regulations. Countries may have rules on import duties which specify that goods in a bonded warehouse need to be custom-cleared within a certain period (e.g., 90 days). In case of a borrower default, this may not give enough time to the lender to work out the situation. It should be noted that cases have occurred where buyers have abused these rules to defraud sellers, cooperating with customs officials to ensure delays, and forcing a situation wherein customs authorities can seize the goods and sell them through public auction (where the original buyers or their agents expect to be able to buy them at a much reduced cost).

How can ACE mitigate this risk?

Should the situation in a country be as depicted, because of ACE's full control over the warehouse and the commodity, it will be possible to take all the necessary corrective actions prior to such expiry dates (in effect, ACE will ensure that the necessary clauses for such action are incorporated in the various agreements).

The enforceability of lenders' rights. In many countries, local judges may not be very experienced in collateral finance, or political factors may lead them to ignore lenders' legitimate rights. In setting up warehouse receipt finance systems, it may often be useful to collaborate with the local legal community, to ensure concepts are properly understood and accepted.

A reputable credit support company can normally manage all these risks. In principle, the credit support company guarantees that the goods are there, and that in case of a default, the financier can exercise his rights. But the financier has to understand exactly what is the extent of a guarantee – not all collateral managers and credit support companies are equal:

- What is the exact status of the credit support company in the country, and what is its level of control over the warehouses that it is to use? For example, if the warehouse is not owned by the credit support company, has it been validly leased? Have signs been posted? Have entrances been locked and sealed? Are movements controlled by independent staff? How does the Collateral Manager demonstrate his exclusive and continuous control of the warehouses? Does he have adequate full time staff? It should also be noted that very often, warehouse documents are invalid unless the issuer is licensed as a general warehouse company

- is it a local or an international guarantee?
- what exactly did the collateral manager/credit support company guarantee? (quality, quantity, weight, risks covered, whose insurance; particular issues with commingled goods)
- could others have priority claims over you, and can collateral managers be forced to hand over goods to others - if so, who is liable? What if the pledge is lost to a third party creditor because proper procedures have not been followed? Is this insured?
- is there a risk of delays in selling stocks - and if so, who is liable? What happens if the credit support company becomes insolvent after a claim arises? Does the bank have a separate claim under the policy?
- what are the goods worth in the location where they have to be sold?
- is the collateral manager well-insured? The collateral manager may fight reimbursement of its clients when it fears that its insurance would not pay out (one problem area in the past have been frauds perpetrated by the directors of the collateral manager, rather than by "mere" staff; unless if a special rider is included, these are generally not covered under a professional indemnity insurance). For example, what if the warehouse receipt is overstated or goods are release without the bank's consent? Is this an insured risk?
- what happens if there was complicity between bank staff, collateral manager's staff and the borrower? What if goods are removed from the warehouse by the borrower (who is also the owner of the goods and the warehouse)? Is this insurable "theft" or "misappropriation"?

The closer the credit support company can come to giving a full "wrap", taking full responsibility on any mismatch between what is supposed to "come out of the warehouse at the end of the supply chain" and what really comes out, the better for the financier. And it is even better if the credit support company's "wrap" benefits of a comprehensive insurance coverage.

About ACE

ACE Audit Control & Expertise Global Ltd. is one of the world's major credit support companies, and a market leader in providing inspection, monitoring and collateral management services. Through its world-class systems and staff, ACE is able to secure commodities as well as a range of consumer goods (pharmaceuticals, vehicles etc.) in any location, providing comfort to companies and banks alike. ACE employs directly or through agency arrangements over 1,220 inspectors and managers operating in 32 offices in 28 countries.

Since its inception in 1996, ACE has provided credit support services for commodity values in excess of US\$40 billion for more than 150 financial institutions and trading companies in more than 75 countries.

ACE is part of the Financial Technologies Group, a US\$2 billion corporate which is a global leader in providing technology solutions to the financial services industry, including digital market places and exchanges, brokerage houses and asset managers.