Commodities Finance
Impact of BASEL II
A guide for banks and traders
Contents of guide

1. Introduction page 2
2. Why is BASEL II important to commodity finance? page 2
3. What is BASEL II? page 3
4. Why is capital adequacy relevant? page 3
5. Changes under BASEL II page 3
6. When does BASEL II come into effect? page 4
7. How does BASEL II affect commodity finance? page 4
8. Credit risk page 4
9. The ‘Standardised’ approach page 5
10. The ‘IRB’ approach page 6
11. PD and LGD page 6
12. Commodity finance as defined in BASEL II page 8
13. Different risk weights applicable to commodities finance page 8
14. Commodity finance - IRB basic approach page 8
15. Foundation approach page 10
16. IRB advanced approach page 10
17. The importance of credit risk mitigation techniques page 10
18. The requirements collateral has to meet under BASEL II page 10
19. Preparing for BASEL II: How can we help? page 13
20. Structuring the transaction page 13
21. Satisfying these requirements: Some recurring issues associated with commodities as collateral page 13
22. Acquiring title page 14
23. Pledges and ownership page 14
24. Some guidance as to ‘Due Diligence’ page 15
25. Commingling of goods page 16
26. Protection from the interests of third parties page 16
27. Collateral management page 17
28. Insurance in trade finance page 17
29. Further advice and assistance page 19
30. Appendix 1: Suppervising rating grades for commodities finance exposures page 22
31. Appendix 2: Commodity Finance - supervisory slotting criteria page 25
1. Introduction

If you are involved in the financing of commodities, whether as a commodity producer, trader, end user, bank, insurer or collateral manager, you should be aware of the implementation and impact of Basel II on commodity finance.

In this booklet:

1. For the benefit of readers unfamiliar with Basel II, we outline the changes to be implemented by Basel II at pages 2-7;

2. We explain why you should be aware of the changes in respect of commodity finance at pages 8-14; and

3. We outline how we can help you prepare for the changes at pages 14-22.

We also provide contact details for members of our International Trade and Commodities and Trade Finance Group who can provide further advice and assistance in connection with Basel II. (These can be found on page 22.)

2. Why is BASEL II important to commodity finance?

The changes introduced by Basel II will impact on the structure of loans for commodity finance and the cost of borrowing funds.

Many borrowers requiring commodity finance have a credit rating of below A- or have no credit rating at all. In addition such borrowers often have a limited trading track record, operate in countries with a high country risk and have limited risk management procedures. Further, many borrowers requiring commodity finance are highly geared and unable to repay the financing from sources other than the commodity being financed.

Such of these borrowers, who can comply with the more stringent requirements imposed by Basel II, particularly as regards the structuring and use of eligible credit risk mitigants, will find that the cost of borrowing will be significantly lower than for those borrowers who are unable to meet the requirements. Those borrowers who are unable to enter into a Basel II compliant facility could find the cost of borrowing is such that they will no longer be able operate competitively in what is, generally, a low-margin market.

Even large corporate well capitalised borrowers with established risk management departments and an established track record need to be aware of the changes under Basel II as structuring transactions in a more effective way could reduce the cost of borrowing.

The use of eligible credit risk mitigants, such as physical collateral, is likely to result in greater demand for collateral managers. Insurance, particularly the strength of the insurer and the extent of any insurance cover is also an important factor in assessing risk under Basel II.
3. **What is BASEL II?**

Base II is the new capital accord which was finalised by the Basel Committee on Banking Supervision at the Bank of International Settlements at the end of June 2004.

Base II will supersede the current capital accord which was implemented in 1988, the purpose of which was to establish a common international standard and method for calculating the capital requirements or capital adequacy of banks.

It is intended that Base II will be implemented in the European Union (EU) and will apply to most financial institutions (referred to below as “banks”) carrying out financial business in the EU.

4. **Why is capital adequacy relevant?**

Capital adequacy is obviously fundamental to the solvency of banks as banks need capital to protect against the risks that they take.

Capital adequacy also impacts upon the cost of lending/borrowing in that exposures with a lower risk weighting, require less capital and will be less expensive. Exposures with a high risk-weighting will be more expensive and may prove to be commercially unattractive for many banks/customers.

The current minimum capital requirement for banks is 8% of risk weighted asset values. In simple terms this means that if a bank has a loan exposure with a risk weight of 100%, the full value of the exposure is taken into account in calculating the capital requirement which translates into a capital requirement of 8%. If the risk weight of an exposure is 20% then the minimum capital requirement is much less i.e. 8% of 20% =1.6%

5. **Changes under BASEL II**

The existing capital accord is considered to be too simplistic and insufficiently risk sensitive. For example, currently all corporate lending has only one risk weighting of 100%. There is, therefore, no differentiation between, for example, a blue chip AAA rated corporate borrower and a small unrated corporate borrower. Further, the current capital adequacy requirement is focussed on credit risk and does not take sufficient account of a bank’s internal risk and capital management practices such as organisational risk or market discipline.

As a result of this Basel II will change the framework for capital adequacy in two main ways. First, Basel II increases the risk sensitivity of the minimum capital requirements. The idea is to allow for better determination of risk in a specific transaction. Secondly, Basel II changes the regulations so that not only minimum capital requirements but also supervisory review and market discipline are taken into account. Thus there is now a three-pillared approach to supervision by the supervisory authorities/central banks, as follows:
• Pillar 1 - Capital Adequacy;
• Pillar 2 - Supervisory Review;
• Pillar 3 - Market Discipline.

6. When does BASEL II come into effect?

The current aim of the Basel Committee is for implementation of the less complex approaches (i.e. the standardised and internal ratings foundation approaches) to take effect in member countries by the end of 2006. It is envisaged that the more sophisticated approaches (i.e. the internal ratings advanced approaches) will be implemented at the end of 2007. The different approaches under Basel II are summarised below.

Implementation in the EU will be by a new Capital Adequacy Directive (commonly known as CAD 3) which is now in its final stages of preparation. The European Commission is aiming to ensure that the CAD 3 Directive is implemented simultaneously with Basel II.

(Although not the subject of this booklet concerns have been expressed as to the extent to which commodity derivative traders will be affected by the implementation of Basel II. The new Investment Services Directive sets out the definition of investment firm activities. Under CAD 3, subject to some exceptions, firms falling within the new Investment Services Directive will be required to meet the capital requirements of Basel II.)

7. How does BASEL II affect commodity finance?

Pillar 1 of Basel II sets out detailed minimum capital requirements for (a) credit risk; (b) market risk and (c) operational risk.

Credit risk has always been thought of as the most important risk for banks financing commodities. Thus the changes that are made under Basel II in calculating minimum capital requirements for credit risk will impact upon commodity finance.

In addition Basel II contains a definition of “Commodities Finance” which is treated as a special category of lending under the internal ratings approach known as the “IRB Approach” to credit risk. This is explained in more detail below.

8. Credit risk

Basel II sets out two main choices for banks calculating their capital requirements for credit risk: (1) the standardised approach (“Standardised Approach”) which relies on external credit assessments and (2) the internal ratings approach (“IRB Approach”). The IRB Approach contains two further options, the IRB foundation approach and the IRB advanced approach.
We will say a few words about what these approaches mean and what their practical effects might be.

9. The “Standardised” approach

Under the Standardised Approach the risk weighting depends primarily upon the credit rating of the borrower. Borrowers are classified into categories such as corporate, sovereigns and banks. The credit ratings are external, issued by credit assessment institutions such as Standard & Poor and Moody. The following is a table showing the Basel II risk weightings for corporates under the Standardised Approach:

<table>
<thead>
<tr>
<th>Credit Assessment</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB+ to BB-</th>
<th>Below BB-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>20%</td>
<td>50%</td>
<td>100%</td>
<td>150%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Accordingly, under the Standardised Approach, a loan to a corporate commodity trader with a credit assessment of below BB- will attract a risk weight of 150% and the effect is that the bank will have to set aside capital equivalent to 8% of 150% i.e. 12%. A loan to an unrated corporate will attract a risk weight of 100% (although supervisory authorities should increase the standardised risk weight for unrated claims where they consider a higher risk weight is justified by the default experience in their jurisdiction or where they consider the credit quality of corporate claims held by an individual bank justify a higher risk weight than 100%). In contrast, a loan to an AAA rated corporate will be risk weighted at 20% i.e. so that only 20% of the exposure will be taken into account i.e. 8% of 20% = 1.6%.

The current risk weighting for corporates under the existing Basel accord is as follows:

<table>
<thead>
<tr>
<th>Credit Assessment</th>
<th>AAA to AA-</th>
<th>A+ to A-</th>
<th>BBB to BB-</th>
<th>Below B-</th>
<th>Unrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Weight</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

It is clear therefore that, under the Standardised Approach, large corporate trading houses with good external credit ratings will benefit from the lower risk weight imposed under Basel II. For unrated corporates, there will be no change to the existing position, loans will be risk weighted at 100% (subject to any changes imposed by supervisory authorities in particular jurisdictions). However, for those corporates with a rating of BB- and below the risk weight increases.
Under the Standardised Approach only limited credit risk mitigants can be used to reduce risk weighting (providing that the strict requirements set out in Basel II are complied with).

In light of the above it is unlikely that banks operating the Standardised Approach will be able to offer competitive commodity financing to small-medium sized corporate traders with a credit rating of BB- or below.

10. The “IRB” approach

Under the IRB Approach, which is the approach being adopted by many banks, banks will be permitted to rely on their own internal estimates of risk components in determining capital requirements for each exposure provided that they meet certain requirements. The latter will vary depending upon whether the bank is following the IRB Foundation Approach or the IRB Advanced Approach.

Risk assessment under the IRB Approach involves measuring the following risk components:

**Probability of Default (PD)** (i.e. the probability of a customer going into default);

**Loss Given Default (LGD)** (i.e. the amount that would be lost in the event of a default);

**Exposure at Default (EAD)** (i.e. the expected exposure at the time of default); and

**Effective Maturity (M)** (i.e. effective tenor)

These components are then used in a risk weight formula to calculate the capital required for each exposure. PD is linked to ratings and the LGD is influenced by the type of transaction or products and the use of any eligible credit risk mitigants such as collateral.

The IRB approach is based on assessments of unexpected losses (UL) and expected losses (EL). The risk weight functions produce capital requirements for the unexpected losses portion. Expected losses are treated separately.

As with the Standardised Approach, exposures are categorised into broad classes namely corporate; sovereign; banks; retail and equity. However, banks will, under the IRB Approach, also be able to distinguish between exposures to small and medium sized enterprises and large enterprises. Each class of exposure has a risk weight function and the risk components provide an input to this function.

11. PD and LGD

As mentioned above PD is linked to credit rating. (Under the IRB Foundation Approach banks can use their own internal rating for PD but must rely on supervisory estimates for the other risk components. Under the IRB Advanced Approach banks may provide their own estimates for all the risk components.)
Whilst models used by banks to assess PD will vary from bank to bank, factors taken into account will normally include the following:

- Leverage
- Activities Risk
- Volatility of assets (commodities) and earnings (markets)
- Country risk

The higher the risk in the above, the higher the PD and the greater the amount of capital a bank will need to set aside to cover potential losses.

Many organisations involved in commodity finance will fall within the corporate asset class (i.e. debts of a corporation, partnership or proprietorship). Further, many small/medium sized corporates involved in commodity finance will have a low level of fixed assets, with assets comprising receivables and commodity stocks. Very often companies are highly geared because of the high turnover required to produce a profit when profit margins are small. In addition the prices of commodities are often volatile. Corporates focusing on one commodity or one country will be highly exposed to commodity price risk or country risk. The overall result is that many small-medium sized commodities corporate borrowers are likely to have a high PD rating which means they will suffer under Basel II, unless they can structure their transactions in such a way that the LGD is significantly reduced by the use of eligible credit risk mitigants such as collateral.

Factors which are likely to impact on the LGD are the level of eligible collaterisation, likelihood of expeditious enforceability and realisation of collateral including availability of liquid markets and mitigation of price and other risks through hedging.

In addition, although one risk weight function is provided under the IRB Approach for corporate, sovereign and bank exposures, five sub-classes of specialised lending have been introduced within the corporate asset class one of which is commodity finance. Different risk weights apply to the categories of specialised lending.
12. Commodity finance as defined in BASEL II

Under the IRB Approach commodity finance is treated as a category of specialised lending within the corporate asset class. Basel II defines commodities finance as

... structured short term lending to finance reserves, inventories, or receivables of exchange-traded commodities (e.g. crude oil, metals, or crops), where the exposure will be repaid from the proceeds of the sale of the commodity and the borrower has no independent capacity to repay the exposure. This is the case when the borrower has no other activities and no other material assets on its balance sheet. The structured nature of the financing is designed to compensate for the weak credit quality of the borrower. The exposure’s rating reflects its self liquidating nature and the lender’s skill in structuring the transaction rather than the credit quality of the borrower”.

Thus if a borrower has no independent capacity to repay the exposure other than the commodity being financed, then the exposure will fall within the definition of commodity finance.

If, on the other hand, a large corporate borrower with diverse operations and an independent capacity to repay the exposure engages in commodity finance, it is likely that such an exposure will not be classed as commodities finance.

13. Different risk weights applicable to commodities finance

An added complexity is that there are three different approaches to commodity finance, under the IRB Approach, namely the Basic Approach, the Foundation Approach and the Advanced Approach.

14. Commodity finance – IRB basic approach

For banks that cannot calculate any of PD, LGD or EAD the Basic Approach will apply.

Under the Basic Approach five important parts of a commodity finance transaction must be assessed namely:

1 Financial strength - Degree of over-collateralisation of the trade;
2 Political and Legal Environment - Country risk and country risk mitigants;
3 Asset Characteristics - Market liquidity of the commodity, collateral and susceptibility to damage from external causes;
4 Strength of the sponsor - Financial strength of trader, track record, trading controls, quality of financial disclosure;
5 Security Package - Asset control measures in the financing facility and insurance against damage.
These criteria are described in Table 4 of Annex 4 to Basel II as “Supervisory Rating Grades For Commodities Finance Exposures”. (The table is reproduced in full in Appendix 1 and contains a useful summary of the risks in a commodity finance transaction).

On the basis of the assessment of the above elements of the transaction, a transaction will be categorised in one of five categories, each of which has a specific risk weight. The risk weights associated with each supervisory category are:

<table>
<thead>
<tr>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
<th>Default</th>
</tr>
</thead>
<tbody>
<tr>
<td>70%</td>
<td>90%</td>
<td>115%</td>
<td>250%</td>
<td>0%</td>
</tr>
</tbody>
</table>

(In response to public consultation the Basel Committee decided that it would be preferable to separate the treatment of unexpected and expected losses within the IRB Approach. As a result of this the risk weight given above relates only to unexpected losses. A table showing the risk weights for both unexpected and expected losses is at Appendix 2.)

Although, as stated above, banks are expected to use the criteria in Annex 4 to derive their internal ratings, each supervisory category referred to in the table above broadly corresponds to the following external credit assessments:

<table>
<thead>
<tr>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
<th>Default</th>
</tr>
</thead>
<tbody>
<tr>
<td>BBB- or better</td>
<td>BB+ or BB</td>
<td>BB- or B+</td>
<td>B to C</td>
<td>Not applicable</td>
</tr>
</tbody>
</table>

The risk weightings for transactions assessed as below “good” (BB or below) are higher than the risk weighting for unrated corporate exposures under the Standardised Approach. Thus banks are unlikely to consider lending where a transaction is assessed as below “good” under the Basic Approach to commodity finance. However, at national discretion banks may be allowed to assign lower risk weights of 50% to “strong” exposures and 70% to “good” exposures in certain restricted circumstances.

Banks operating the Basic Approach to commodity finance are, therefore, unlikely to be able to offer financing at competitive levels to small-medium sized corporates who do not have independent capacity to repay the exposure.
15. Foundation approach

Banks that satisfy the requirements for adopting the Foundation Approach will be entitled to estimate PD themselves but will have to follow the supervisory risk weights for the other risk components. Given that commodity borrowers will often receive a high PD weighting and the fact that the bank will have to adopt the Supervisory Approach to the LGD, it is also likely that banks operating the foundation approach will be unable to provide competitive commodity financing to small-medium sized corporates.

16. IRB advanced approach

Banks that meet the requirements for estimating both PD and LGD can use their own models to determine the same for commodity finance. Whilst the PD is likely to remain high, it is possible to reduce the LGD where the structure has effective credit risk mitigation techniques. If the LGD is low then this will reduce the expected loss enabling the bank to offer more competitive financing.

17. The importance of credit risk mitigation techniques

Various credit risk mitigation techniques are recognised under Basel II under both the Standardised and IRB Approach. However, as is clear from the above most banks active in commodity finance are likely to operate the IRB Foundation or IRB Advanced approaches because of the greater flexibility. In addition, a wider range of credit risk mitigants are recognised under the IRB Approach (such as certain types of physical collateral) than under the Standardised Approach.

However, there are strict requirements which have to be met before credit risk mitigants such as physical collateral and receivables are eligible to reduce risk.

In the case of exposures to small/medium sized corporate commodity traders who do not have a credit rating or have a credit rating below A, being able to provide eligible security and/or structuring a transaction in such a way that recognition is given to the credit risk mitigation techniques could be crucial in reducing the cost of borrowing by reducing the LGD.

18. The requirements collateral has to meet under BASEL II

As mentioned above, any security or collateral provided by a borrower has to be recognised under Basel II for it to be effective in reducing any risk weighting.

The requirements for recognition are summarised below in respect of physical collateral and receivables, being the type of security commonly offered by a commodity finance borrower.
1. Legal Certainty - Documentation

One of the key criteria is that in respect of any credit risk mitigation technique, certain minimum standards for legal documentation must be met.

All documentation used must be binding on all parties and legally enforceable in all relevant jurisdictions. Banks must carry out a proper legal assessment to verify enforceability and must review the assessment when necessary to ensure continuing enforceability.

2. Legal Enforceability - Right to Liquidate and Take Legal Possession of Collateral

In addition, it is a requirement that the legal mechanism by which physical collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of it in a timely manner in the event of default, insolvency or bankruptcy.

Banks must also take all steps necessary to satisfy requirements in respect of registration of any of the bank's interests in the relevant jurisdiction so as to ensure the bank has an enforceable priority security interest.

Banks must have clear and robust procedures for the timely liquidation of collateral.

Collateral custodians should segregate collateral from their own assets and banks must take reasonable steps to ensure that they do so.

Legal enforceability must be supported where necessary by legal opinions confirming enforceability and priority.

3. Valuation of Collateral

The loan value of any collateral/security must not exceed the fair market value at the time the loan is drawn down.

Any collateral must be pledged for the life of the exposure, marked to market and revalued with regular frequency (including physical inspection) particularly where the market is subject to significant changes in conditions.

In circumstances where there has been a material depreciation in value relative to general market prices or default by the borrower the collateral should be revalued by a qualified professional valuer.

The loan agreement must include detailed descriptions of the collateral plus detailed specifications of the manner and frequency of revaluation.

4. Insurance of Collateral

Any collateral must be insured adequately against the risk of loss or deterioration.
5. **Recognition of Physical Collateral - Markets and Prices**

Liquid markets must exist to enable disposal of collateral in an expeditious and efficient manner together with well established publicly available prices for the collateral.

6. **Legal Enforceability - Receivables**

The legal mechanism by which receivables are pledged or transferred must ensure the bank has clear rights over the proceeds, can realize all proceeds and (if appropriate) sell the same in a timely manner in the event of default by the borrower.

All steps necessary to satisfy registration requirements in any jurisdiction must be taken so as to ensure the bank has an enforceable interest. A framework should exist that allows the bank to have a perfected first priority claim.

Legal enforceability and priority must be confirmed where necessary by appropriate legal opinions.

7. **Risk Management - Receivables**

Banks will also need to have proper procedures for assessing credit risk in the receivables. The procedures should take into account factors such as the borrower’s business and industry/market cycles, borrower’s credit policy and types of customers involved.

The value given to any receivables must reflect all appropriate factors including the costs of collection and any potential concentration risk. The procedures adopted by the bank must include a continuous monitoring process appropriate for the relevant exposure which may include, for example, control of trade documents, borrowing base certificates, frequent audits of collateral, ageing reports, confirmation of accounts, control of the proceeds of accounts paid, and regular financial analysis of the borrower and the issuers of the receivables. This is particularly so where a small number of significant receivables are taken as collateral. Under the procedures, compliance with loan covenants, environmental restrictions and other legal requirements should be reviewed on a regular basis.

The receivables pledged should be diversified and not unduly reliant upon the borrower for their viability. In such a case, these risks should be taken into account in calculating margins. Receivables from affiliates of the borrower (including subsidiaries and employees) will not be recognised as risk mitigants.

The bank should have a properly documented process for collecting receivable payments in a default situation.
19. Preparing for BASEL II: How can we help?

Compliance with the more stringent requirements imposed under Basel II as regards the recognition of collateral will be imperative for many borrowers who wish to secure competitive commodity financing. No longer will it be possible to rely on personal relationships and local knowledge to fill in gaps in the legal structure and documentation. It is also likely that compliance with the requirements under Basel II will, at least initially, increase the cost to banks and ultimately the borrowers.

As a result of our experience in commodity finance and particular issues that arise in different jurisdictions, as outlined below, we can help borrowers and banks meet the requirements imposed by Basel II and reduce the potential costs involved.

20. Structuring the transaction

As explained above structuring commodity finance transactions in a way that meets the requirements for recognition of collateral under Basel II will impose a burden upon banks and their commodities clients of ensuring that the transaction and collateral is properly documented, supported by legal opinions confirming compliance with these requirements and with the law in general and that the bank’s interest is properly registered. In addition, the banks must be alive to any changes which may affect the enforceability of the bank’s interest.

21. Satisfying these requirements: Some recurring issues associated with commodities as collateral

As is recognised in the definition of commodity finance under Basel II one of the unusual features of a transaction that involves security over a commodity is that the sale of the security being offered to the bank or lender (“bank”) is also the means by which the debtor’s indebtedness will be repaid. Thus, the repayment of the loan will be dependent on the debtor’s ability to sell the very goods that form the subject of the security and realise their value. Added to this tension is the fact that the commodity itself may be easily moveable and perishable. In almost every case, it will be exposed to market price fluctuations. Finally, but very importantly, it will be much easier to dispose of and convert into cash than, say, a fixed asset. Inevitably, these characteristics make it difficult for banks to control or monitor the value of its security and indeed the security itself at any given time and thus expose it to other risks peculiar to commodities finance.

Our experience has shown that wherever in the world they may be doing business, banks and finance houses entering into transactions that involve commodity stocks as security can run into a variety of problems when things go wrong. The problems range widely: they can include procedural difficulty in realising security, or worse, discovering that legal technicalities in the locality of the security prevent enforcement, through to finding that the commodity which forms the subject matter of the security no longer even exists.
22. Acquiring title

The starting point for taking security over commodity stocks in a foreign jurisdiction, must always be that due diligence is done on the local legal environment (now essential for collateral to be recognised under Basel II). This is because questions as to the effect of security over commodity stocks will virtually always be governed by the law of the place in which the commodity is situated: the “local law”. All questions as to ownership of the commodity and the effect of documents representing the commodity (for instance, a warehouse receipt) and all questions relating to the priority ranking of creditors on an insolvency will be determined by the local law. It does not matter how many times it is said in the underlying loan document that, say, English law applies. Ultimately, it is a court in the country where the goods are located which will have to decide whether the bank or trader’s security is effective and protect the creditor’s right to take possession of the goods and realise their value in fulfilment of the debt.

If the local legal system is unreliable or affords no protection to a secured creditor, then the security itself is likely to have little value and will not be recognised as a valid credit risk mitigant under Basel II.

If the transaction is to be successful, and to conform with the Basel II regulations, the bank will inevitably wish to retain control over the commodity itself. The bank should therefore have an understanding of the commodity’s production, storage, transport, pricing and delivery.

23. Pledges and ownership

Security over a commodity will often take the form of a pledge over the commodity. However in many jurisdictions ownership of the commodity itself is transferred to the bank as collateral for the financing.

In its most basic form, a pledge involves the debtor taking an asset which he owns and giving possession of it to the bank. The bank holds onto the asset and advances a loan to the borrower. If the borrower repays the loan, the bank returns the asset. If the borrower does not repay the loan, the bank retains the asset and has the power to sell it in order himself to redeem the loan.

Another type of security interest offered to banks, particularly where a borrower does not wish to give the bank actual or constructive possession of the commodity, is a hypothecation of the commodity. Under English law, this is, however, a much poorer form of security than a pledge as the bank has no control over the commodity, the bank will only have an equitable and not a legal interest in the commodity and the registration requirements may be unclear. However in other jurisdictions a hypothecation over goods may provide a bank with stronger security than in England.
The third type of interest in a commodity that is frequently offered to the bank is ownership or title to the commodity. In English law this may be achieved by suitable words which reflect an intention to transfer title to the bank. In some countries, it may be by transfer of a warehouse receipt. Where the bank is itself selling goods on credit terms, the bank may retain title to the goods by reserving title pending payment under a retention of title clause.

Ownership of the commodity itself is, theoretically, the best option for a bank as it should avoid issues that can arise in respect of pledges such as priorities between competing interests. But ownership may carry with it a variety of complications, responsibilities, liabilities and costs that a pledge does not. The choice will depend on a variety of factors including the fiscal consequences of ownership, its accounting implications and above all what the local law says about the best method of securing the banks interest.

24. Some guidelines as to “Due Diligence”

The first, and the most important pre-requisite, is to verify that the borrower/pledgor himself owns the goods in the first place. Once again this is an exercise that will require regard to the local law. So, before accepting a pledge over stocks, a bank is well advised to undertake a further due diligence exercise. A bank needs to be satisfied as to who, as a matter of the local law, is the existing owner of the goods. This is in itself a difficult task unless (which is rare) a public register exists for ascertaining whether any prior interests exist over the commodity stocks.

In cases where the bank is not a local entity, the next steps will be to check whether the local law will recognise the security interest or ownership rights of a foreign company. There are a number of jurisdictions around the world, where a foreign company cannot own commodity stocks.

There is a tendency for people to assume that if they hold a warehouse receipt, effectively they own the goods. This is because, traditionally, some jurisdictions view warehouse receipts as documents of title, the transfer of which can transfer ownership of the goods, such as India and the US. In England and in many other countries on the other hand, a warehouse receipt is not generally regarded as a document of title; it is only viewed as evidence of title. Without more, there is therefore a risk that the holder of a warehouse receipt, or the beneficiary of a pledge over a warehouse receipt does not hold a valid pledge over the goods.

Whether one opts for security by way of a pledge of stocks or ownership, there are two other frequently recurring issues that give rise to risk and create major problems and which require consideration.
25. Commingling of goods

The first problem is storage and the question of whether an effective security interest can be given in goods which are commingled as part of an undifferentiated bulk. Leaving aside the practical difficulties that such an arrangement can give rise to, the legal position can also have adverse consequences on the bank's security. In many countries (and until relatively recently in England) the purchaser of a specified quantity of a bulk of goods is not deemed to have acquired title to those goods until this portion is actually separated from the rest of the bulk. By extension, if there is any doubt over a borrower's title in the asset this will impact upon the validity of the bank's security interest as such an interest can only be as good as the borrower's title.

Commingling of the security undoubtedly carries greater risks that banks must be aware of. In our experience commingling gives rise to a greater risk of disputes arising between the parties interested: for example, the chances of a competing interest being asserted where goods are commingled. This is likely to be greater than where the goods are segregated. Complications are also likely to arise where part of the commingled goods deteriorate or are destroyed. Insuring the goods against certain risks, such as misappropriation, is likely to be impossible. Of course, such issues will not arise where the stocks of individual depositors are stored separately and in readily identifiable lots.

26. Protection from the interests of third parties

Another recurring issue is that of protecting your security interest against the interests of third parties. When a bank and a borrower enter into an agreement using an asset (such as a stock of a particular commodity) as security, the security interest is said to “attach” to that asset. The bank can take full control of the object, and sell it to satisfy the debt in the event of default. However, attachment alone may not be enough to protect the bank against the rights of third parties. For example, the borrower may have sold the asset to someone else who did not know of the bank's security interest. This person may acquire the asset free of the security interest. Therefore, while the borrower remains contractually liable for the outstanding amount of the loan, and perhaps other damages for breaching the security agreement, the loan is now unsecured.

The way around this problem is to perfect the security interest. Perfection occurs by some act defined by law which is deemed to give notice to third parties (whether specific third parties or, in some circumstances, to the world at large) that a bank has taken a security interest in a particular asset.

Perfection gives priority to the interest of the secured party over the interests of other claimants.

It is imperative that the law of each country be analysed to determine whether perfection is possible for a given type of commodity.
27. Collateral management

A collateral management agreement (or “CMA”) is a warehouse agreement (between borrower, bank and warehouse/owner), but with the added involvement of a professional collateral manager – often one of the large supervision companies.

The idea is that through the involvement of a disinterested, reliable and creditworthy third party collateral manager, the bank can police the receipt, storage and release of the underlying commodity which represents his security.

The CMA combines the terms on which the warehouse will store the goods (dealing with location, condition of the warehouse, security of the warehouse etc.,) with terms that define the ambit of its responsibility, provide for the form of and issue of warehouse receipts, document how goods are to be released and deal with the control of the commodity and the monitoring of its physical condition.

The warehouse keeper or warehouse owner may not always be a party to the CMA but the relationship between the collateral manager and the warehouse keeper should, at least, be carefully documented by means of a separate agreement or lease which gives control of the warehouse facility to the party responsible for safeguarding the goods (i.e. the collateral manager).

Most importantly, CMAs give the bank the option of securing their security through the services of a warehouseman/collateral manager of real substance who is prepared to agree acceptable terms regarding the governing law and jurisdiction.

Our experience is that CMAs are being used with increasing frequency but with varied results. Ultimately, even the largest and most reputable of supervision companies providing services under such agreements depends on the reliability and honesty of its local people “on the ground”. Mistakes are sometimes made and losses happen. It is therefore important to ensure that the terms of the CMA provide a fair and balanced way of guarding the interests of all of the parties concerned and providing recourse to the bank or finance house against the collateral manager if things go wrong. In particular, the small print of your CMA will sometimes include exclusion clauses and limitation of liability clauses benefiting the collateral manager. Such clauses can militate against the benefits of CMAs.

28. Insurance in trade finance

The recent trend of using insurance as an adjunct to commodity finance is likely to increase as a result of Basel II.

Insurance in this context can take a number of forms. It might be a special “all risks” cargo cover over the commodity itself. Misappropriation is also important in this context and should be spelled out. It might be specific insurance covering contract frustration, failure by the borrower/exporter to export, failure by the borrower to repay an advance or cover against government intervention, or trade credit risks.
A word of warning about the use of insurance. It is very often forgotten, that just because a premium has been paid, does not mean that the insurer will invariably be obliged to pay out in the event of a loss.

Under English law (and many other similar legal systems), contracts of insurance are unlike any other commercial contract. In most commercial contracts, the parties are free to negotiate what terms they like and there is no positive obligation on one party to volunteer information that is helpful to his counterparty. Insurance is different. Insurance contracts are contracts which require the utmost good faith between insurer and insured. That means that the insured – be that the primary insured or a (financing) co-assured or loss payee – is under an obligation to disclose to the insurer all material facts. A material fact is any fact or circumstance which the insurer would have liked to have known in order to enable him to decide either whether to take the risk at all, or, if so, at what premium. A failure to disclose a material fact may entitle the insurer to terminate the cover.

By the very nature of the jurisdictions in which commodity finance is necessary, it is easy to imagine circumstances in which the insured might have knowledge of difficulties in the local trading environment or a bank might have knowledge of previous loan defaults, which, with the benefit of hindsight, might from the insurers’ point of view, have had a bearing either on whether he took the risk at all, or, if so, at what premium. It is equally easy to see why in the context of negotiations leading up to the creation of an insurance policy, the insured party might overlook to mention what might appear to be a small matter but which assumes vital importance when something goes wrong.

Warranties

Policies that cover trade finance frequently contain a list of “warranties” by the insured. Any deviation from these warranties will constitute a breach of warranty by the insured. For example in a credit risk policy, it would be usual to find a warranty saying that you shall not extend credit in circumstances where debtor fails to meet a deadline for any payment due to the financer. A breach of warranty, however slight, can entitle the insurer to avoid cover. It would not matter that the loss for which the assured is seeking an indemnity from the insurer has little to do with the breach of warranty.

Limitations of using assignments of insurances or being a “loss payee”

Bearing above points in mind, it is crucial (a) that those at the trade house or bank who “operate” the insurance arrangements with the borrower are aware of the disclosure obligations and of the terms of the insurance policy to ensure that material facts are properly disclosed and (b) that none of the terms of the policy are breached by the assured. It is advisable that those relying upon insurance as part of a package of security (for example, by way of an assignment of insurances to the bank or by naming the bank as “loss payee” in the policy) be aware of the limitations of relying upon such assignments of insurances or “loss payee” clauses.
Neither an assignment nor a “loss payee” clause will assist the bank if the borrower has not properly complied with his obligations as insured under the relevant policy.

Our advice to our clients seeking insurance in respect of goods that are held as collateral, is that it is rarely enough to simply rely upon general warehouse insurance covers and that such transactions may warrant a separate insurance policy. We would recommend to our clients that they prepare a special written presentation which encompasses all of the relevant aspects of the transaction.

29. Further advice and assistance

We have within our International Trade and Commodity and Trade Finance Group wide experience of the issues that can arise in structuring commodity finance transactions and in “workouts”/litigation when things go wrong. We are able to assist our clients in preparing for and meeting the new requirements to be implemented under Basel II.
Contacts

If you would like further advice regarding commodity finance and/or Basel II, please contact:

**Nola Beirne**

+44 (0) 20 7247 6555 main
+44 (0) 20 7772 5901 direct
+44 (0) 20 7247 5091 fax
nbeirne@reedsmith.com

**Kyri Evagora**

+44 (0) 20 7247 6555 main
+44 (0) 20 7772 5896 direct
+44 (0) 20 7247 5091 fax
kevagora@reedsmith.com

**Siân Fellows**

+44 (0) 20 7247 6555 main
+44 (0) 20 7772 5806 direct
+44 (0) 20 7247 5091 fax
sfellows@reedsmith.com

**Celia Gardiner**

+44 (0) 20 7247 6555 main
+44 (0) 20 7772 5933 direct
+44 (0) 20 7247 5091 fax
cgardiner@reedsmith.com

**Richard Swinburn**

+44 (0) 20 7247 6555 main
+44 (0) 20 7772 5887 direct
+44 (0) 20 7247 5091 fax
rsSwinburn@reedsmith.com
## Appendix 1

### Table 4 - Supervisory Rating Grades for Commodity Finance Exposures

<table>
<thead>
<tr>
<th>Financial Strength</th>
<th>Strong</th>
<th>Good</th>
<th>Satisfactory</th>
<th>Weak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Degree of over-collateralisation of trade</td>
<td>Strong</td>
<td>Good</td>
<td>Satisfactory</td>
<td>Weak</td>
</tr>
<tr>
<td>Country risk</td>
<td>No country risk</td>
<td>Limited exposure to country risk (in particular offshore location of reserves in an emerging country).</td>
<td>Limited exposure to country risk (in particular offshore location of reserves in an emerging country).</td>
<td>Limited exposure to country risk (in particular offshore location of reserves in an emerging country).</td>
</tr>
<tr>
<td>Political and legal environment</td>
<td>No country risk</td>
<td>Limited exposure to country risk (in particular offshore location of reserves in an emerging country).</td>
<td>Limited exposure to country risk (in particular offshore location of reserves in an emerging country).</td>
<td>Limited exposure to country risk (in particular offshore location of reserves in an emerging country).</td>
</tr>
</tbody>
</table>
## Appendix 1

### Asset Characteristics

<table>
<thead>
<tr>
<th>Strength of Sponsor</th>
<th>Weak</th>
<th>Satisfactory</th>
<th>Good</th>
<th>Strong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial strength of trader</td>
<td>Commodity is not quoted or liquid. Liquid is limited given the size and depth of the market. No appropriate hedging instruments. Commodity is susceptible to damage.</td>
<td>Commodity is quoted and can be hedged through futures or OTC instruments. Commodity is not susceptible to damage.</td>
<td>Commodity is quoted and can be hedged through futures or OTC instruments. Commodity is not susceptible to damage.</td>
<td>Commodity is quoted and can be hedged through futures or OTC instruments. Commodity is not susceptible to damage.</td>
</tr>
<tr>
<td>Track record, including ability to manage the logistic process and risks</td>
<td>Limited experience with the type of transaction in question. Average record of operating success and cost efficiency.</td>
<td>Sufficient experience with the type of transaction in question. Above average record of operating success and cost efficiency.</td>
<td>Extensive experience with the type of transaction in question. Strong record of operating success and cost efficiency.</td>
<td>Very strong, relative to trading philosophy and risks.</td>
</tr>
</tbody>
</table>

### Strength of Sponsor

<table>
<thead>
<tr>
<th>Financial strength of trader</th>
<th>Weak</th>
<th>Satisfactory</th>
<th>Good</th>
<th>Strong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial strength of trader</td>
<td>Commodity is not quoted or liquid. Liquid is limited given the size and depth of the market. No appropriate hedging instruments. Commodity is susceptible to damage.</td>
<td>Commodity is quoted and can be hedged through futures or OTC instruments. Commodity is not susceptible to damage.</td>
<td>Commodity is quoted and can be hedged through futures or OTC instruments. Commodity is not susceptible to damage.</td>
<td>Commodity is quoted and can be hedged through futures or OTC instruments. Commodity is not susceptible to damage.</td>
</tr>
<tr>
<td>Track record, including ability to manage the logistic process and risks</td>
<td>Limited experience with the type of transaction in question. Average record of operating success and cost efficiency.</td>
<td>Sufficient experience with the type of transaction in question. Above average record of operating success and cost efficiency.</td>
<td>Extensive experience with the type of transaction in question. Strong record of operating success and cost efficiency.</td>
<td>Very strong, relative to trading philosophy and risks.</td>
</tr>
</tbody>
</table>

### Asset Characteristics

<table>
<thead>
<tr>
<th>Strength of Sponsor</th>
<th>Weak</th>
<th>Satisfactory</th>
<th>Good</th>
<th>Strong</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial strength of trader</td>
<td>Commodity is not quoted or liquid. Liquid is limited given the size and depth of the market. No appropriate hedging instruments. Commodity is susceptible to damage.</td>
<td>Commodity is quoted and can be hedged through futures or OTC instruments. Commodity is not susceptible to damage.</td>
<td>Commodity is quoted and can be hedged through futures or OTC instruments. Commodity is not susceptible to damage.</td>
<td>Commodity is quoted and can be hedged through futures or OTC instruments. Commodity is not susceptible to damage.</td>
</tr>
<tr>
<td>Track record, including ability to manage the logistic process and risks</td>
<td>Limited experience with the type of transaction in question. Average record of operating success and cost efficiency.</td>
<td>Sufficient experience with the type of transaction in question. Above average record of operating success and cost efficiency.</td>
<td>Extensive experience with the type of transaction in question. Strong record of operating success and cost efficiency.</td>
<td>Very strong, relative to trading philosophy and risks.</td>
</tr>
</tbody>
</table>

### Appendix 1

... cont'd

---

**Appendix 1**

... cont'd
<table>
<thead>
<tr>
<th>Strong</th>
<th>Strong</th>
<th>Excellent</th>
<th>First perfected security interest provides the lender legal control of the assets at any time if needed.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good</td>
<td>Adequate standards for counterparty selection, hedging, and monitoring.</td>
<td>Good</td>
<td>First perfected security interest provides the lender legal control of the assets at any time if needed.</td>
</tr>
<tr>
<td>Satisfactory</td>
<td>Past deals have experienced no or minor problems.</td>
<td>Satisfactory</td>
<td>At some point in the process, there is a rupture in the control of the assets by the lender. The rupture is mitigated by knowledge of the trade process or a third party undertaking as the case may be.</td>
</tr>
<tr>
<td>Weak</td>
<td>Trader has experienced significant losses on past deals.</td>
<td>Weak</td>
<td>Contract leaves room for some risk of losing control over the assets. Recovery could be jeopardized.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Strong</td>
<td>Excellent</td>
<td>Strong</td>
<td>Excellent</td>
<td>Strong</td>
<td>Strong</td>
<td>Excellent</td>
<td>Strong lands and hedging policies</td>
</tr>
<tr>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good lands and hedging policies</td>
</tr>
<tr>
<td>Satisfactory</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
<td>Satisfactory</td>
</tr>
<tr>
<td>Weak</td>
<td>Weak</td>
<td>Weak</td>
<td>Weak</td>
<td>Weak</td>
<td>Weak</td>
<td>Weak</td>
<td>Weak lands and hedging policies</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Insurance against damages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strong insurance coverage including collateral damages with top quality insurance companies</td>
</tr>
<tr>
<td>Advanced insurance coverage not including collateral damages with acceptable quality insurance companies</td>
</tr>
<tr>
<td>Satisfactory insurance coverage not including collateral damages with good quality insurance companies</td>
</tr>
<tr>
<td>Fair insurance coverage not including collateral damages with acceptable quality insurance companies</td>
</tr>
<tr>
<td>Weak insurance coverage not including collateral damages or with weak quality insurance companies</td>
</tr>
</tbody>
</table>

Appendix 1... cont'd
## New risk weights

<table>
<thead>
<tr>
<th>Category</th>
<th>UL Proportion</th>
<th>EL Proportion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strong</td>
<td>70%</td>
<td>5%</td>
</tr>
<tr>
<td>Good</td>
<td>90%</td>
<td>10%</td>
</tr>
<tr>
<td>Satisfactory</td>
<td>115%</td>
<td>35%</td>
</tr>
<tr>
<td>Weak</td>
<td>250%</td>
<td>100%</td>
</tr>
<tr>
<td>Default</td>
<td>0%</td>
<td>625%</td>
</tr>
</tbody>
</table>

**UL** = Unexpected Loss  
**EL** = Expected Loss