Trade finance in Nigeria: Structured commodity financing as an instrument for mitigating risk

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The buoyancy of international trade and access to trade finance are key contributors to the development of any nation's economy In 2009, the volume of Nigeria's international trade amounted to circa US$80.74 Billion constituting about 22.6% of its total Gross Domestic Product (GDP)[1]. Since more than ninety percent (90%) of trade transactions involve some form of credit, insurance or guarantee, trade finance is undoubtedly, the very fulcrum for international trade. By bridging the information asymmetry between buyers and sellers, and creating a trust-based system whereby upon fulfilment of certain conditions, sellers receive payment for goods sold and buyers get the goods they paid for, trade finance guarantees increased international trade.

Trade Finance in Nigeria - Aftermath of the Global Financial Crisis

Like most other countries in Sub-Saharan Africa, Nigeria is often considered a high risk market by international commercial lenders and has consequently attracted inadequate financing relative to its needs. Given that Nigeria is largely import-dependent, there is heavy reliance on credit from local and international banks to finance import activities. Unfortunately, the recent global financial crisis adversely affected the Nigerian banking sector[2] and eroded the volume of trade finance provided by these banks. Nonetheless, international trade continues to remain a significant contributor to Nigeria's GDP.

Mitigating Risk using Structured Commodity Finance

Despite its immense benefits, international trade involves a significant amount of risks. These range from commercial risks arising from non-acceptance of goods by the buyer, failure of the buyer to make payments, delay in the delivery of goods, failure of foreign banks to honour documentary credits or currency devaluation, to political risks arising from such factors as inconsistent government policy, wars, riots and civil commotion, and restrictions on foreign exchange dealings. The effectiveness of trade finance is measured by the extent to which it facilitates the reduction of these risks.

Different types of financial tools and packages have evolved over time as a way of mitigating these risks. One of such tools is structured commodity finance. Structured commodity finance involves the financing of trade flows and or capital goods while taking security over the goods that constitute the trade flow. Through structured finance, assets that are related to the relevant trade transaction, having more or less predictable cash flows can be isolated from the originator (importer or exporter) and used to secure the credit advanced, thus mitigating risks of the originator's default or non-payment.

Structured Commodity Finance in Nigeria

Two basic models of structured commodity finance that are increasingly being utilised in Nigeria are import financing collaterized with warehouse receipts and export receivables-backed financing.[3] These

[1] Central Intelligence Agency, The World Fact Book accessed online on July 19, 2010.
[2] The global financial crisis which brought along with it a declined oil price and stock price meltdown triggered a crisis in the Nigerian banking industry with several banks suffering erosion of capital base and illiquidity. This prompted the intervention of the Central Bank of Nigeria, the apex regulator of Nigeria's banking and financial services sector, which led to the removal of the managements of eight banks and the injection of ₦620 Billion (approximately US$4.11 Billion as Tier II Capital into the affected banks.
[3] Other variants of structured commodity finance are inventory financing and prepayment.

models simply involve the use of security structures that complement security interests like pledges and charges.

With respect to import finance collaterized with warehouse receipts, it is common for banks to secure the financing of international trade by taking pledges over the goods purchased by the importer with the credit advanced. However, given the impracticability of the bank to actually take physical possession of the goods, the bank would usually take a pledge over the bills of lading[4] and appoint an independent collateral manager, who is knowledgeable about the nature of the goods, to monitor the goods. For this purpose, the bank, the collateral manager and the importer would enter into a tripartite collateral management agreement. Under this agreement, the collateral manager assumes, on behalf of the bank, custody of the goods until they are sold to final offtakers and the proceeds of sale, used to offset the importer's outstanding loan with the bank. Importantly, upon importation of the goods, same are transferred to a warehouse under the control of the collateral manager. The collateral manager then issues warehouse receipts,[5] made out in the name of the bank, which state the quality of the goods, the quantity received, and the value at time of receipt. These warehouse receipts will serve as a security for the loan advanced to the importer.

The collateral manager is also obliged to issue periodic reports which ensure that the bank can monitor the total value of the goods in stock and the accounts receivables, thereby effectively keeping an eye on its credit risks. Stock will be released from the warehouse only upon the instructions of the bank. Likewise, movement of stock from one storage facility to another will require prior authorisation of the bank and will be subject to the supervision of the collateral manager.

It is pertinent to note that in addition to the appointment of a collateral manager to issue warehouse receipts, in order to guarantee the effectiveness of the bank's security, the creation of a pledge over the warehoused goods, the assignment of offtake contracts for the sale of the goods to the bank and the creation of a charge over an account (maintained with the bank) into which proceeds of sales of the goods will be remitted, are essential.

With respect to export receivables-backed financing, a loan is granted to an exporter, security is provided by the assignment of export sales contracts and receivables, and repayment comes from export proceeds paid by identified offtakers into a bank account controlled by the bank. Credit enhancement devices such as export credit insurance and export credit guarantees may also be utilised in hedging against risks.

Creating Effective Security

For a structured commodity finance transaction to be successful, the underlying security taken by the bank must have been duly created and perfected so that it can be enforced and fully realised in the event of a default by the importer or exporter. As mentioned above, there are other forms of security interests that may created over the goods. Proper legal documentation which give effect to these interests must be prepared and entered into by the parties and these security interests must be duly perfected in accordance with local laws. With respect to Nigeria, the main issues surrounding perfection of security interests include stamping and registration of the instruments by which the security interests were created.

[4] A bill of lading can be pledged because it carries with it the benefit of the carrier's obligations to deliver the goods and thus represents the goods. Therefore, a pledge of a bill of lading is good security as the endorsement and delivery of the bill of lading can transfer possession not only of the piece of paper itself but also of the underlying goods.

[5] Depending on the transaction structure such warehouse receipts may either be negotiable or non-negotiable.

Stamping

Under Nigerian law, stamp duty is chargeable on a wide range of instruments with connection to Nigeria. Specifically, stamp duties are payable ad valorem, on virtually all security documentation. Duty rates range from 0.375% to 1.5% of the amount secured and, vary with the specific type of security and the nature of the assets involved. Under the Stamp Duties Act Cap S8 Laws of Federation of Nigeria ("LFN") 2004 ("SDA"), relevant instruments are required to be stamped within thirty (30) days of execution or where executed outside Nigeria, within thirty (30) days of receipt of the instrument in Nigeria. The obligation to stamp is statutorily imposed on the obligee (the banks); although in practice, the burden for the payment of the duty is usually transferred to the obligor (the borrower).

The payment of stamp duty is particularly relevant for the purpose of enforcing the security created by the security documents. This is because instruments that are required to be stamped under the SDA are precluded from being admitted in evidence by a Nigerian court without the required duty and applicable penalties, first being paid. Further, late payment of stamp duty attracts a penalty of interest at the rate of ten percent (10%) per annum from the due date up to the time when the amount of interest is equal to the unpaid duty. Thus, in order to enforce the security interests created by documents such as a letter of pledge, contracts assignment agreement and or deed of charge over account in Nigeria, it is imperative that same are duly stamped.

Where stamp duty is chargeable at an ad valorem rate of the amount secured, most times, depending on the sum that was borrowed, the borrower may be unable to pay the full stamp duties payable or even where able, the parties may agree that it is prudent to minimise the transaction costs. In practice, parties need not secure the entirety of the borrowing company's obligations in the first instance but may agree on a notional amount for stamping purposes and subsequently, where the need arises, upstamp the secured amount to the full obligation. This structure will assure that the parties only incur the full stamp duty obligation where the need arises. In this regard, section 202 of the Companies and Allied Matters Act Cap C20 LFN 2004 ("CAMA"), permits parties to a registrable charge to determine a figure as the maximum amount secured by the charge, particularly where the charge secures fluctuating or uncertain amounts. The proviso to section 202 of CAMA further states that the maximum sum deemed to be secured by a registrable charge can be increased at any time prior to the winding up of a company, provided additional stamp duty is "subsequently" paid on such increase. It is however pertinent to note that the instrument will only be enforceable in respect of the additional amount, from the date of upstamping thereof and charges registered by third parties over the same asset during the intervening period may claim priority over the additional amount in respect of which the instrument is upstamped.

Registration

Section 197 (1) of the CAMA prescribes that every charge created by a company with the intention that it provide security, shall be void against the liquidator and any creditor of the company unless it is registered with the Nigerian Companies Registry (i.e. the Corporate Affairs Commission ("CAC")) within ninety (90) days of its creation. The CAMA requires the registration of all floating charges and specified categories of fixed charges including charges "for the purpose of securing any issue of debentures."

The registration with the CAC is done after stamping of the security documents and attracts a fee of one percent (1%) of the amount secured. Barring any unforeseen circumstances, the registration of a charge with the CAC can generally be concluded within a period of two (2) weeks from stamping of the security documents.

Overcoming the Challenges

Structured commodity finance in Nigeria, is not without its challenges. The use of storage facilities owned and or controlled by port authorities or other government agencies (as against the borrower or non-government third party's warehouses) for storage of the financed goods is a typical challenge that banks have had to grapple with.

A key element in the collateralisation of goods using warehoused receipts is that the collateral manager should have unfettered access to and control over the warehouse in which the goods are stored. Typically, this is achieved by the collateral manager leasing or subleasing the warehouse from its owner and obtaining a waiver of any liens or other security interests which the warehouse owner, as lessor, may have over the warehoused goods. In the case of a government-controlled warehouse, for example, a warehouse owned by the Nigerian Ports Authority (NPA), neither a lease of the warehouse nor a waiver of lien can realistically be obtained. The degree of control a collateral manager would have over such a warehouse (and the goods in it) is necessarily limited. Thus, in the event of an importer's breach of the contract between the NPA and such importer, the NPA could exercise a lien on the goods regardless that the bank may also have a lien thereon. The preferred approach for most banks is to avoid, to the maximum extent possible, the use of government warehouses; however this may mean increased transaction costs as private warehouses are sometimes more expensive. Where government warehouses are used, a helpful approach would be to adopt the terms of the lease agreement with the government agency into the collateral management agreement so as to ensure the importer's compliance with the terms of the lease agreement with the government agency. Notwithstanding the foregoing, it is clear that the collateral manager's control of the warehouse remains limited.

Another common challenge facing financiers in structured commodity finance transactions is how to manage risks associated with the warehousing of commodities that require further processing. Although the borrower owns the commodities that are to be processed, the storage of such commodities in independently controlled warehouses is impractical because the commodities require further processing before they can be sold to the final consumers. This challenge may however be resolved by the release of the goods to the borrower against the execution of a trust receipt in which the borrower acknowledges receipt of the goods from the bank, recognises the bank's interest in the goods and is obliged to remit the proceeds of sale of such goods to the bank in payment of the loan. There is, of course, still a risk of default and prudent banks would agree to release goods on trust receipts only when they have confidence in the integrity and creditworthiness of the borrower. An alternative to the use of trust receipts is to, where practicable, place the warehouses in which the goods are stored during and after processing under the collateral manager's supervision.

Other drawbacks of structured commodity finance are its complexity and additional transaction costs. However, although upfront costs of structured finance may be high, the overall cost of funding may be lower than that in traditional financing because of better pricing of debt. Also, the more perishable and volatile a commodity and its price are, the riskier it is to store. The risk of price volatility may however be hedged by using futures or options.

Conclusion

Given Nigeria's commodities export base, and huge reliance on imports, structured commodity finance appears to be the future of trade finance in Nigeria. By offering better pricing, through enhanced credit and mitigation of risk, overall lower transaction costs as well as longer maturity periods, structured finance enables financing on better terms. With structured commodity finance increasingly gaining popularity, Nigerian importers and exporters can have access to a whole range of alternative financing solutions, with a single, overriding objective - obtaining credit in markets where conventional financing methods have not been optimal.