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## **BUILDING A WAREHOUSE RECEIPTS PROGRAM THAT WORKS FOR ALL STAKEHOLDERS**

**NOTES FROM THE FIELD NO.1**



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# **BUILDING A WAREHOUSE RECEIPTS PROGRAM THAT WORKS FOR ALL STAKEHOLDERS**

## **NOTES FROM THE FIELD NO.1**

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## INTRODUCTION

Warehouse receipts have for some time been recognized as an important tool to provide the agricultural sector with increased flexibility in marketing decisions and also as a mechanism to obtain financing for farm operations. **A warehouse receipt is a certification of legal ownership of a particular commodity that is stored in a specified location and is of a specified quality and condition**, such that when the commodity is sold, the buyer can have the comfort, without physical inspection, that the product they have purchased will be available to them when required, in the condition outlined on the warehouse receipt. Development practitioners and donors have pushed to have warehouse receipts used to provide benefits to smallholder farmers to enhance their participation in the broader market for agricultural products. **Warehouse receipts are also an integral part of agricultural commodity exchanges as they allow trade to take place with “paper or receipts” rather than the physical commodity.** This article will set out that warehouse receipts are not an isolated service or function; rather they are a derived service which is based on a functioning and transparent transaction system that will drive the demand for warehouse receipt services.

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USAID Zambia had been searching for a way to support the development of a warehouse receipt program that would involve smallholders and allow them to participate in the market. When an initial intervention through an organization called ZACA (Zambia Agricultural Commodity Agency) was unable to establish an effective warehouse receipt system, USAID used the PROFIT (Production, Finance and Improved Technology) project to work with the

private sector to establish a new entity, ZAMACE (Zambia Agricultural Commodity Exchange) with a stronger commercial focus and a link to a regional commodity exchange.

There were five underlying reasons that ZACA did not perform as anticipated.

- a) The lack of a coherent national, transparent and volumes-driven commercial market for commodities that effectively provided an incentive for warehouse services. There were only isolated incidences of commercial warehousing services that were issuing receipts, but only for private purposes with no uniform standards or grades.
- b) With limited demand for the warehouse certification process, there was limited commercial confidence in, and demand for, the WHR, which in turn meant that there was little support from the financial sector to ‘adopt’ the WHR as a financial product – despite a USAID funded partial credit guarantee on WHR lending. Traditionally, the risk-averse banking sector has required expensive collateral management agreements with their borrowers that provide minimal risk to the banks themselves – at great cost to the borrower and thus out of reach of many market players. One of the main incentives for certification and WHR is to create a measure of security to the financial sector to lend against – and with little chance of shifting the mindset of the financial community, there was little incentive to invest in certification services

- c) Despite extensive lobbying efforts by ZACA and other stakeholders, an amended Agricultural Credits Act developed five years ago that would enshrine the WHR in law as a document of first title never reached (and has still not reached) Parliament. This has further increased the reluctance of the financial sector to participate in WHR.
- d) Through a variety of donors, ZACA had a mandate to focus on smallholder participation, which could not bring about the volumes needed to shift market-wide behavior towards greater transparency and a volumes-driven market mechanism (i.e. exchange).
- e) Poor management led to a series of interventions in the market that compromised the independent position of the agency and this, combined with a record of poor service delivery to the few commercial clients, a lax certification and inspection procedure, a reputation for smallholder focus and very low volumes of business meant there was no market value to the ZACA brand - in fact quite the opposite.

This paper will outline some of the lessons around the launch of the new entity and how smallholders will be involved once a functioning commodity exchange and linked warehouse receipt program is established.

## BACKGROUND

The agricultural commodities market in Zambia, as in many other parts of Africa, faces a multitude of market imperfections that stifle growth in the wider agricultural sector. In addition, the enabling environment in Zambia fosters instability by creating a short term time horizon for return on investment.

Other constraints are:

- Poor market information/intelligence
- Few reliable data on trade flows
- A large proportion of informal trade
- Poorly defined industry-wide quality standards
- Poor communication
- Low levels of transparency and trust
- Limited enforceable contracts/dispute resolution mechanisms.
- High transaction costs associated with the risk of quality variations.
- High cost of physical movement of goods.

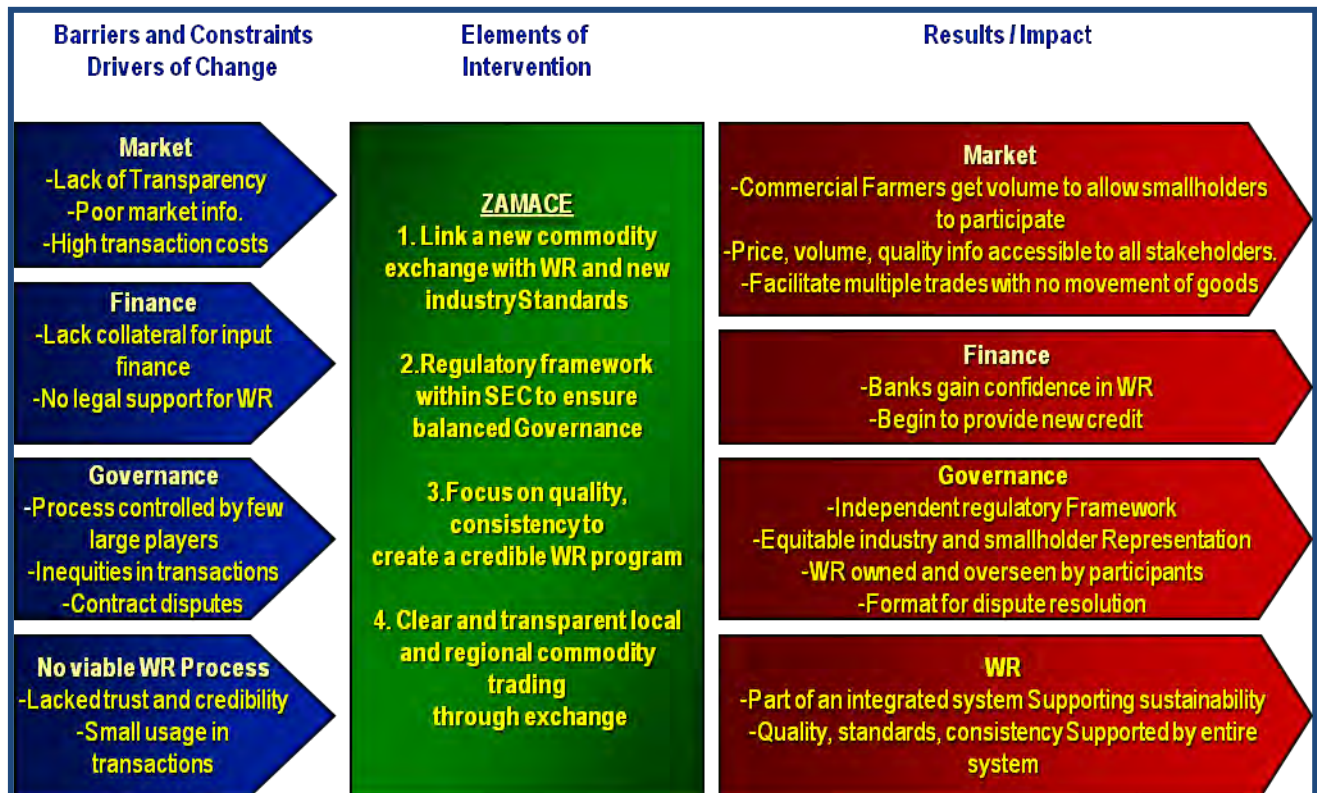
There is considerable demand by the majority of stakeholders in the agricultural sector for some form of formalized market mechanism that can address these issues, and it is on this basis that ZAMACE has been formed. The market was undergoing a transition of which the majority of the players (farmer, commercial traders/brokers, and processors) were interested in and wanted to participate in a more transparent market mechanism that could set standards and drive volumes. However, a few larger players that had gained benefits in the past from using their purchasing power to drive down prices locally were hesitant. This initial resistance was not substantial because even though they did obtain some gains these few firms did increase their transaction costs through more protracted negotiations and resistance from their suppliers. At present, these firms have all bought into the importance of a transparent more efficient market mechanism and are all members of the new Exchange.

## METHODOLOGY

The approach taken by the PROFIT project in the launch of the new entity was based on the following parameters.

1. Establish a strong commercial entity that can provide a clear and reliable market mechanism for agricultural commodities.
2. Establish 'ownership' of the entity by the private sector as soon as possible and design the entity to be commercially viable within a specific period of time and therefore sustainable
3. Develop a link to an agricultural commodity exchange to provide a pathway based on a functioning transparent market, which will create a broad range of derived services, a major one of which would be a clear commercial rationale for a warehouse receipts program
4. Develop a governance structure that will involve a broad sample of the industry and which will develop a set of industry standards and a regulatory framework what will not require government laws.
5. Recognize that both smallholders and commercial farmers want an entity that provides trust, quality, consistency, independence, uniformity, and enforcement.
6. Ensure that warehouse receipts will be of a quality and accessibility to provide to farmers the following options: to consolidate crop in a secure location at a standard recognized by the industry; to control timing of commodity sales; to use the receipt as collateral with financial institutions; and to act as a trading mechanism for a national or multi country commodity exchange.
7. Focus on establishing the entity with the support of commercial farmers and traders to drive sufficient volumes to make the system financially viable, and once established, to develop mechanisms to involve smallholders in the now proven and credible entity.

**Figure 1: Summary of Approach to ZAMACE Development**



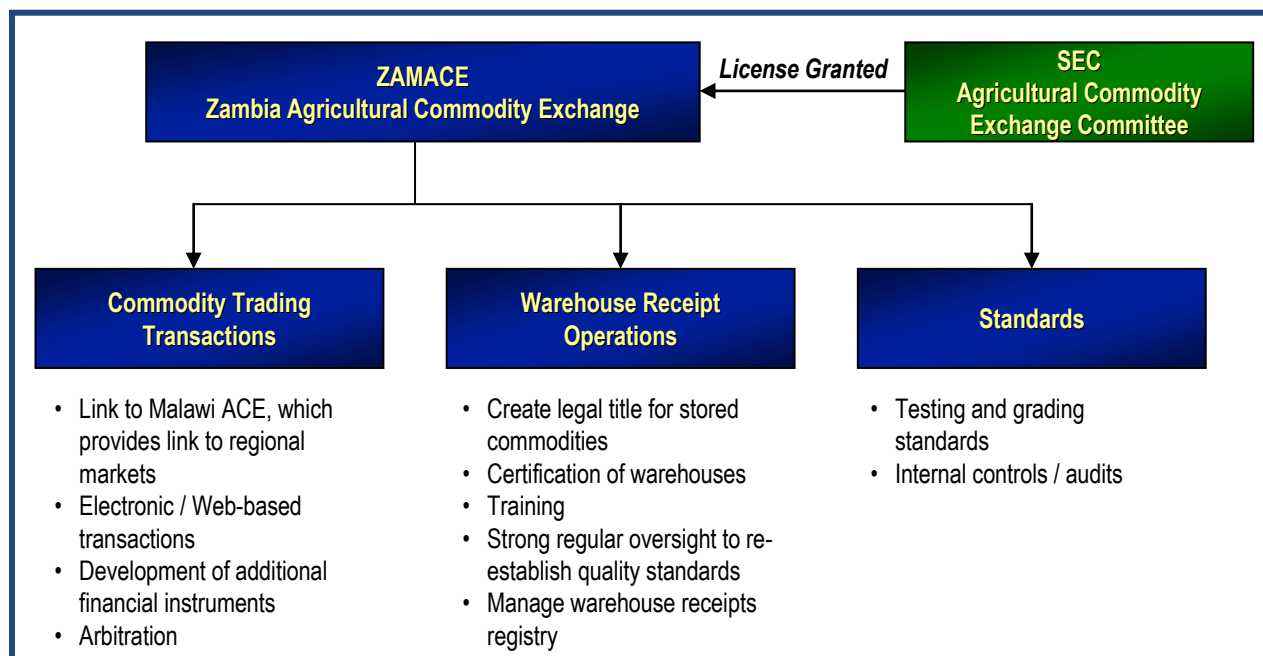
## KEY ELEMENTS OF APPROACH

The PROFIT project had been providing assistance to ZACA and also exploring the ways to link Zambian markets to Agricultural Commodities Exchange for Africa (ACE), a USAID Malawi funded regional trading platform. A recommendation was quickly made to combine the Warehouse receipts functions of ZACA with a commodity exchange function affiliated to ACE, by creating a new entity that combines both functions. In conjunction with the private sector, PROFIT established ZAMACE and provided financial and technical assistance to the new company.

The primary factor that pushed PROFIT to accelerate its pace of facilitating the emergence of ZAMACE was the one-season structure of Zambian farming. Also important was the integration with ACE PROFIT wanted to maintain the warehouse certification process started by ZACA, by having it integrated into an exchange platform, and the harvest season was fast approaching. If ZAMACE was not functional for that season any momentum that had been built through ZACA, including general acceptance of receipts and legal support for their transferability, would have been lost, creating an even more skepticism in the public and commercial sectors. At the time it was believed that ACE provided a means to speed up the process of establishing an operational trading platform, and provided leverage of previous USAID investments.

Governance of the new entity was critical and required a clear separation of operating an exchange on a daily basis in a business context, from the regulatory oversight to ensure that the interests of all stakeholders are considered. The government of Zambia is actively engaged in the commodities market and as such, creates substantial distortions and increases market instability. At the same time, parts of the initial legislation that was sponsored by ZACA through support from USAID implied that ZACA should both issue warehouse receipts and provide oversight for warehouse certifications. PROFIT believed that a balance had to be achieved that allowed for third party oversight, but minimized direct government involvement. In the Zambia context therefore an Agricultural Commodity Exchange Committee was established under the existing Securities and Exchange Commission (SEC) which provided an acceptable balance. Because of the previous record of ZACA, and because warehouse receipts were in an embryonic stage with no commercial track record, and with no precedent to working with the Exchange, the new entity had to demonstrate a strong and transparent governance structure in order to begin to establish market credibility.

Figure 2: System Structure of the Zambian Warehouse Receipts





**T**he SEC committee has representation of the industry (traders, processors, and commercial farmers), banks, smallholders and government. ZAMACE is owned by the trading brokers who are members, that is, they have bought seats on the exchange. The Board of ZAMACE comprises representatives of those members and advisory persons from the milling and farming sectors, financial institutions and government.

**T**he link to the Malawi commodity exchange (ACE) allowed ZAMACE to have immediate access to a regional internet-based trading platform and all the rules and regulations for the operations of both a commodity exchange and a warehouse receipts system.

Obviously an Exchange functioning properly depends on warehouse receipts (WHR), rendering unnecessary the need for physical inspection of product quality and quantity before trading. While banks are coming on board with lending against certificates, outside speculators can inject liquidity into the market, if the WHRs are associated with a rigorous certification and inspection process. The SAFEX exchange in South Africa, for example, trades maize up to 11 times before it physically moves.

**A**s the financial viability of the new entity depended on the volume of throughput, ZAMACE identified key groups of commercial farmers and traders willing to put a large proportion of their crop through the exchange, thus providing a kick start for the exchange and warehouse receipt program. Both farmers and traders saw the benefits of having independent and timely market information in their dealings with processors and a strong contracting and disputes arbitration system. Of these three benefits, the most important is the access to a transparent exchange mechanism that decreases transaction costs and volatility by unifying standards and grades, operating under clear and transparent rules and policies, and broadening access to market information. As transaction costs and volatility decrease volumes will increase.

Working through ZNFU (the Zambian National Farmers Union), which represents all categories of farming interests, ZAMACE was able to expand on some of ZACA's activities to promote awareness of warehouse receipts and the Exchange in the smallholder sector, including launching some pilot projects in which smallholders would pool their commodities and place them on the exchange as a group.

The linkage to the Zambia SEC strengthens the arbitration and dispute settlement capacity of ZAMACE and PROFIT will also conduct additional workshops with independent mediators and arbitrators to strengthen the capacity to resolve disputes in Zambia's commodity markets.

**A**s outlined in the figure above the STANDARDS function has been separated out, because it is a high priority of the new entity and something that was lacking in Zambian commodity markets. ZAMACE has established, in conjunction with industry stakeholders, a clear and transparent set of industry-wide standards for wheat, maize and soya, these being the major tradable crops. Other standards may evolve over time; however already standards for transport, fertilizer, warehouse space are being examined.

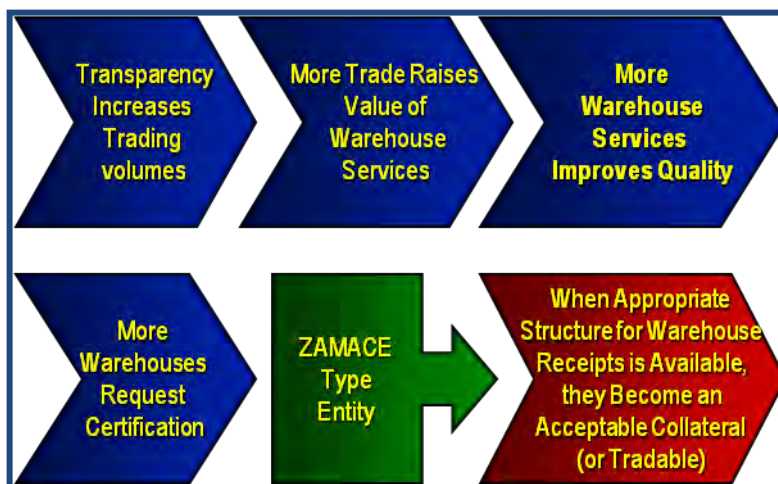
Training is underway with the staff of ZAMACE on how to establish and maintain clear and transparent standards for tradable goods that are accepted by the industry.

## LESSONS LEARNED

Some of the major lessons learned from the ZAMACE initiative to date can be summarized as follows.

1. The lack of success of ZACA was related to the fact that it was not linked to a transparent market from which valued services could be derived. Further, ZACA concentrated on enhancing the involvement of smallholders in the warehouse receipt system without first establishing the credibility of the system within the agricultural and financial industries. Poor enforcement of the system and poor client services, driven by low volumes, led to a loss of interest among the commercial warehousing sector, and the donor focus removed any sense of ownership by the industry.
2. Another key issue is that warehouse receipts are derived from a transparent trading system that fosters a high volume of transactions (figure 3). Warehousing services derive their value from increasing volumes, and as warehousing services become valued, the quality of service becomes more important. The quality of service makes certification and inspection a valued support service. The effectiveness of these support services provides the basis for warehouse receipts being tradable and acting as collateral.

**Figure 3: Transparency increases volume which increases value which increases trading**



3. To establish the new sustainable entity, the primary focus was with the commercial industry segments in the country and not with smallholders. While this was initially counterintuitive from a donor perspective, it became clear that smallholders could best benefit when there is an established, reliable and sustainable entity providing services to the market. The immediate volumes obtainable from the commercial sector will allow ZAMACE to reduce the per unit price for services, thus allowing smallholders to participate.
4. Greater price discovery is also an immediate and profound benefit. Bulk crops can now be defined by accepted standards, stored safely and traded when needed. This contrasts with the current environment where smallholder maize is discounted in the market on an arbitrary basis with little reward for high quality product. Small farmers or groups of farmers now have a greater variety of sale and trading options, including storage for sale at a later date, and the option of borrowing against stored crop using warehouse receipts.
5. Warehouse receipts are not currently recognized by law as documents of first title or ownership on a particular commodity and as a result the financial institutions are hesitant to

lend against them. It is unknown when, if at all, enabling legislation to enshrine warehouse receipts in law will be enacted. In the meantime, ZAMACE has increased the level of security through the addition of a nationally recognized, government-managed 'agricultural charge' to the package offered to the financial markets that effectively provides 'first title' and by demonstrating over time that WHR are a consistent and trusted 'currency' within the industry, ZAMACE will be able to draw financial institutions into extending credit into the sector using stored crop as collateral, thus injecting much needed liquidity into the agricultural trading market. Rather than attempting to change the mindset of all financial sector players initially, ZAMACE is working closely with two of the more innovative banks, hoping to use competitive pressure to apply change to other market players over time

6. In Zambia a number of large processors, traders, and other market makers initially resisted the concept of an exchange and the transparency it provides to a market. Now that the Exchange is functioning, all these companies have become members of the Exchange. They have realized that increased marketing options through a regional trading floor, increased market stability, predictability, and confidence through a reliable warehouse receipting system and a clear disputes arbitration system are good for business.
7. The Government of Zambia is a regular intervener in the market and has a major influence on the prices of staple crops, particularly maize. They are active in buying and selling of maize and regularly place "bans" on private sector import and export based on food security and policy issues. While this is out of the control of ZAMACE, it is hoped that providing a strong and credible private sector alternative that is inclusive of all players in the market including smallholders may persuade the government, through the Food Reserve Agency to utilize the Exchange and its associated warehouse receipt system to secure strategic access to food reserves with less distortion of agricultural markets. ZAMACE is also lobbying large food aid donors (such as World Food Programme) to pilot local procurement functions through the Exchange

## SUMMARY

**A warehouse receipting system can be a more robust and sustainable function if it is built around an existing marketing system, and not just considered as a financing option,** as is the case in many countries. Over time and with rigorous enforcement, the receipt will gain credibility as a respected tradable instrument and make buying and selling more efficient. Because buyers need not take physical delivery of stock in order to trade, stocks may trade several times before they leave the storage site.

## FOR ADDITIONAL INFORMATION

**Coulter, J. and G. Onumah (2002).** "The Role of Warehouse Receipt Systems in Enhanced Commodity. Marketing and Rural Livelihoods in Africa'

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