

**PAPER ON STRUCTURED FINANCE AS AN ALTERNATIVE
SOURCE OF BUSINESS FINANCING PRESENTED TO
PARTICIPANTS ATTENDING A BREAKFAST MEETING FOR
BUSINESS AS MISSION ORGANIZED BY THE CHURCH
MISSION SOCIETY AT THE ACK GUEST HOUSE, NAIROBI,
APRIL 19, 2007**

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PAPER ON STRUCTURED FINANCE PRESENTED TO PARTICIPANTS ATTENDING A BREAKFAST MEETING FOR BUSINESS AS MISSION ORGANIZED BY THE CHURCH MISSIONARY SOCIETY AT THE ACK GUEST HOUSE, NAIROBI, APRIL 19, 2007: By Marubu Munyaka

1. Introduction

Structured finance deals with modern techniques for dealing with international trade and financing under difficult economic and political environments. Their usage is also extended to:

- The domestic financing of commodities trade
- Commodity production
- Commodity storage.
- Tenders, contracts, performance bonds and bid bonds.

It entails removing the risk from the borrower to the commodity / service that is being financed.

Structured finance transactions provide more security because specific repayment procedures are included. They are however more expensive to arrange than secured transactions. For locally financed transactions, costs could be much lower especially if a good physical and legal infrastructure is in place. Structured financing transactions contain two components:

First, arrangements which ensure that if the transaction proceeds normally, the credit provider is automatically reimbursed, that is the loan is self liquidating. This includes an arrangement between the Buyers and a credit providing Bank that the buyers will pay to the Bank, rather than the Supplier; the Bank then pays the supplier what it has received after deduction of its original credit plus charges.

Secondly, arrangements which ensure that, if the transaction goes wrong, the credit provider has recourse to a collateral and / or Irrevocable Letter of Undertaking / Instruction from or to the Buyer; he can sell it or determine the said undertaking / instruction and thus get its money back. These arrangements are usually backed up with insurance cover to protect against the risk that for one reason or the other (theft, nationalization, export bans, etc.), the collateral is no longer available where the financing involves export of goods to a foreign country.

In essence, structured finance involves transferring risks for parties less able to bear those risks to those considered more capable. It provides working capital in difficult environments by mitigating the risks through mortgaging domestic / foreign sale proceeds.

- The common approach is the letter of undertaking from the Buyers if they are triple A Companies that are reputable.

- Where a Buyer is not willing to issue such a letter of undertaking and / or is very sensitive, then the Supplier / Client would issue the Buyer with an "Irrevocable Letter of Instruction" to pay proceeds of the sale to the Financier.
- Such a Letter would be copied to the Bank; would be acknowledged and date stamped by the Buyer, with the original copy being forwarded to the Bank for Safe custody until the maturity date of the payment for the sales.
- On the basis of this the Bank would issue its own conditional letter of undertaking to the suppliers of materials and goods to the client
- The duration of such an undertaking by the Bank would be longer than the one the bank receives from the buyer of the goods / services, the rationale being that the bank would only use its liquidity once it has received the same from the buyers.
- Where parties issuing the Letters of Undertaking are likely to default in the eyes of the Financiers and or where the goods are likely to be imported and the sellers would need guaranteed payments, then the Financier would demand a "Domestic Letter of Credit (DLC)", against which, the Financier would either issue a Back to Back L/C or transfer part of the Credit to the Overseas Supplier and / or domestic supplier. KPLC has lately become a market leader in issuing DLCs to our domestic suppliers / contractors.
- Where goods are being imported, this would also entail appointing a reputable firm of clearing and forwarding Agents that would clear the commodity at the point of entry and deliver it to the Buyers directly; having the delivery note date stamped and delivered to the financier until the date of delivery, etc.
- In other cases, the financier would have the commodity moved and stored in an Independent Bonded Warehouse until such time that it is delivered to the Buyer(s), like in the case of petroleum products, ensuring at all times that you minimize the costs of carry.

Where the contract involves labour contract, then the Buyer would open a DLC in favour of the Financier with or without a Red Clause calling for an advance payment of say 10 % or more.

The following paragraph attempts to address the way in which a Bank would be collateralized while undertaking the issuance of Bid Bonds, Performance Bonds and Tender / Contract financing:

Tender / Contract Financing

Most tenders / contracts would call for a Bid Bond and where the applicant is successful, it has to favour the Buyer with a Performance Bond. Once the performance bond is issued then the Contractor would need money to commence work and / or supply. That is where advance payments come in very handy but buyers would only issue such advances against Bank Guarantee. Depending on the relationship between the contractor and the buyer, such

advances could also be issued without bank guarantee either by way of cash or a Letter of Credit with a Red Clause allowing for such an advance.

Whereas in the past, bid bonds were issued by the insurance companies, these days the issues of tenders insists that the bid bonds be issued by commercial banks. This is a requirement of tendering not only in Kenya but also in the neighbouring countries of Ethiopia, Zimbabwe, etc. My own feelings here are that these are conditions given by donors for getting financial support from the said donors. Indeed they are prevalent in those instances where procurement is being financed by donor funding.

The essence of the Bid Bond is that the bidder should not withdraw one it has quoted and has been notified of the acceptance of its bid by the Buyer during the period of the bid validity. If having been notified of acceptance of its bid by the Buyer, the Bidder fails or refuses to execute the contract from, if required; or fails or refuses to furnish the performance security in accordance with the instructions to bidders, the Bidder must indemnify the Buyer by offering a collateral by way of a bid bond. The value of the bid bond is usually equal to 1% to 2 % of the value of the tender and / or value quoted by the bidder.

When insurance companies issue these bonds, they do not insist on collateral like in the case of performance bonds. All they assure is that the bidder would not withdraw its bid or fail to sign the contract or fail to issue a performance bond when called upon to do so once notified that it has won the tender.

Most commercial banks would usually offer them freely to their clients provided there are other funding and / or collateral relationship between the bank and the client for large clients with long history with their bankers.

However, for new clients who are either getting to business after long financial storms like has been witnessed in Kenya over the last 15 years, where do they get them from? There is need to place these people into business and to assure that they remain in business. These are the clients who would become big business Mongols in the days ahead and we need to support them now.

Obviously, the Bank would like to be collateralized and this is where the insurance companies would come in handy, given that the clients may not have any collateral from their own sources to offers to the Bank. The insurance companies would indemnify the Bank issuing such a bid bond to these clients.

Performance Bonds

All Banks would have to be collateralized before they can issue any performance bond. The value of these tenders is sometimes so large that in most cases, it becomes extremely difficult for the local supplier to have own tangible securities to collateralize the Bank. The result of this is that the Kenyan clients lose the lucrative tenders and / or simply can not participate in such tenders. The following paragraph attempts to identify the issues that lead to the inability of Kenyan suppliers to participate in the lucrative tenders:

a. The insistence that the performance bonds must be issued by a commercial bank. Very few commercial banks are willing to issue them unless they are fully collateralized as we have just alluded to in the foregoing paragraph

- i. Usually, performance bonds are equal to either 5 % or 10 % of the tender value.
- ii. In issuing the performance bond, the Bank is telling the Buyer that in the event the supplier is unable to supply the goods under the tender, the Bank would pay damages to the Buyer for an amount equal to the value of the performance bond.
- iii. In view of clause (ii) in the foregoing paragraph, the remedy to the Bank is get a collateral that would assure that the supplier is able to perform and in the event that it (supplier) is unable to perform, it has a collateral to fall on to recover damages it would have incurred to the Buyer
- iv. Given that our local suppliers are usually the agents for overseas suppliers and further that they may not have any and / or inadequate collaterals to offer to the Bank, then this letter is proposing that the Banks resort to the **ultimate overseas suppliers** to offer the indemnity necessary to make it possible for the Bank to offer its performance bond to the Buyer.
- v. Such indemnities would either come from their commercial banks and / or from their insurance companies and / or financial intermediaries, provided that the said indemnities are bonafide, genuine and are issued by reputable parties as would be attested by the correspondent Banks of the local Bank issuing the performance bonds
- vi. Alternatively, where a DLC is issued in favour of the Bank, then the 10 % advance payment and / or the profit margin on the tender / contract would form the collateral for the performance bond to be issued by the Bank / Financier
- vii. In this case, the Financier would have insisted on a prior letter of undertaking from the buyer confirming that it (the buyer) would issued a DLC in favour of the Financier once it received the said Performance Bond from the Financier
- viii. Alternatively, the Financier would issues a "Conditional Performance Bond" which becomes operational upon issuance of the DLC in favour of the Financier / Banker
- ix. Where the contract is labour based, then the DLC opened in favour of the Financier should form the basis of the collateral and should be such that it can be transferred to the Financier

b. The mere size of the tenders and therefore the performance bonds.

The way to overcome this anomaly is to adopt the approach recommended in clause 2(iv)-(ix) in the foregoing paragraph.

Warehouse Receipt System Financing of Commodities

In the **importation of petroleum products** into the developing countries, the problem is similar but the principles of financing are largely the same. For a long time in Kenya, it has been common knowledge that Multinational Oil Companies have imported petroleum into the country using the same concept but also backed up by a "Letter of Awareness" from their Home Offices that they are aware that the companies are borrowing the money to import petroleum into the host countries and further that they are fully behind their subsidiaries.

After the liberalization of the oil sub-sector in this country in the mid 90's, the problem that the locally licensed oil companies have faced is that of lack of financial support from their bankers. Their Bankers are willing to support them to buy petroleum products from the local supplies usually the foreign oil companies provided they have prior orders from reputable buyers in the country. The Bankers are however reluctant to render financial support to import unless they are fully collateralized with collaterals other than oil itself citing all kinds of risks.

Yet with the introduction of the current tendering system, the risks are however minimal given that all the oil companies signatory to the tendering system are required to take the product that lands into the country under the tender system.

The Bankers continue to assess the creditworthiness of the client as opposed to transferring the risk to the commodity and therefore by so doing deny the local companies the chance to compete in the market. In the case of NOCK, for instance, the Financiers would look at the past and the Financials and conclude that it is not a viable client. They miss the point.

- *Their risk profile synopsis should focus on the marketability and price risk and not other risk factors.*
- *The other major weakness in our banking system is lack of innovation due to lack of adequate competition.*
- *They rely on archaic products which are being phased in the modern banking system world wide.*

Yes price risk could be a major concern but in the absence of the hedging mechanisms in the country and indeed many African countries, we rely on the market and in Kenya today, there are quite a number of small independent petroleum dealers whom are ready to take up the product unlike the situation in the past, when the buyers were limited to the few multinational oil companies which had a cartel and they would never allow their outlets to buy the so called "adulterated products".

While the government has done a wonderful job of liberalizing the oil sub-sector, it has lagged behind in liberalizing the banking system which has largely remained traditional in its approach to lending, and operating with a narrow range of financing instruments.

The gains of the liberalization of this sector in the 80's have been reversed and the failure of domestic banks and financial institutions which played a useful role in the modernizing this economy is blamed on poor management but it is also well known by well wishers in the country that their failure was to a large extent motivated by politics of the day.

In view of the foregoing and given that Kenyan Bankers may not wake up in a long time to come, aggressive regional Banks and financial intermediaries are emerging and striving to venture into the oil industry in this country and the commodity sector at large. They see opportunities for making money in the country by offering new financial products for financing commodities as practiced in the rest of the region with exception of our country, Kenya.

It is therefore imperative to advise that warehouse receipts are commonly used by commodity dealers in the process of financing goods stored in a warehouse prior to their sale and transportation or prior to and during processing. The borrower arranges for the storage of goods in an **independently controlled warehouse** which issues warehouse / storage receipts for the merchandise deposited.

The warehouse receipts are in most countries considered as **title documents**, with their possession considered as evidence of the ownership of the goods represented; while in others, they are merely considered as **proof of deposit**. Compared to a simple bill of sale (which gives title to commodities to credit providing institution), the use of warehouse receipts as collateral provides the additional benefit that the **commodities are no longer in the possession of the borrower**, and hence, if the borrower defaults, the lender has easy recourse to the commodities.

Banks or trading companies normally have few problems to advance funds against commodities that are being stored in a **reliable warehouse** and have been assigned to the bank or trading company through warehouse / storage receipts. Once the bank or trading company has the warehouse receipt in its hands, it advances to the borrower a specified percentage of the value of the goods represented by the receipts. The amount it lends depends primarily on the acceptability and ease of control of the collateral and whether or not the commodity is hedged.

Given that under the current tendering system in Kenya, all oil companies have offered their bids to buy the petroleum are bound to take up the product, there is a **natural hedge** on the commodity being financed.

The identity of the borrower (whether this is a triple A rated company or a one person firm), is of very little relevance. It should be noted, though that once banks have positive experiences with their borrowers, they are likely to increase the percentage of the collateral's value they are willing to lend for commodities that are not hedged. The funds advanced are to be repaid with the cash collected from the sale of the goods

If the petroleum product to be used as collateral is stored in a warehouse / storage facility like those provided by the Kenya Pipeline Company (KPC) Limited, the warehouse operator (KPC)

issues receipts, in one form or another (depending on a country's legal and regulatory system). These receipts then form the basis for financing.

Rather relying on the importer (NOCK) promise that the goods exist, and that the proceeds of their sale will be used to reimburse the credit provider, the goods are put under the control of an **Independent Warehouse Operator** in this case the KPC. The provider still needs to ensure itself that the goods have not been previously pledged.

KPC becomes legally liable for the goods it stores. If these goods are stolen, damaged or destroyed, through any fault of it, it (KPC) and the insurance companies have to make up for the value lost (additional insurance can be obtained for catastrophic events).

The integrity of this warehouse operator (KPC) is secured by government licensing and controls, and by outside guarantees which the KPC can obtain from Bonding companies (subsidiaries of Banks which provide against defaults) and insurance companies.

Commodity trade finance collateralized by warehouse / Storage Receipts requires relatively much paper work compared to unsecured finance, and also involves higher costs: The fees for the warehouseman and of inspection services and where applicable the registration fees for warehouse / storage receipts, although this is negligible compared to the savings on interest rate paid. These costs generally amount to only **0.5 % -3.5 % of the value at risk** of the deal or less.

But on the other hand, commodity companies like NOCK with a weaker capital base and a short or a poor track record, which would not otherwise be eligible for international loans (at interest rates normally much below domestic rates) can in this way obtain low costs credits.

Steps in Financing Petroleum Importation

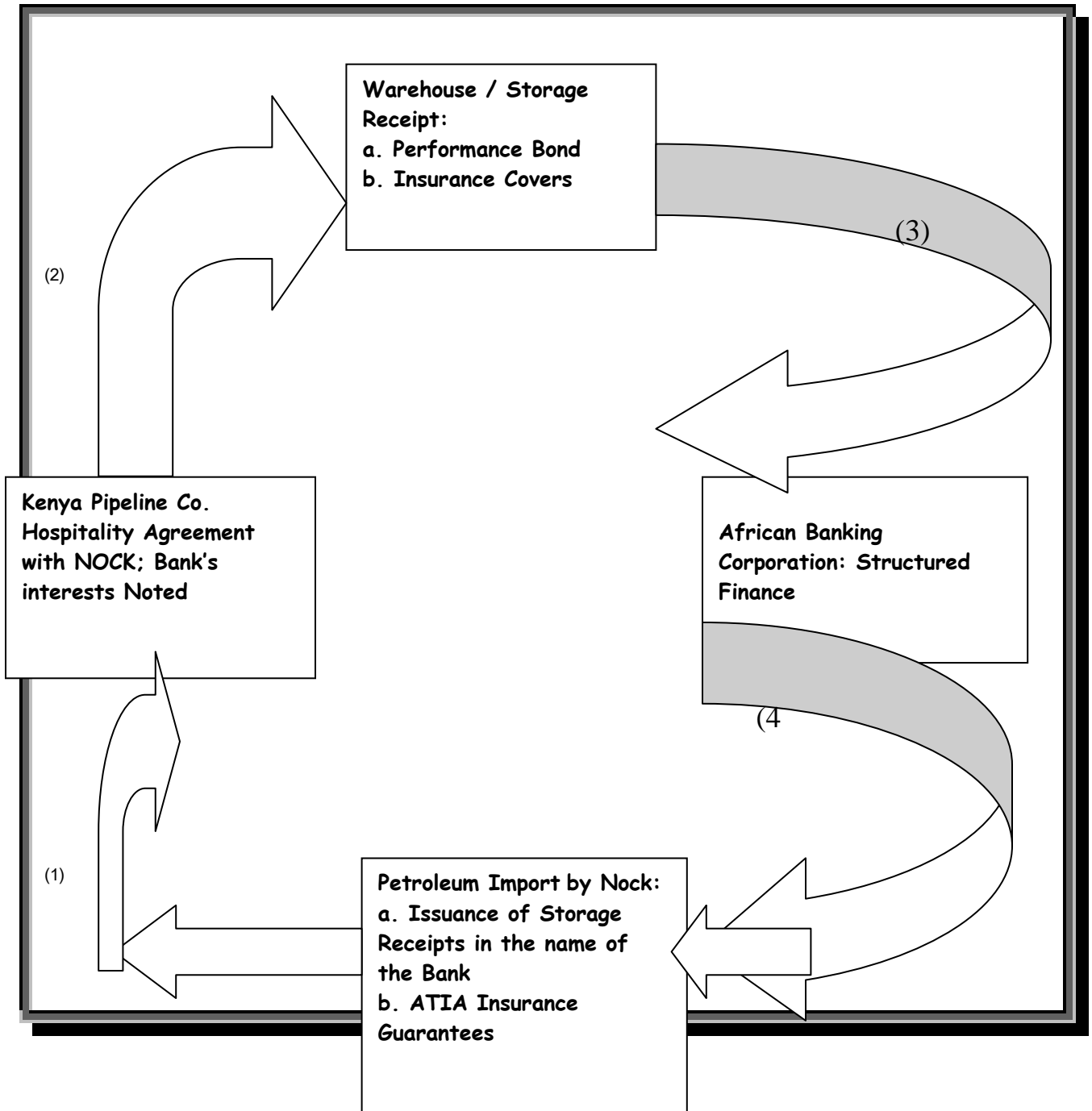
We assume here that the importer is NOCK.

- A Memorandum of Understanding (MoU) and / or a Term Sheet would be signed between the NOCK and the Financial Consultant / the Financier as a first step in the facilitation of the said facility. That the MoU / Term Sheet would set forth the terms and conditions of the facility from the Financier
- The Financier would take the petroleum product as the collateral.
- The Financier would appoint a Collateral Manager, either a Domestic Bank, SGS, or Cotechna as the case might. The Collateral Manager would be to be the custodian of the petroleum product, in the designated warehouse, to allow withdraws following instructions to do so from the Financier or his designated Agent. It would also keep record of the stock levels and would give a return on the quantity disbursed and the outstanding stock each time stock is withdrawn from the Storage facility (warehouse facility).

- The petroleum product would either be collateralized to the Financier or would be domiciled in the name of the Financier and would remain a product of the Financier until such time that the product is paid for in full by the Buyers
- The Financier would open an escrow account in Nairobi where all the proceeds of sale would be paid by the prospective Buyers and / or an irrevocable undertaking from the Bankers of the Borrower be obtained prior to the disbursement of the facility confirming that proceeds of sale of the petroleum product financed under the said facility would be remitted to the escrow account or other such account as may be directed by the Financier
- The product would be released upon receipt of payment or upon irrevocable undertaking of either the Borrower's Bankers or the Bankers of the Buyer and upon a written confirmation by the Bank in which the Escrow Account is operated that indeed such payment and / or undertaking has been received and further, upon subsequent instructions given to the Collateral Manager for each tranche for which payment and / or guarantee has been received, etc.
- Upon accent of the proposal from the Financial Consultant by the Financier, a Finance / Loan Agreement would be signed between the Borrower and the Financier setting down the terms and conditions of the structured finance facility
- The MoU forms the basis for the Loan Agreement and would be annexed to the Loan Agreement
- There would be a facilitation fee to be paid to the Financial Consultant which would be in line with internationally accepted fees scale when brokering facilities of this nature, which would be negotiated with NOCK within the guidelines agreed on between the Financier and the Financial Consultant, and subject to the limitations given by the Monetary Authorities in any one given country (This can be obtained from either the Central Bank of Kenya or the Treasury).
- The signing of the MoU depicts an authority to the Financier to recover the facilitation fees from the Loan amount and pass it on to the Financial Consultant upon approval of the facility by the Financier
- That the Borrower would insure the product in the warehouse against fire, and theft through an internationally acceptable underwriter in foreign currency with a lien engrossed therein confirming that the beneficiary of the policy is the Financier
- That the Borrower would take a political risk insurance cover with the African Trade Insurance Agency (ATIA), headquartered in Nairobi, stipulating clearly that the beneficiary under the cover is the Financier

- The Borrower would arrange to secure a Performance Bond from the Warehouse Manager (Kenya Pipeline) for *an amount at risk* to the effect that the Warehouse Manager would be solely responsible for any loss of the product released from the Storage Facility without proper authorization as called for under the requirement of this facility
- The Borrower would sign Hospitality Agreement with Kenya Pipeline or any other such Storage Company as approved by the Financier which would assure and ascertain that the requirement of the Loan Agreement as stipulated in the MoU are adhered to strictly
- The Hospitality Agreement would also recognize and confirm that the product in the Storage is *under lien* to the Financier
- The foregoing requirements of the Facility may not be conclusive as the Financier might have the need to advise more requirements or minimize some of the requirements stipulated in this MoU
- The cost of Borrowing under the Dollar Facility would be "Libor plus country risk, L/C Guarantee, Facilitation Fees and any other costs that may be agreed on under the terms and conditions of the Finance / Loan Agreement between the Borrower and the Financier
- The "Financier" may not necessarily be call for additional collateral outside the petroleum product, unless the conditions in the country dictate otherwise.

(The Diagram Below depicts the functioning of the proposed financing system)



Key Legal Requirements for Commodity Warehouse Receipt Financing

To enter into the transaction following conditions must be fulfilled:

- The presence of a warehouse operator is needed;
- There has to be a sound legal basis for warehouse receipts, providing clear title to their holder;
- The importer needs to be able to obtain an import license, even long before the actual imports are to take place;
- The protection of the value of the goods in the warehouse should be possible, i.e., insurance in foreign currency, with the financing bank / company as beneficiary, should be allowed and if hedging is allowed, and possible (taking into account currency controls), more financing can be provided

To allow easy liquidation in the case of default, following conditions must be in existence:

- The Bank / financier needs to be able to take possession of the commodity;
- Bankruptcy law should be clear and provide for the speedy transfer of commodities to the financier;
- The Bank / financier needs to be able to re-export the commodity;
- Banks and / or other foreign financiers need to be allowed to hold export licenses;
- Protection against the risk of government intervention (either nationalization of the commodities, or a ban on their export) should be accessible;
- Sovereign risk insurance should be available at an affordable cost; Sovereign risk insurance is only affordable if the political and economic system are stable, and
- Legal and regulatory systems are transparent.

Warehouse receipts can also reduce the credit needs of importers:

Where foreign oil traders are unwilling to provide credit to importers, they can use the warehouse receipts to ensure cash payments for products exported to the country. This practice of **pay against commodities** is quite common in countries of the CIS and since the devaluation of the CFA franc, in West-African countries. Rather than selling directly to local buyers, foreign oil traders prefer to deliver the commodity to a local warehouse / storage facility.

When the commodity is discharged from the warehouse / storage facility, simultaneously cash is paid by the buyer, eliminating all payment risks. Warehouse receipts will show the ownership of the commodity, and insurance cover on such goods held overseas in readiness for quicker delivery to buyers is available to protect against the loss of the goods or a ban on the re-export of the unsold commodities.

The Financing of Commodity Processing

Processors like the Kenya Petroleum Refineries Limited are among the key beneficiaries of improved financing system. The value of the commodities they have to keep in stock is often high, especially in relation to their processing margins. This problem is even stronger in developing countries than in developed ones, as poor infrastructure and logistics make just in time delivery prohibitively difficult. The processor owns commodities, but naturally, their

storage in an independently controlled field warehouse is impractical because the processor requires the goods for further processing to make the final sale.

In such cases, and if the Bank has a great degree of trust in the processor, it may be willing to release the goods to the processor against the signing of a trust receipt in which the processor:

- Acknowledges receipt of the goods or the title documents (warehouse receipts) from the Bank;
- Recognizes the Bank's security interest in the goods he is receiving;
- States that he is acting as the Bank's trustee in delivering the goods to the customer;
- Promises to remit the proceeds from the sale of these goods to the Bank in payment of the loan (or return the goods to the Bank if they are not sold) and / or to release the processed product to the designates warehouse operator, in our case the Kenya Pipeline Company (KPC) Limited; &
- Agrees to keep the goods fully insured against all insurable risks

Obviously as we are aware, there are default risks in this type of approach hedging on dishonesty. The Bank will therefore release goods on trust receipt only when it has *full confidence in the reliability and moral responsibility of the processor.*

However, where there is a letter of credit from the buyers whether domestic or international, then the process becomes easy to handle.

In summary therefore, the above modus operandi covers all other commodities including maize, coffee, sugar cane, etc, whether for production, processing, storage or sale domestically and in the national markets. I would appeal to our Bankers to wake up and modernize but better still the Government must give them a wake up bell by licensing competition not just mere rhetoric that it is liberalizing. Full liberalization when no one bank in Kenya controls more than 4 % of the banking market in this country.

We have lately begun to see that via Equity Bank and a few other banks that have woken up. This is not anything new but we have always had this approach for years. This only died at the behest of the Banking Regulators who became pre-occupied with collateral in the 80's and spent most of their time harassing the banking industry because a few indigenous banks were troubled. The end use, you and I should also put pressure on the banks to adopt the "Structured Finance Approach" to lending.

Thank You.

(Marubu Munyaka is the CEO / Principal Financial Consultant at the firm of PSM Financial Services Kenya Limited. He is a Structured Financial Consultant for the African Banking Corporation of Gaborone, Botswana, and Industrial Development Corporation of South Africa, among others. He also packages structured financial transactions for one or two domestic banks in this country. Prior to relocating home, in 2005, he was the Commodities Consultant for the African Union, Addis Ababa, Ethiopia. Marubu is also a seasoned Banker of repute for many years in this country prior to relocating to the diaspora in 1999)

