Using Warehouse Receipts in Developing and Transition Economies

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Warehouse receipts provide an important addition to the store of negotiable instruments in a country’s financial sector. They can be especially useful in developing and transition economies where new market instruments need to be created.

WAREHOUSE receipts, negotiable instruments backed by the underlying commodities, are an integral part of the marketing and financial systems of most industrial countries (see box). The overall efficiency of markets, particularly in the agribusiness sector, is greatly enhanced when producers and commercial entities can convert inventories of agricultural raw materials or intermediary or finished products into a readily tradable device. Since warehouse receipts are negotiable instruments, they can be traded, sold, swapped, used as collateral to support borrowing, or accepted for delivery against a derivative instrument such as a futures contract. Unfortunately, the use of warehouse receipts is limited in many developing and transition countries because of institutional and structural shortcomings, among which the most prevalent are the following:

- lack of incentives for the development of a private storage industry owing to government intervention in agricultural markets—usually by setting support prices that take insufficient account of price variations over time or in different regions to allow for profitable storage;
- lack of an appropriate legal, regulatory, and institutional environment to support a system of warehouse receipts; and
- limited, if any, familiarity of the country’s commercial, including its banking, community with warehouse receipts.

Benefits

It is worth trying to overcome these constraints, since a well-functioning system of warehouse receipts has important economic benefits.

Warehouse receipts provide farmers with an instrument that will allow them to extend the sales period of modestly perishable products well beyond the harvesting season. When delivering the product to an accredited warehouse, the farmer obtains a warehouse receipt that can be used as collateral for short-term borrowing to obtain working capital. That way, the farmer does not need to sell the product immediately to ease cash constraints. Of course, this option will be attractive only if the farmer expects that seasonal price increases will make it worthwhile to store the product and sell it later. Unfortunately, governmental price supports are often structured in such a way that these expectations are not met. Rather, owing to governments’ efforts to decrease price volatility and “stabilize markets,” support prices are frequently fixed for most of the period between harvests and, on top of that, are set uniformly for the entire country. Moreover, real interest rates are often very high in developing and transition countries, making borrowing against

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inventories infeasible. This occurs because it is unlikely that borrowing costs can be recouped through seasonal price increases, even in the absence of other price-dampening measures.

The availability of secure warehouse receipts may, however, allow owners of inventories to borrow abroad in currencies for which real interest rates are lower, particularly if loans are made against inventories of an export commodity, thereby hedging against the foreign exchange risk of foreign borrowing. This practice is followed in Kenya and Uganda, where coffee stocks are often financed in pounds sterling. Also, since high real interest rates are often linked to perceived risks, particularly when it concerns agriculture, secure warehouse receipts may reduce risk and lead to lower lending rates.

Correctly structured warehouse receipts provide secure collateral for banks by assuring holders of the existence and condition of agricultural inventories “sight unseen.” Warehouse receipts can be used by farmers to finance their production, and by processors to finance their inventories. If there is a default on any obligation guaranteed with the warehouse receipt—for instance, a bank loan—the holder has first call on the underlying goods or their monetary equivalent. Collateralizing agricultural inventories will lead to an increase in the availability of credit, reduce its cost, and mobilize external financial resources for the sector.

Warehouse receipts contribute to the creation of cash and forward markets and thus enhance competition. They can form the basis for trading commodities, since they provide all the essential information needed to complete a transaction between a seller and a buyer. Their availability will thus both increase the volume of trade and reduce transaction costs. Since buyers need not see the goods, transactions need not take place at either the storage or the inspection location. Indeed, with a functioning warehouse-receipt system, commodities are rarely, if ever, sold at the warehouse proper. A transaction can take place informally or on an organized market or exchange. In either case, the warehouse receipt forms the basis for the creation of a spot, or cash, market. If transactions involve the delivery of goods on a future date, warehouse receipts can form the basis for the creation of a forward market and for the delivery system in a commodity futures exchange. A broader benefit of warehouse receipts is that they increase the confidence of participants, particularly those in the private sector, in market transactions.

A warehouse-receipt system provides a way to reduce gradually the role of government agencies in agricultural commercialization. Government intervention in agricultural markets usually has two main objectives: to support prices, by buying directly from producers, and to guarantee a measure of food security. In order to support prices, governments can accept warehouse receipts when prices drop below a support floor, rather than taking delivery of physical inventories—a system similar to the loan rate system used in the United States until recently. Since warehouse receipts guarantee the existence of stocks, governments can achieve their food-security objectives by merely holding these receipts. The private sector will be responsible for purchasing, storing, and disposing of the physical stocks. When private sector initiatives designed to protect market participants against price fluctuations develop—for instance, through hedging in a futures market—the government will no longer need to play a role in this area.

Warehouse receipts can be combined with price-hedging instruments. This combination provides borrowers with secure collateral, in the form of warehouse receipts, and puts a minimum value on it, through the hedging operation. For example, the PTA Bank in Kenya finances coffee exporters by taking their warehouse receipts as collateral and also offers them a put option, purchased at the London Commodity Exchange, that guarantees sellers a minimum price for the coffee they have in storage. By assuring a floor price for the stored coffee, the PTA Bank can provide finance for a higher percentage of the value of coffee than it could justify in the absence of the floor price. Banks will often advance 80–90 percent of the value of the transaction if it is hedged, but only 50–60 percent if it is not.

Preconditions for viability

In order for a warehouse-receipt system to be viable, the economy within which it operates must meet certain conditions:

The legal system must support pledge instruments, such as warehouse receipts, as secure collateral. The pertinent legislation must meet several conditions:

- warehouse receipts must be functionally equivalent to stored commodities;
- the rights, liabilities, and duties of each party to a warehouse receipt (for example a farmer, a bank, or a warehouseman) must be clearly defined;
- warehouse receipts must be freely transferable by delivery and endorsement;
- the holder of a warehouse receipt must be first in line to receive the stored goods or their fungible equivalent on liquidation or default of the warehouse; and
- the prospective recipient of a warehouse receipt should be able to determine, before acceptance, if there is a competing claim on the collateral underlying the receipt. The lack of an appropriate legal environment is probably the single most important constraint on the creation and acceptance of warehouse receipts in many
developing countries and in most countries in transition.  

Operational conditions must be conducive to the creation of a warehouse-receipt system and include the following:

- reliable warehouse certification, guaranteeing basic physical and financial standards;
- the existence of independent determination and verification of the quantity and the quality of stored commodities, based on a national grading system (with inspection of warehouses and stored commodities performed, in most cases, by the private sector under license from a government body—for agricultural goods, usually the ministry of agriculture); and
- the availability of property and casualty insurance.

The integrity of the system must be assured through performance guarantees. A key prerequisite for the acceptability of warehouse receipts by the trade and by banks is the existence of a performance guarantee for warehouses, assuring that the quantities of goods stored match those specified by the warehouse receipt and that their quality is the same as, or better than, that stated on the receipt. Without this guarantee, farmers and traders will be reluctant to store their crops, and banks will be hesitant to accept warehouse receipts as secure collateral for financing agricultural inventories. The unavailability of performance guarantees—for instance, because of the absence of reliable inspection and certification—may occasionally lead to second-best solutions. For example, in Brazil, a system of warehouse receipts operates that is limited to products stored in bank-owned warehouses.

Performance guarantees are usually posted as insurance bonds, which are sometimes supplemented, as in many US states, with an indemnity fund. These funds are created through contributions of participating warehousemen, collected as part of the fees they charge for their services. The funds are used either alone or as a secondary guarantee alongside insurance bonds. In the latter case, they reduce the cost of the main guarantee instrument, the insurance bond, making the provision of guarantees accessible to smaller warehouses. This broadens the market for warehouse services and increases competition in the storage industry.

Poland’s system

Some of the principal issues involved in developing and transition countries’ efforts to introduce systems of warehouse receipts may be most easily explained by looking at one country’s experience in some detail. Consider the case of Poland. The restructuring of Poland’s agricultural sector during economic transition resulted in, among other things, the breakup of cooperative marketing structures and of the country’s marketing and processing monopoly for cereals, as well as the creation of a government-owned marketing agency for agricultural products, the Agencja Rynku Rolnego (ARR), that is modeled on the US Commodity Credit Corporation. The ARR is to assist the emerging private sector with agricultural marketing while attempting to minimize expected disruptions during the transition period. As yet, there are few alternative marketing channels in the agriculture sector, particularly for grains; and, hence, for the moment there is no orderly way to withdraw the ARR from the market without disrupting trade. The rural finance sector is dominated by a state-owned agricultural bank, the Bank for Food Economy, which pursues traditional policies of support for production and investments.

High risks, limited familiarity with agriculture, and the absence of appropriate lending vehicles keep the emerging banking sector, by and large, from venturing into agriculture and the rural economy in general. The legislative process that will lead to creation of the legal underpinnings of pledge instruments, such as warehouse receipts, is currently under way. And, finally, there is abundant underutilized storage capacity in Poland—much of it still in public hands—but the relevant facilities mostly lack the appropriate physical infrastructure and the financial wherewithal to guarantee the condition of the stored commodities.

Pilot project. The US Agency for International Development is funding a pilot project that aims at introducing warehouse receipts in Poland using a non-governmental organization—the United States’ Volunteers in Overseas Cooperative Assistance—as the executing agency. A task force to examine the issues and propose solutions appropriate for Poland has been created that encompasses all stakeholders—farmers, warehousemen, regulators and legislators, lending institutions, and insurance companies. The pilot project called for the examination of 100 grain elevators, from which 20 were chosen to participate in the project based on their management practices, the condition they were in, and their financial situations. They are spread over the entire country. Eighteen of the elevators chosen are private, and two belong to ARR.

The project has created an interim system of examination and inspection of warehouse facilities that is to be succeeded by a nationwide system. In addition to examination and inspection, the project calls for the design of standards for the commodity stored in cases where existing storage standards are deemed insufficient. While the ongoing activities in inspection and examination are sufficient to support a pilot project, they need to be broadened to include nationwide application of the warehouse-receipt system. In particular, private companies need to be involved in inspections and quality assessments called for by a government authority.

Legal issues. A new law on collateral has been discussed in parliament and has been sent to a special committee that is soliciting comments. Warehouse receipts are considered pledge instruments under this law. The law also supports the creation of a central pledge registry, which will facilitate resolution of disputes owing to competing claims before the lending or acceptance of warehouse receipts takes place. A draft law on commodity exchanges has been prepared, under which warehouse receipts are further defined, particularly as instruments to facilitate commodity trade by, among other things, supporting delivery under futures contracts. In addition, a special warehouse-receipt act might be required to complete the legal foundation for an effective system of warehouse receipts.

Another issue related to warehouse receipts in Poland is the implication of the tax law on warehouse receipts. Under present Polish law, the Ministry of Finance has the right to create “statutory tax liens,” popularly known as “secret tax liens.” These liens have priority over previously registered mortgages or pledges, including warehouse receipts. As a result, creditors whose loans are supposedly secured with registered warehouse receipts cannot be certain that the value of their collateral will not be eroded or eliminated by the debtor’s failure to pay taxes in the future. In contrast, in the United States and Western Europe, the tax authorities do not, with minimal exceptions, have priority over previously registered secured creditors. Also, under current Polish law, if a warehouseman owes taxes, the tax authorities have the right to seize all goods in the relevant warehouse. This applies even to stored commodities for which the storing enterprise is merely the custodian. Although these tax-related issues do not make the use of warehouse receipts impossible, they do make these instruments less secure collateral than
they would be in the absence of the proposed laws and may limit the acceptability of warehouse receipts among banks and other creditors.

It is noteworthy that the project is proceeding in the absence of a complete legal foundation and in the presence of the threat of the secret tax liens. This is possible because the pilot project relies upon existing relations of trust between particular participating warehouses and their banks. Thus, the warehouse receipts to be issued under the pilot project will, for the time being, have a limited utility, confined as they are to specific pre-existing relationships. Once a complete legal foundation is in place, these warehouse receipts will become the nucleus of a nationwide system.

Guarantees. Insurance bonds for warehousemen are expensive in Poland, because the system of warehouse receipts is new and somewhat risky. The high cost of compliance guarantees is particularly problematic for small warehouses and is a serious barrier to new entrants into the industry. It is typically much less of a problem for established, large operators such as ARR. The system that Poland is currently designing provides for a combination of insurance bonds and an indemnity fund, which is to be established as a mutual insurance fund among the participating enterprises.

Recently, planning was initiated for a World Bank project that aims at assisting in the development of a warehouse-receipt system in Poland. The Bank's project is to carry out three main functions: contributing to the creation of the indemnity fund; assisting in the development of an enabling legal environment; and supporting the development of warehouse licensing and inspection systems and associated activities.

The Bank's contribution to the creation of an indemnity fund will be in the form of a contingent loan, the proceeds of which will be available during the formative stage of the fund. Private warehousemen will charge a fee on every transaction and deposit the proceeds in the fund. Thus, over the duration of the project, the Bank's exposure will gradually diminish and ultimately fall to zero, in step with the capitalization of the fund—that is, as the fund grows, reliance on the Bank's implied guarantees will decline. The fund, which will cover warehouses that are licensed and inspected, will protect lenders against the risk of inefficient licensing, selection, and inspection of warehouse facilities that can result in warehouse defaults.

Conclusions

For countries in transition and developing countries where commodity subsectors have undergone liberalization, the quick establishment of credit flows is crucial to the success of reforms. Warehouse receipts provide a method of collateralizing crops and lowering the risk to the lender, thereby lowering financing charges to the borrower. In addition, warehouse receipts provide a marketing tool to the emerging private sector, thereby allowing the orderly withdrawal of the state from commodity marketing.

The experience of several developing countries that have tried to establish warehouse-receipt systems indicates that, in order to work well, warehouse receipts need a recognized basis in law, so that the ownership established by the receipt is not challenged. Equally important are provisions for performance guarantees and the establishment of systems for warehouse inspection and crop-quality determination.