

FIELD WAREHOUSE RECEIPT FINANCING

IMPLEMENTATION PHASE



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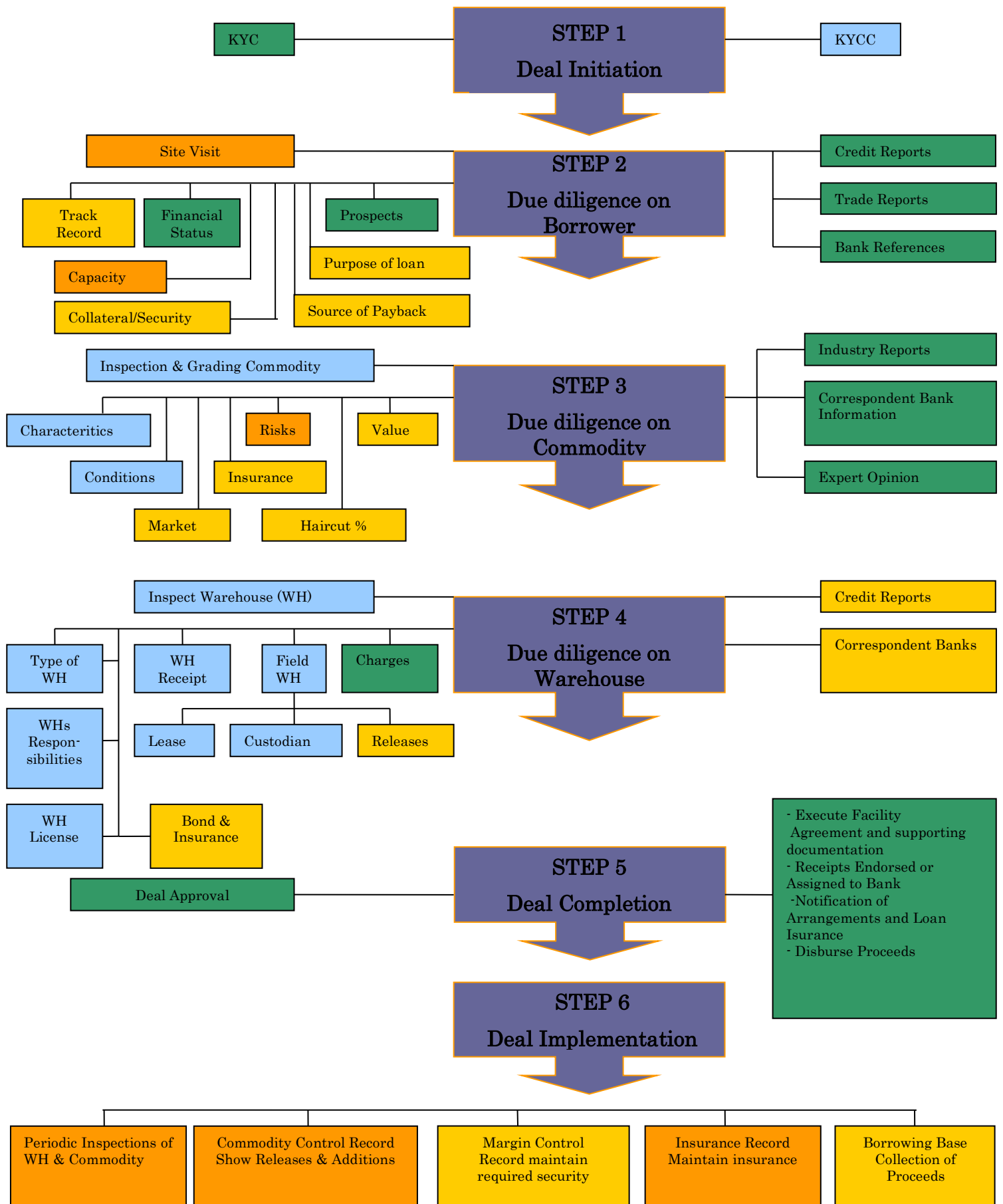
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Note

Briefly, the following steps should be observed (see figure 2) :

- Receipt of application (preliminary screening of applicant)
- Due diligence on borrower (credit checks, plant visit)
- Due diligence of commodity (normal risks of commodity, proof of adequate insurance, maximum lending amount)
- Due diligence of warehouse (legality of warehouse receipts, credit checks, license, bond, insurance)
- Closing loan (execution of essential documents, filing financing statement, adequate insurance coverage, invoices)
- Servicing loan (note and liability record, commodity control record, periodic inspections of commodity and warehouse, insurance)



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Field Warehouse Receipt Financing

The following recommendations are mainly for the use of lenders, particularly banks, who need to secure their loan when financing export or import transactions.

The procedures involved in granting loans secured by all kinds of field warehouse receipts are basically the same. However, additional security measures should be taken when field warehousing is involved.

If properly controlled, field warehouse receipt financing is convenient to the borrower and safe to the lender. However, banks' lending funds on the security of warehouse receipts covering goods in storage should clearly understand a number of features of these receipts.

To safeguard their interest to the fullest extent possible, the lender will need to appoint an independent Collateral control company in order to establish in a legal court of law if required the « independent, notorious and continuous » control of the collateral.

Various issues referred to hereunder may apply to any field warehouse receipt financing

1- Validity of the Warehouse Receipt

This crucial point in every warehouse receipt transaction is sometimes given insufficient attention. The bank should satisfy itself that every receipt offered as collateral is valid and that it is signed in ink or indelible pencil by authorized persons only.

Nevertheless, from a collateral security viewpoint, caution is in order when there are close intercompany relations between the owner of the pledged goods and the facility that is storing them. Private or subsidiary warehouse receipts may be perfectly acceptable to the lender, so long as the warehouse is controlled by a reputable operating company. The receipt, however, is merely scrip since control of the goods remains, directly or indirectly, in the hands of the depositor.

In this situation field warehousing is generally exercised by the borrower himself and the main risk for the lender is misappropriation, considering that no permanent and independent control is performed over the stored goods.

Description of goods. In any case, receipts should describe the goods for which they have been issued, and identify them when possible. Receipts issued for fungible commodities, and particularly where there are multiple receipt holders looking to the same pool of collateral, necessitate absolute and distinctive identification of goods. Their validity may be determined by checking with the warehouse company.

In other words, the lender must carry out regular stocktaking operations and compare the physical findings in the warehouse with the documentary evidence as provided by the borrower.

Here again the lender is at the entire mercy of the borrower, especially if the bank's officer in charge of control is not familiar with both the variety of goods which could be involved and warehousing and documentary techniques.

Warehouseman verification. The lending bank can verify the validity of non-negotiable receipts when it notifies the warehouse of the transaction and requests a new receipt in the name of the bank as depositor. Negotiable receipts need not be surrendered for new ones, but should be checked for validity during the normal course of the loan due diligence. It is also important to keep in mind the differences in rights that the bank has as holder of a negotiable receipt and as holder of a nonnegotiable receipt.

Therefore, prior to entering into any finance agreement, the bank must seek the legal opinion of a local law firm or credit support company of good reputation.

2- Capability and Reputation of the Warehouseman

Banks that consider field warehouse receipt financing an important activity should develop their own files on warehouse companies. These can contain reports from banks, trade associations, agency reports or even newspaper stories.

The warehousing company should be asked for references, which can then be contacted by the bank either directly or through its correspondents.

Files should contain information regarding the warehouseman's financial and moral responsibility, capacity, and reputation in the trade, credit record, method of operation, type and adequacy of warehouse facilities, experience with various types of commodities, and insurance (legal liability and fidelity) protection afforded to receipt holders.

In addition, when field warehouse receipts are being pledged as collateral, the lending bank should determine:

- Whether the premises are suitable for storing the particular goods.
- Whether the leasing arrangement is legal
- Whether the pledged goods are properly separated from unpledged assets
- Whether signs and markers are clearly displayed inside and outside the warehouse
- Whether the goods are adequately described as to weight, quantity and nature in the receipt and are readily identifiable in the storage premises
- Whether the receipt itself meets the requirements of the law of the state in which it is issued
- Whether the custodian fully understands and performs his duties, so that the borrower's dominion over the goods will not be jeopardized
- Whether proper bond protection is given the receipt holder as an independent guarantee of the field warehousing organization's performance and against losses arising from infidelity of employees
- The extent to which field auditors of the field warehousing company independently examine each warehouse. These examinations should occur at irregular intervals for the surprise element and should include a careful check of stocks, custodian records, adequacy of markers, and any other points that may be desirable for the protection of the receipt holders

This is time-consuming, so it is advisable for the lending bank to deal with well-established and responsible field warehousing companies.

However, it must be recognised that all these technicalities are not very familiar to banks whose first mission is to focus on their pure banking activities. Furthermore, too much confidence given to a warehousing company even if the latter is considered of good reputation may lead to unpleasant situation. Rather than trying to assess the capability of the warehousing company by its own internal means, most of the time the lender will appoint a totally independent service company who will undertake the proper investigations. Collateral Control Companies are most familiar with warehousing techniques and thanks to their local coverage they are in a position to provide reliable and comprehensive information to banks. It is recognised that bank's credit committee decision are often based on the findings of the Collateral Control Company.

3- Warehouse Custodians

In a pure field warehousing environment lenders must take into account an important human factor, namely, the psychological pressure that may be exerted on the warehouse custodian.

Employees of a terminal warehouse are answerable only to the warehouse owner for their acts, so there is a minimum of pressure on them to undertake unauthorised actions. If the warehouse arrangement were to be terminated, it is more than likely that the warehouseman's employee would again return to the payroll of the owner.

Consequently, the field warehouse employee may feel a degree of loyalty and dependence toward the owner of the commodities. In turn, this leads to the danger that the custodian may undertake actions not necessarily in the best interest of those looking to proper control of the commodities.

This does not make terminal warehousing good and field warehousing bad. Both terminal and field warehousing serve useful and constructive purposes in the field of finance, but basic principles and controls applicable to each should be followed.

In the case of field warehousing, the close involvement of an independent third party is imperative if the lender wants to mitigate the risks described above. In other words, the borrower will not be left alone and the appointment of a credit support company will have to be envisaged.

When field warehousing was new, there was a serious question as to the propriety of an employee –or former employee- of the bailor serving as a custodian of the goods for the warehouseman. In fact, there is still a difference of opinion among bankers, warehousemen, and others on this point. Some maintain that the custodian must be wholly in the employ of the warehouseman, while others feel that a “former” employee of the borrower can serve in that capacity so long as he is paid by and employed by the warehouseman and the warehouse company is fully liable of all acts of the custodian. The latter arrangement is convenient for the warehouseman, since the custodian is familiar with the owner's operation. With ordinary care, lender's experience with the use of “former” employees has been satisfactory.

In any case and even when the custodian is officially appointed as a member of the warehousing company and paid by the latter, the recourse to an independent third party is highly recommended as it will bring additional comfort and security for the lender.

4- Credit Analysis of the Borrower

The prime issue in any loan decision is the lender's confidence that the debtor will repay the loan. With so much procedural emphasis on security and collateral in warehouse receipt financing, this fact is sometimes overlooked.

A warehouse receipt is not a blank check. It is not a loan guarantee, nor is it a substitute for good banking. A warehouse receipt is merely a receipt for goods in the warehouse, giving the holder whatever title or degree of title resided in the depositor of the goods in the first place. Thus, it is not even a guarantee of title to goods.

If a bank deals with people of less than proven integrity, either directly or indirectly, it runs a serious risk of incurring losses. Clearly, banks must always remain alert to credit fundamentals. Character, capital, capacity, and conditions of the times are just as important in warehouse receipt financing as they are in any other credit situation.

The taking of additional risk can rarely be justified merely because a borrower has pledged warehouse receipts to secure the loan. Lender's decisions must be based on favorable judgments of the borrower's growth potential, earning power, financial and moral responsibility, and desirability as a bank customer. Only then can assignment of warehouse receipts provide an added measure of safety to the loan.

As part of its procedure, the bank will undoubtedly request the borrower to submit periodic financial statements. These are usually in the form of balance sheets and operating statements.

If the borrower is a commodity dealer or manufacturing concern trading in commodity markets for its raw materials, the bank should also request "position statements".

These listings of the borrower's commitments in commodity futures help the analyst determine whether the borrower has reduced vulnerability to market price swings by hedging. At the same time, it indicates the degree of price-change risk contained in the pledged collateral.

It is also accepted that the bank's due diligence exercise is not always objective enough. If the borrower is an existing client, the bank may be incited to be more flexible than with a new client, thus increasing its risks. Furthermore and even if the bank is very strict with its in-house procedure, it may not be familiar enough with the technical and operational aspects of the borrower's activities and inclined to limit its due diligence on balance-sheet only. On the contrary, it is the very objective of the Pre Loan Survey as proposed by the Credit Support Company:

- To carry out a complete investigation and analysis of the nature of the collateral, the market perception, pricing, debt management, integrity and trading ability of the prospective borrower
- To propose independent technical assistance to the lender
- To help determine whether the prospective borrower is an acceptable risk

The Pre Loan Survey will also particularly insist on such issues as :

- Ownership and control
- Management competence
- Technical capability to handle the asset conversion cycle
- Financial history and projections
- Suppliers and customers
- Country and currency risk
- Legal environment

The Credit Support Company will help identify all aspects of the potential transactional risks, with description of mitigants and procedures and secure the whole transaction for the benefit of the lender.

5- Analysis of Endorsers

The depositor's title to stored goods passes, upon assignment or endorsement, to the new holder of the warehouse receipt. If the previous owner had good title, the transaction should pose no problem to the lending bank. But if the previous owner did not have clear title or if there is a question of fraud or misrepresentation, the transferred warehouse receipt does not serve as a guarantee of title to the new holder. Clearly, prior owners of commodities covered by warehouse receipts should themselves be acceptable credit risks.

At this stage adequate legal procedures can be put in place by the Credit Support Company to prevent from any possibility of recourse from prior owners of the goods.

Although field warehouse receipts embody the goods they represent, the lender assumes a basic risk that goods or commodities of specified quality and value stand behind the receipt. The lender receives no guarantee of commodity grade with the warehouse receipt and should look to the previous owner or the other sources of sound information on commodity grade and quality.

Therefore, the bank's analysis of the loan risk should be focused on the borrower, but it should also include the endorser or prior owner, the collateral, and the warehouse.

Inspection companies can be appointed to check the quality of the goods when they are taken as collateral. When the goods do not meet all contractual specifications same are rejected and no warehouse receipt is issued.

6- Collateral Security

Contact with the custodian as well as the authorized representative of the warehousing organization enables the bank to be certain that its interest are understood and will be protected. Subsequent routine transactions give the bank an opportunity to check first impressions. Minor infractions of recognized procedure should be corrected immediately.

Compliance with law. Check the warehouse company's receipts to see that they comply with the laws of the state where issued. The bank's attorneys can check into this matter and –at least on the initial credit of this kind– review the litigation that has come before the state courts on matters involving warehouse operations.

One of the objectives of the Pre Loan Survey as described above is to identify and investigate all the legal aspects of the transaction. Being already on the spot the Credit Support Company is certainly in the best position to understand and secure the legal environment.

Substitution of collateral. Except where goods are stored as fungible commodities, there can be no substitutions of collateral under a receipt. If substitutions are made, it is necessary to release the goods and receive a new receipt. The bank should review its receipts to check slow-moving goods. The bank can do it itself or preferably by appointing a third party.

Commodity hazards. Besides being physically separated from other goods owned by the borrower, the items covered by the warehouse receipts should be adequately protected from natural and unnatural hazards, harmful weather elements, damaging temperature and humidity, and the many other factors that affect their value and cause deterioration.

It has to be noted that the bank may lack the corresponding experts but the risk of commodity hazards must not be minimized.

Collateral Controller. In general, the warehouseman or collateral Manager is not responsible for the quality and weight of commodities stored.

In describing commodities, most warehouse receipts use the clause “said to be or contain”, and thus provide no guarantee of the commodity grades. It is important that banks use adequate collateral controller.

If in the past banks used to perform their own physical controls, present modern banking procedures favour the nomination of specialized experts who are familiar with the various situations which may occur and which all need appropriate and specific answers.

They should test the adequacy of the warehouse in every respect. A properly run warehouse must maintain continuous, declared, and exclusive control of the commodities if it is to have a foolproof bailment.

“Bailment” means the transfer of the possession of Goods by the owner (bailor) to another (the bailee) which shall thereafter maintain notorious, continuous and exclusive possession of all the Goods, for particular purposes such as hiring, financing, pledge of goods, and the delivery of Goods for carriage, safe custody or repair.

As a further precaution, banks must guard against undue concentrations of collateral at any one warehouse location. Whenever heavy concentrations cannot be avoided, steps should be taken to minimize bank exposure.

Here again the Collateral Control Company intervenes and will ensure that strict procedures are respected by the warehousing company.

Liens and Charges. Be sure that stored merchandise is free of liens, and that the pledger has good title. Check periodically with the warehouseman to determine that storage charges are being paid, for such charges are a first lien on the goods stored. This is particularly necessary when terminal warehouse is concerned.

Margins. In this type of financing, margin of security may be so low that it is fairly easy for the operator to incur too much debt.

For example, it is customary to finance cotton on a 15 per cent margin. The 15 per cent represents the borrower’s equity in the cotton; strict adherence to the margin requirement prevents the borrower from expanding his credit beyond his financial capacity. In addition, the margin is an important protection to the bank if the price of cotton declines.

There is no substitute for reasonable equity; any lender ignoring this premise may receive a startling shock in a wide market swing.

In many situations, the security margin may be much higher than 15% as mentioned above. As an example, unprocessed goods may have to be financed and the margin will have to be based on the outturn of the finished product. As a rule however, the security margin decided by the bank also depends on the estimated level of risk of the transaction.

7- Marketability of Collateral

On the chance that a loan may be defaulted, the nature and marketability of the underlying collateral are important considerations. Goods for loan security may be staple or no staple.

A readily marketable staple can be defined as “an article of commerce, agriculture; or industry of such uses as to make it the subject of constant dealings in ready markets with such frequent quotations of price as to make (a) the price easily and definitely ascertainable and (b) the staple itself easy to realize upon sale at any time”.

A non-staple is not as easily defined, but the principles of marketability still apply. The goods must be readily saleable at a price, even in forced liquidation, sufficient to meet the selling expense incurred and retire the loan.

It is, of course, preferable to have the borrower move the collateral in a normal and orderly fashion; any indication that forced liquidation is likely should warn the banker away from the loan. To provide an additional measure of safety to the loan, however, the lender will want to consider the following factors:

Appraisal. Before approving a warehouse receipt loan, the bank should obtain a fair appraisal based upon present liquidating values of the commodity. The fact that a staple is actively traded and its market price is daily quoted by market services and newspapers with a financial page is not enough. The margin of market value over the amount advanced should be considered in the light of the following questions:

- Where is the market located?
- Who makes up the market?
- How wide is the market?
- Is the borrower a large factor in this market?
- What has the range of prices been over a period of years?
- Is the market activity seasonal?
- What are the out-of-season penalties?
- Does the published quotation cover only one classification of the goods?
- How many standards are there and how is the security to be classified?
- What penalties are imposed for poor quality?
- What are the risks of decay, shrinkage, discoloration, rust, obsolescence, and other causes of quality deterioration?
- Can a firm commitment or purchase order covering the goods be obtained from a responsible source?

It is the role of the Collateral Control Company to answer the above questions when carrying out the Pre Loan Survey. It is obvious that a full knowledge of the market is necessary to make valuable recommendations to the lender. Being on the spot, it is the duty of a reliable third party to be fully aware of market location, composition of market or commodity grades.

Market location. The location of the market is important, particularly when it is distant from the storage place of the goods. Not only must freight costs be considered, but negotiations for sale may also require travel or lengthy correspondence in order to build up contacts. Little reliance can be placed on outlets of the borrower since they may have been based on a relationship that no longer exists when the bank takes possession of the goods.

Composition of the market. Be completely familiar with the market peculiarities of the pledged goods. In some industries, producers or converters are widely scattered, but sell to a small and well-coordinated group of buyers. In others, buying and selling are done by brokers, distributors, or manufacturers' agents, so sales effort is confined to just a few outlets.

If the client has been a big factor in the market, the goods may be so well known that forced sale is comparatively simple. Goods of a small producer or manufacturer selling in a narrow segment of the market will probably meet greater sales resistance.

Prospects. Compare the present stock of the borrower with past sales and financial capacity, for there is no substitute for net working capital or equity. Security by pledge, though convenient and economical in warehousing, should not instill a false sense of safety to the exclusion of fundamental principles of sound financing. Likewise, the moral risk is as important as in any other type of financing.

Seasonal aspects. The bank should have some prior knowledge of seasonal aspects of the borrower's business. It also helps to know how long it takes to manufacture the goods in question, and to have some idea of when and where they can be sold. Falling prices, a non-receptive market, or a poor season can weaken the collateral position of the lender.

Sources of market information, government agencies, trade associations, and trade publications provide current and worthwhile information on the different markets. Reliable information can also be obtained from correspondent banks in the larger centers, since they usually subscribe to specialized commodity market services. Financial newspapers and periodicals are also good additional sources of market information.

Commodity grades. Grades and standards of pledged goods should be the same as those quoted in the market, for those factors affect values and marketability.

Off-grades in sizes, color, shape, and general quality may result in much lower prices at liquidation. On this question of grades, the lender can seek the advice of competitors,

Market authorities, independent laboratories, professional men, government bureaus, and other sources by submitting samples or having the actual goods checked.

Quality of pledged goods remains one if not the main risk to be considered by a serious and professional lender. Furthermore, the value of the pledged goods as announced must be in strict conformity with the actual value of the stored goods. To mitigate these risks, a thorough quality inspection at time of delivery of goods into warehouse is imperative just like regular physical controls during storage.

The bank should feel no compunction about obtaining this protection. In fact, checking might well be continued in some cases by selecting mine-run samples from time to time. The quality of collateral does not in itself make a good loan; a smaller margin of high quality product may be better security.

8- Insurance Coverage

Adequate insurance coverage is essential. The lender should learn what insurance covers the pledged commodities and receipts and be sure that his interest is fully protected by a loss-payable clause in favor of the bank.

The policies can cover losses from liability, fidelity, physical damage, boiler and machinery breakdown, and a number of other causes.

The insurance policies of the borrower and the warehouseman should also contain a provision in the loss-payable clause that the bank's interest in the insurance may not be rescinded or invalidated through a neglectful act of the borrower or the warehouseman. Furthermore, the lender should require ten days written notice of cancellation or of any material change in the policy.

More generally, the lender should never enter into a financing arrangement without prior assessment of the policies. Recourse to insurance experts is advisable.

Liability and fidelity. Only accept a receipt issued by a field warehouse company that carries adequate warehouseman's legal liability insurance and fidelity coverage on its employees. The coverage offered by larger insurance companies varies in some degree, but generally it is in the nature of a blanket policy in favor of the warehouse company. Terminal warehouses should also carry such insurance.

A reliable Collateral Control Company must be in a position to propose to lenders an adequate insurance coverage and among others:

- An Error & Omission policy
- A Comprehensive Fraud policy
- An “all risks” cargo insurance including misappropriation plus Fog +FOQ

In any case, and in addition to the maritime leg, these policies must also be valid for goods being moved, processed or warehoused both up-country and in port areas.

Physical damage. The warehouseman is liable for burglary and pilferage losses resulting from his failure to exercise due care and generally is not under any obligation to insure the commodities stored against physical loss or damage resulting from fire, water, wind, collapse, decay, shrinkage, rust, spoilage, and other forms of deterioration.

Field seed, for instance, might lose its germination if carried past the planting season. Lumber may warp from moisture or stacking. Certain products require fairly rigid temperature control, or proper ventilation.

The practice of selecting an employee of the borrower as field warehouse custodian or assistant custodian can help here. While all warehousemen cannot be expected to have a detailed knowledge of storing conditions of all goods, certainly a former employee of a concern handling a particular item would be well informed on this point.

This practice of selecting an employee of the borrower may seem to be cheaper but all well considered it cannot replace the independent approach of a specialized third party.

9- Administration of Warehouse Receipt Loans

The conscientious administration of warehouse receipt loans can very well mean the difference between successful and unsatisfactory experience with this type of financing.

It goes without saying that record keeping must be precise and up to date. Check internal procedures frequently to make sure that documentation is correct. Bank personnel handling day-to-day transactions on warehouse receipt loans must carefully follow sound practices, especially in the verification of authorized signatures.

Notify warehousemen of transfers with a minimum of delay when their receipts are pledged as collateral. Keep current all records of charges and liens outstanding against the collateral. Practice all the other common rules of accurate and adequate record keeping.

Audit the warehousing arrangement from time to time. Review the terms of the arrangement with the bank's customer, and make unscheduled inspections of warehouse facilities in which pledged goods are being stored. As discussed earlier, the capability and reputation of the warehouseman should be checked periodically.

Some banks may wish to set up files on warehouse companies, containing much of the information that is normally found in credit files. They may also list warehouse receipts they have received, according to the names of the issuing warehouses, and set limits as to the dollar amount they will accept from each warehouse.

Beyond the points already covered –and more important than any of them– the bank must base its credit analysis on the four C's of credit as they apply to the customer requesting the loan. There is no substitute for a favorable opinion regarding the borrower's ability and willingness to pay.

In the final analysis, the soundness of a bank's position in this type of financing is directly related to its determination to learn–and apply–the peculiarities of warehouse receipt lending.

Collateral Control can apply to many types of goods, finished or unfinished and necessitate some wide knowledge of international trade finance.

Of course the banks are the experts in this field but due to the many facets of structured finance, they may have advantage to dissociate the operational and technical aspects of the transaction from their pure banking activity.

It is difficult to be an expert in all fields and to avoid conflict of interests; banks are now more and more inclined to mitigate their risks by appointing independent Collateral Control Company in order to really secure their transactions. In this very context, ACE GLOBAL provides sophisticated collateral control services using adequate credit support tools relevant in respect of field warehousing, collateral management and monitoring in 40 countries.