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## Structured Financing Products as an Alternative to the Traditional Financing

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**Abstract.** The article examines key aspects of the structured trade financing instruments and prerequisites for their existence. The research is based on an analysis of synergies between financial and commodity markets, and aimed to the development of sustainable risk management tools by enhancing access to capital thru alternative financial instruments, especially for the small and medium size entrepreneurs. The main focus is concentrated around developing economies.

**Keywords:** financial markets, financial instruments, commodity trading, derivatives, ware-house receipt

## Структурированные продукты финансирования как альтернатива традиционным финансовым инструментам

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**Аннотация.** В статье исследуются ключевые аспекты инструментов структурированного торгового финансирования и базовые условия для их существования. Исследование основано на анализе синергии между финансовыми и товарными рынками и направлено на разработку устойчивых инструментов управления рисками за счет расширения доступа к капиталу с помощью альтернативных финансовых инструментов, особенно для малых и средних предпринимателей. Основное внимание исследования уделяется развивающимся странам.

**Ключевые слова:** финансовые рынки, финансовые инструменты, торговля товарами, деривативы, складские расписки.

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### Structured trade finance

Implementation of the new technologies and instruments in global markets open up new opportunities and growth potential for international trade.

Structured Commodity Finance or SCF is a type of lending mechanism used within commodity markets. It is implemented when a simple and straight forward bilateral lending is not effective.

Structured commodity transactions create an alternative way for trade security and lending. An example of this is structured commodity finance in relation to oil transactions and taking security around assignments of off-take agreements.

It is important to analyze commodity-based transactions based on fundamental elements of the market like trading cycles, products, buyers, sellers, risk management and time periods of trades. In this context, the role of financial institutions as a provider of financing, risk management tools as well as, supporting clearing and hedging of FX risks play an important role.

Structured Commodity financing mechanisms includes:

- Pre-export Finance
- Letters of Credit
- Export credits
- Inventory Finance
- Barter and Inventory Finance

Structured Commodity Finance is important as allows businesses to get funding when

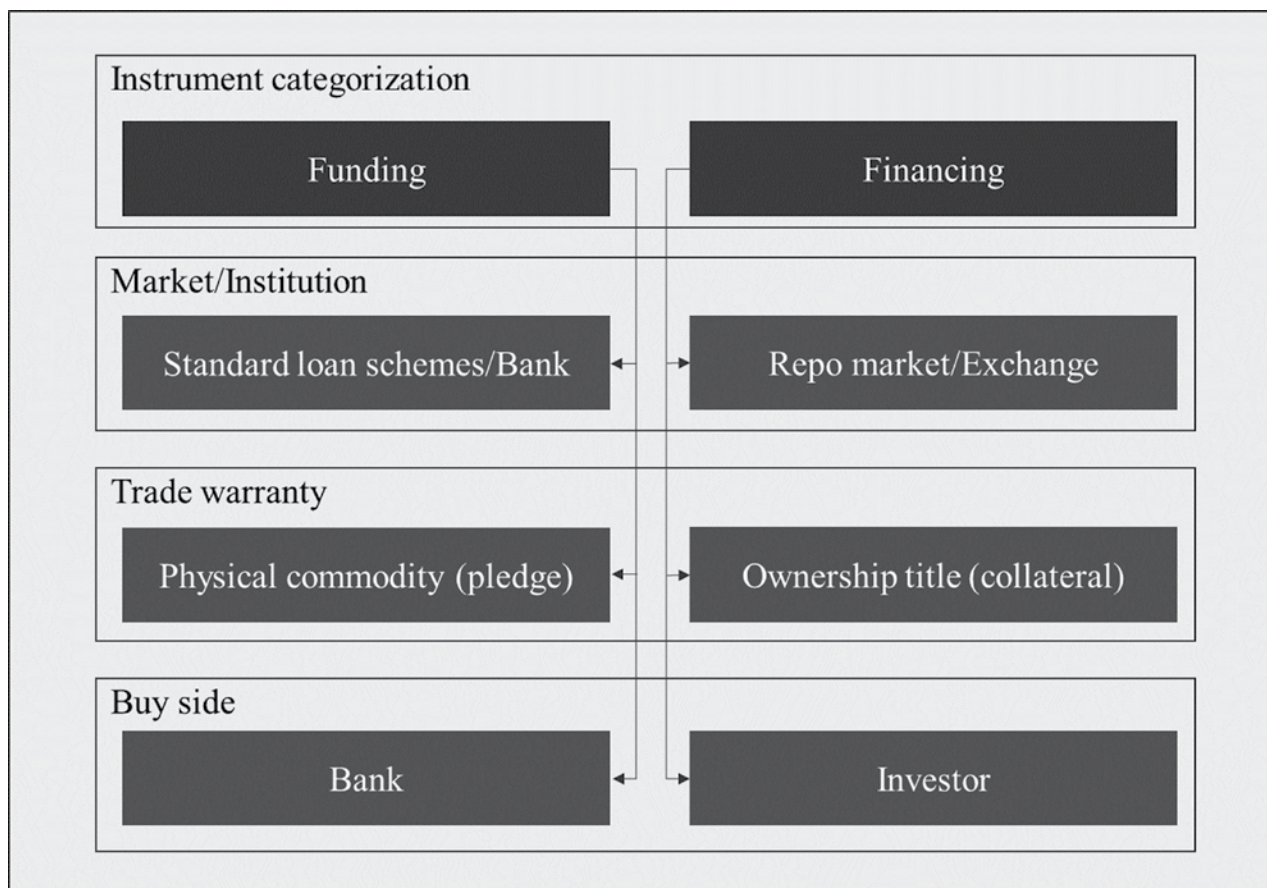
the standard financing tools are not economically efficient. Considering the fact that, in standard borrowing model, to finance the business borrower must own an asset of a greater value than their lending requirement. This problem is especially stressful within the commodities world, where volumes are high but margins are typically low. Structured finance instruments allow normally “un-fundable” trades to be viable.

The privilege of the structured commodity finance is the possibility to use wide range of commodity products as a base. The product can be constructed depending on investors’ preference for main lending parameters like commodity class, leverage ratio, jurisdiction, collateral structure and etc.

An important aspect for structured finance is the accuracy of the construction of the lending collateral base, or saying another way, the structure of the assets to be used as a warranty for the fulfillment of obligations. Within this framework, parties can still utilize standard, generally accepted risk mitigation tools.

In a competitive environment, financial institutions developed tailored solutions to meet the client’s exact needs for all sizes of transactions.

According to the research, agency finance, structured commodity trade finance (SCTF), syndicated trade loans, trade receivables finance, commodity repos are the typical forms of structured financing instruments in the market. A general market model is provided in figure 1.



**Figure 1.** General characteristics of the commodity-based finance structures

Source: The author

### Commodity repo as an innovation for commodity financing

Commodity repos have long been used by public sector market players in commodity trade as an alternative financing instrument. Hereby, the interest income is structured under sale and re-purchase agreements of the underlying asset. A subject for the repo agreement may vary from securities to commodity. A nature of the repo instrument is mainly financial, in a broader context it is a financial market instrument. Applying it for the commodity market creates a bridge between financial and commodity markets.

Even though, repos carry out the characteristics of a derivative instrument, they are relatively simple products rather than typical derivatives [1].

Commodity repos use a warehouse receipt as an underlying collateral, which is in broader terms, a right to the commodity rather than commodity itself. To put it simply, a repo is equivalent to a cash transaction combined with a forward contract for the purchase/sale of the underlying asset or commodity (further it will be referred to commodity meaning underlying asset). The cash transaction results in the transfer of money to the borrower in exchange of a legal transfer of the underlying asset/commodity to the lender. The forward contract ensures repayment of the loan to the lender and the return of the collateral to the borrower.

The difference between the forward price and the spot price is the interest on the loan and the settlement date of the forward con-

tract is the maturity date of the loan. The party who originally buys the commodity effectively acts as a lender and the party who originally sells the commodity acts as a borrower. Here, commodity is used as a collateral for a secured cash loan or in other words warrants the execution of the second leg of the transaction on a repo maturity date.

A repo transaction is based on sale of a commodity (commonly represented by warehouse receipts) for cash, and its repurchase at a later stage on a repo maturity date. Period between first and second leg transaction is classified as a repo duration, which may be fixed or open depending of the repo agreement [2].

The main problem of calculating the second leg price or the maturity price of the commodity-based repo transaction is the cost associated with carrying a commodity through time (storage costs) and the cost of borrowing a physical asset in an arbitrage (spot market price at the date of maturity).

From the perspective of effectiveness of the inventory management, commodity repos provide operational liquidity to companies those, otherwise would have been tied up to inventories.

According to the Robert W. Kolb and James A. Overdahl, repo is a “synthetic loan of the security”, meaning that it is just a forward contract combined with a sale of the underlying asset in the spot market [1].

Legally, an underlying asset for repo is not treated as a pledge, but conducted as a collateral which in turns requires less legal routine and no liquidation risk. While a pledge-based commodity financing carries liquidation risk and legal procedure (usually requiring the settlement via a court) in case of the borrower's default.

In commodity repo transactions, a lender has an actual title, but usually not possession, of the commodities financed. Thus, commodity repo structure carries various risks, mainly related to legal framework and safekeeping of the commodities [2].

As an example, in case of bankruptcy of the borrower, a court decides that the repo was not a true sale, but rather a hidden loan. And with this regard, it reclassifies the repo transaction as a loan, and any claims the lender has are part of the overall bankruptcy proceedings. Which means they are so no longer secured. This may happen if the repo price radically deviates from the market price, or if the borrower had kept effective control over the commodities [2].

Another example, in case of the warehouse's failure of the commodity delivery at the date of repo maturity, the borrower demands the return of the physical commodity, rather than the title (warehouse receipt), from the lender as a prerequisite to fulfill its payment obligations or in other words to return the loan [3]<sup>1</sup>. Once the repo transaction is signed, financing is providing on the condition of a transfer of

<sup>1</sup> Citi vs Mercuria case which relates to whether the transfer of warrant certificates really does constitute a “delivery” of the commodity in question. Mercuria started legal proceedings against Citi in June, after the US bank demanded the early repayment of \$270m extended under a ‘repo’ agreement. The dispute over the repos flared up after Chinese authorities have sealed the warehouse facilities at Qingdao and Penglai linked to a financial fraud. The financing was thus provided to Mercuria on the condition of a transfer of depository receipts, rather than a transfer of physical commodity, and which could be terminated upon the redelivery of the warrants to Mercuria by Citi. Mercuria, however, are arguing that because a delivery of warrants doesn't amount to the delivery of physical metal, they are not obliged to return the financing since Citi has not fulfilled its terms. Source: *Financial Times*, December 3, 2014, “Markets Equities Citi vs Mercuria, a.k.a when commodity repos go wrong”, Izabella Kaminska [3].

warehouse receipts, rather than a transfer of physical commodity. Keeping in mind that, the warehouse receipt represents the commodity instead. While the repo duration the warehouse where the actual commodities are stored may become insolvent. And on the date of maturity the borrower may argue that, because a delivery of a title doesn't mean the delivery of a physical asset, they are not obliged to return the financing since the lender has not fulfilled its terms.

Considering obstacles that, first, the most financial institutions would rather choose not to go through the routine of having own warehouses, just to be able to provide financing to commodity traders, and the second, delivery of warrants doesn't constitute the same thing as delivering physical commodity significantly increase the risk associated with repo transactions for banks. So, the safekeeping issues of the commodities while the repo term becomes even more important.

All repo terms and conditions are fixed in a Repo Master Agreement. The main purpose of having master agreements in the context of repos is to facilitate the margining of transactions across the portfolio of transactions and offer a pre-agreed exit strategy on a close-out in case one of the parties' defaults [4].

While the close-out procedure, where parties do want to net off repo against stock lending positions or either against positions in OTC derivatives, they are likely to use the Cross-product Master Agreement. In common practice it not widely used as, it is not generally permitted for regulatory capital purposes to net off positions on off-balance sheet transactions (ie, OTC derivatives) with on-balance sheet transactions (which include repo and stock lending transactions) [4].

Repo contracts links commodity assets directly to the capital market by bypassing the banking system. It matters when financing thru the banking system is economically inefficient for both lender and borrower.

According to the FAO and World Bank research, in countries with a highly efficient financial sector, the gains for lenders are small while, for borrowers, the gains primarily depend on the terms at which they usually access finance. In countries with well-developed corporate rating systems and a strong legal system, farmers, processors and traders often already have good access to finance at acceptable rates [5]. For these reasons, commodity repo systems are not widely used in those markets.

For instance, history of agricultural finance in the United States shows that, with the improvement of financial record keeping in agriculture, the role of warehouse receipt finance declined strongly. Specifically, in countries of the EU and countries that will soon access the EU, a repo system for agricultural finance may have only limited benefits [5].

Another important aspect of repo transaction is a taxation dilemma. As legally, repo contracts are not loans, but purchases and sales, at some extend they can be considered as subject to VAT. VAT for the repo-based finance has been a real problem, for example, in the Russian Federation, where banks had to set up special vehicles to deal with this issue [5].

Generally, if a VAT policy is too complex or VAT reimbursements are very slow, there will be hard to impossible to find a reliable or workable solution. Also, there might be a lack of market infrastructure or adequate means in order to deal with the VAT implications of repo trade.

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