

# Review of Warehouse Receipt As An Instrument For Financing In India

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**Abstract:-** One of the important aspects of the Indian commodity derivative market is the introduction of warehouse receipts (WRS) as an alternative solution for market participants to access short-term finance. The concepts of the WRS system is based on warehouse receipts which can be used as collateral for accessing finance. The system is made more sophisticated by adopting measures such as grading of commodities according to their quality, rating warehouses according to their size, reputation and integrity etc. In India receipts issued by Central / State Warehouses are accepted as collateral by banks however those issued by private warehouses are not. Since farmers / traders will not deposit their goods with a warehouse whose receipts are not financed by banks viability of the private warehouse is at stake. Hence there is scope for expanding the warehousing infrastructure and also WRS system by making it mandatory for the banks to endorse private WRS.

**Keywords:** Collateral, Commodity, Depositor, Finance, Warehouse Receipt, Exchange, Grades and standards

## 1. INTRODUCTION

Warehouse Receipts (WRS) are documents issued by warehouses to depositors against the commodities deposited in the warehouses, for which the warehouse is the deposit bailee. This gives depositors the confidence that their commodities will be stored with guaranteed quality and quantity. These are negotiable instruments that can be traded, sold, exchanged, and used as collateral to support for short term financing. The financial institutions, which accept warehouse receipts as collateral, are able to reach a higher level of liquidity of the pledge because commodities always have clear market prices and gain the right to claim the collateral before other creditors. The banks also receive a higher level of protection of the collateral enforced both by the good management practices of the licensed warehouse and the supervision of the regulatory agency.

## 2. Review of Literature

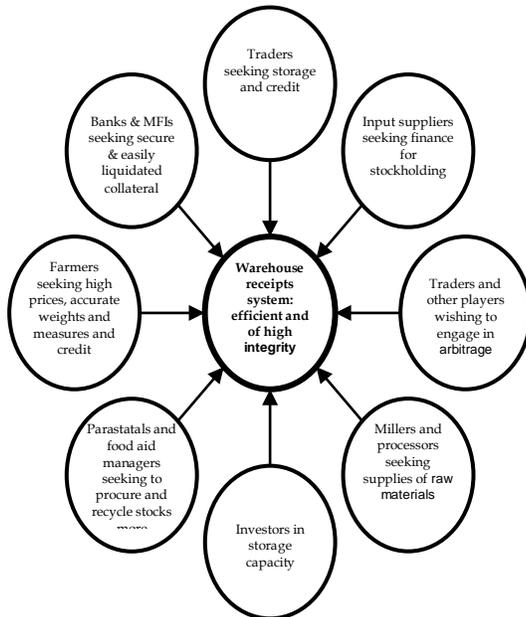
According to Coulter and Martines (1998) agricultural production and trade are often considered low-margin, high uncertainty operations and are perceived as risky investments by financiers. Physical collateral such as land and machinery is rarely use in mitigating financiers risks and as a result finance for agriculture can be difficult and expensive. In light of this warehouse receipt finance can play an important role in smoothening income for farmers by providing liquidity at times when cash flows dry out. In this context Kiriakov (2007) viewed that government institutions and market participants should form a consensus on the necessitates of the WRS and commit to be involved in the process. Without the political will and understanding of the benefits that the system brings to participants there is a high probability for failure. It is imperative that the WRS system be developed in full structural capacity and covers all aspects of licensing, inspection, supervision and performance guarantees.

Department of banking operations and development (2006-07) pointed that the most common and accepted system for control is the creation of 'Government regulatory Agency' which is responsible for the licensing, regulatory and inspection procedures of the public warehouses. However Mor and Fernandes (2009) expressed that if there is insufficient political will for the creation of enabling legislation or where the marketing infrastructure is underdeveloped there should be working models that substitute the regulatory functions of the government agencies with utilization of private surveying companies. WRS provides a platform for the introduction of other institutional innovations, notably grading, contracting and exchange trading. It is difficult to introduce grading systems into markets where most grain is traded informally and not graded. Buyers don't look for graded produce because it is unavailable, while farmers don't grade because of the lack of a price premium. By grading commodities on arrival at warehouses, it is possible to overcome this problem (UNCTAD, 2009). Pal and Wadhwa (2007) expressed that a well developed WRS can provide a focus for development of the entire commodity chain, providing incentives for a range of different parties, including farmers, financiers, traders, processors, public sector buyers, food aid managers and investors in storage capacity (Figure-1). WRS can help farmers retain more food for their local consumption requirements. This enables the farmers to avoid repurchase grains in the market price when they experience unanticipated shortages for consumption. In fact, in Africa there are numerable instances of farmers 'overselling' crops, which are shipped out to urban centers, only to be shipped back as either grain or meal, and at much higher prices in the lean season (Hollinger and Kiriakov 2009). Under the circumstances better storage facilities and localized warehouse receipting can help farmers hold back more crops, avoid circuitous transport and better assure their local food security. As per the RBI (2005) report the warehouse may be linked to Indian multi-commodity exchanges through which the farmer can sell the goods. Alternatively, the farmer may sell privately or make use of a simple settlement mechanism to ensure that he (along with the bank and warehouse operator) gets paid before the goods are removed from the warehouse. Report also explains that a transaction can take place informally or on an organized market or exchange. In either case, the Warehouse Receipt forms the basis for the creation of a spot, or cash market. If transactions involve the delivery of

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goods on a future date, Warehouse Receipts can form the basis for the delivery system in a commodity futures exchange. A broader benefit of Warehouse Receipts is that they increase the confidence of participants, particularly those in the private sector, in market transactions.

**Figure-1:** Parties with incentives to participate in WRS



However Department of Banking operations and development (2006-07) report on warehouse receipts and commodity futures explained that brokers in commodities are required to deploy funds with the exchange to obtain trading limit and the composition of funds is in the form of bank guarantee and fixed deposit. In order to obtain bank guarantee most of the brokers are required to deploy liquid funds which reduced their leveraging capacity as a significant component of their assets are in the form of commodities. This is particularly true for traders in commodities which have long shelf life like castor, pulses, cereals, cotton, rubber etc. Such a requirement can be resolved by provision of bank guarantee to members of commodity exchanges against their holding of WRS. The availability of secure WRS may also allow owners of inventories to borrow abroad in currencies for which real interest rates are lower, particularly if loans are made against inventories of an export commodity, thereby hedging against the foreign exchange risk of foreign borrowing. This practice is followed in Kenya and Uganda, where coffee stocks are often financed in pounds sterling. Also, since high real interest rates are often linked to perceived risks, particularly when it concerns agriculture, secure WRS may reduce risk and lead to lower lending rates (UNCTAD, 2001).

### 3. Various Warehouse Approaches to Commodity Financing and Storage

There are three major categories to commodity financing and storage.

- I. Public Warehousing
- II. Private Warehousing and
- III. Farmer focused approaches

#### Approach I: Public Warehousing

Public warehousing, this term does not imply public ownership, but refers to a company storing goods for public in general on behalf of whosoever wishes to deposit in the warehouse and issues to the respective depositors warehouse receipts that can be used for trading purposes or as collateral for raising finance. This in turn divided into-

##### I. A- Unregulated independent warehouses-

An unregulated independent warehouse set up by the company concerned sets up business, invests in grain handling and storage plant, and uses it to trade and provide a variety of other services, including storage and warehouse receipting. In principle these are purely private initiatives, where the company believes it can best serve its business interests by offering farmers and smaller market intermediaries a choice of marketing arrangements allowing for immediate or later sale. Export Trading Company is already offering the service to farmers in Tanzania. The main limitation to this approach is the small number of companies currently able and willing to offer the service. Banks would not trust many commercial operators to hold third party stock as collateral managers, probably only the largest companies in the Region.

##### I. B- Warehouses regulated by the State

In this case, the regulatory service is a State-controlled technical service which licenses warehouse and ensures that they perform accordingly to a set of clearly understood rules. This may involve the suspension or revocation of licenses or taking over the management of failing warehouses. There are two major pre-requisites to the establishment of such a service: a) that it can be kept completely free of political influence, avoiding the sort of problems if this cannot be assured one should not try to establish such a service, and b) That there is sufficient demand to make the service self-financing on the basis of user fees. This approach, which builds mainly on the North American experience, is being implemented in Tanzania, Ethiopia and Uganda.

##### I. C- Warehouses regulated by a trade body

In this case regulation may be carried out on a purely contractual basis, or under delegation of State powers. This approach has quite good prospects in Kenya, though some significant hurdles must be crossed. EAGC (trade body) is already certifying warehouses in Kenya, and can do likewise in other countries. Its survival depends on its establishing fruitful dialogues with Governments. With its membership base, EAGC is moreover well placed to promote exchange trading.

#### Approach II: Private Warehousing

This approach would allow private players to issue warehouse receipts against their own stock for the purpose of raising bank financing, and also of transferring title to buyers. Potentially this could increase market efficiency, to the benefit of both farmers and consumers at either ends of the chain. It could help establish a more level playing field among trading companies, making it easier for local operators to access low cost capital. It is moreover a sort of self-propelling innovation, building on the motivations of the proposing company. It is however quite a risky approach, where the regulator has little direct control over the actions of the licensee, who may move stocks around without the knowledge of a regulator who is not on site. Moreover, if such a warehouse operator goes

bankrupt, it may also be difficult for the bank to prevent priority being given to other creditors.

### Approach III: Farmer focused approaches

These are approaches involving the storage and financing of commodities deposited (more or less exclusively) by farmers with the objective of supplying local food needs in rural areas or bulking product prior to marketing. There is a general need to increase farmers' role in crop storage. If more is stored locally in villages, rural people will be more food secure in the lean season, notably households who produce insufficient to cover their needs, or who sell early for financial reasons. Occasionally rural storage initiatives have resulted in large increases in seasonal storage, lessening the need for States to establish price stabilization mechanisms. This is sometimes undertaken through marketing cooperatives. Large and multi-tiered cooperative marketing structures sometimes do not have a very good record, but there is some evidence that primary societies or groups can work effectively in bulking goods for marketing through public warehouses. An alternative approach involves rural storage financed by a local micro-finance institution (MFI). A highly successful experience in Madagascar suggests that this can work well where the local MFI is integrated into a structured microfinance (MF) network that can provide necessary management and financial support. However the system has had little impact with other crops, due to difficulties with storage and less predictable price pattern. Since 2005, micro finance-linked approaches have gained a foothold with paddy in Tanzania, with upwards of 10,000 tonnes being stored by farmers per year, but have failed with maize, mainly on account of uncertainty with a crop subject to largely unpredictable Government intervention. Technological improvements in farm-level storage are a natural complement to financial approaches, appropriate in countries like Malawi where intensified maize production results in storage of pest-susceptible varieties and encourages early disposal. There is a need to revisit this area and explore the scope for relatively trouble-free hermetic storage structures.

## 4. Preconditions for viability of Warehouse Receipt System

In order for a Warehouse Receipt system to be viable, the economy within which it operates must meet certain conditions. The legal system must support pledge instruments, such as Warehouse Receipts, as secure collateral. The pertinent legislation must meet several conditions (RBI, 2005):

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

creation and acceptance of Warehouse Receipts in many developing countries.

Besides the above pre-conditions, the pre-requirements of an efficient WRS includes-

**Grades and Standards-** The practice of independent determination and verification of the quantity and the quality of stored commodities, based on a national grading system (with inspection of warehouses and stored commodities performed, in most cases, by the private sector under license from a government body for agricultural goods, usually the ministry of agriculture); and the availability of property and casualty insurance. The integrity of the system must be assured through performance guarantees. A key prerequisite for the acceptability of Warehouse Receipts by the trade and by banks is the existence of a performance guarantee for warehouses, assuring that the quantities of goods stored match those specified by the Warehouse Receipt and that their quality is the same as or better than that stated on the receipt. Without this guarantee farmers and traders will be reluctant to store their crops and banks will be hesitant to accept Warehouse Receipts as secure collateral for financing agricultural inventories. The unavailability of performance guarantees - for instance, because of the absence of reliable inspection and certification may occasionally lead to second-best solutions. For example, in Brazil, a system of Warehouse Receipts operates that is limited to products stored in bank-owned warehouses.

**Commodity market conditions-** Any successful effort to establish a WRS system should pay serious attention to the overall commodity situation in order to determine the applicability of the system. This type of analysis should cover several market components and evaluate their role for successful implementation. The commodity assessment is crucial because international experience shows many different commodities appropriate for warehouse receipts like grains, cotton, cocoa, coffee, rubber, crude palm oil, and even olives. For farmers used to centuries of trading through *adhathiyas* on the *mandi* and availing of loans from them, trading on an electronic exchange and availing of finance against the stored commodities has been a new experience. The commodity exchange follows a rigorous quality-testing procedure unlike regular *mandis* where quality is gauged simply by picking up a handful of commodity. A value reduction is applied if the commodity does not meet the set parameters. Farmers who initially took a while to understand the quality testing process now feel the process is more fair and transparent than the one they were used to.

**Market Information-** Access to a system of reliable market information is of utmost importance for proper operation of a WRS system. The benefits of using warehouse receipts can be achieved to their highest extent only if the participants in the system are well informed about the domestic and international markets situation and price trends. WRS are not a magic solution to inherited problems in the commodity system. They can improve the situation only when users are able to plan their business well and make decisions according to the expectations of the market. Market information is also important for banks when they determine the value of the collateral. In cases in which there is no reliable spot or futures

market for price discovery, financial institutions should find alternative ways to acquire such information. One of the ways to resolve this is by establishing a price discovery network that includes major domestic buyers. Buyers can quote daily purchasing prices to banks, and banks can use these prices to determine the commodity value for collateral.

## 5. Financing against Warehouse Receipts in India

Financial accommodation against WRS is still not very popular in India although it is an upward trend. Some of the difficulties faced by banks in popularizing financing against Warehouse Receipts and their solutions as envisaged by them, are given below-

- WRS to be made transferable through endorsement under Sale of Goods Act. This will enable the WRS holders to take delivery of the underlying goods on the same terms and conditions as would have been to the person who had originally deposited the goods.
- Making WRS fully negotiable instrument, under Negotiable Instruments Act 1881, will enhance liquidity of the product and help in mitigating counter-party default risk.
- Electronic maintenance of records of such WRS in a dematerialized form resolves the problem of inadequate speed of transaction, splitting of Warehouse Receipts, forgery and loss of receipts etc.
- For all types of lending to agriculture sector in general and financing against WRS in particular the risk weight for the purpose of capital adequacy may initially be reduced to the level of 75 percent from the current level of 100 percent.
- Difficulty in disposing of a security in case of default would be removed by creating a screen based spot market along with uninterrupted clearing and settlement facilities.
- Receipts issued by Central / State Warehouses are financed by banks but those of Private Warehouses are not freely financed by banks. Since farmers / traders will not deposit their goods with a warehouse whose receipts are not financed by banks viability of the private warehouse is at stake. Hence it is necessary that private WRS should be endorsed by the banking system.
- High margins, up to 40 percent stipulated by banks create liquidity problem for the farmers who are therefore not very keen on obtaining finance by means of WRS. The margins could be reduced to 10-20 percent if the issues regarding quality and grade and ease of disposing the stocks in case of default as mentioned above are solved.
- Some state governments have introduced stamp duty on pledge / hypothecation which have an adverse impact on the nascent WRS in India. Hence at this early stage of development, WRS needs all the concessions from the state until it can bear the burden of state duties.

## 6. Conclusion

Again, Warehouse Receipts (WRS) can greatly facilitate financing of agriculture as it could serve as highly credible collateral for agricultural credit. Hence the widespread acceptability and faith in the integrity of WRS based system is

essential for modernization of agricultural financing. The importance of WRS stems from the fact that it can provide surplus-producing farmers (including smallholders) with a market window which can help them secure the best possible deal, by allowing them to deal directly with downstream buyers and financiers, and overcome asymmetric power relationships within the market chain. Farmers (or groups of farmers) can overcome various embedded market constraints by depositing their crops in a warehouse that dries, cleans and grades them according to established standards, and holds them until they wish to sell. WRS issued against the stock can be used by the farmers to access agricultural credit.

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