Risk Management & Food Security: SAFEX-based Option Strategy & Application in Malawi

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FAO Workshop on Public/Private Sector Solutions for Food Security

March, 23, 2006

Agenda

- The Problem
- How can Risk Management Solutions help?
- The Product
- Impact
- Lessons Learned
- Limitations

The Problem

Although South Africa had 6 million metric tons surplus in 2005/6, commercial exports were not moving efficiently to countries with deficits

…Leading to…

Increasing local prices

…Leading to…

Potentially higher levels of humanitarian need

…Leading to…

Intervention to maintain sales at subsidized prices

…Leading to…

Continued disincentives to private sector trade

C.R.M COMMODITY RISK MANAGEMENT

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The Problem – Systemic:

- Private sector unable/unwiling to meet full demand
  - In Malawi
    - Unable to compete against ADMARC's subsidized prices
    - Waited for donor/WFP purchases – only wanted to sell to them
    - Except for 2-3 big traders, others do not have capacity to carry out large scale imports (logistics / trade finance / risk management)
  - In Zambia
    - Difficult to import when government intervention increases cost & risk
    - Difficult to import when no clear view of what gov't is going to do

More Problems:

- No trust between gov't and private sector
- Donor programs & WFP can have negative impact on the commercial market
- No planning – everything done at the last minute when costs are high & transport corridors are constrained

How can Risk Management solutions help?

Import Risks	Mitigating Impact of Option Contract:
Policy Risk	1)Provides government with better response than ad hoc interventionist policies 2) Can help define, contractually, the space between public / private sector in countries where private sector has difficulty managing imports
Market Risk	*same as above
Price Risk	Provides price ceiling for imports
Credit Risk / Access to Trade Finance	Solution will depend on counterparties & contract structure
Logistics Risk	Structured by strong counterparties who can handle the international transport while local traders handle national transport

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Question:

Is Risk Management

a Better Role

for Government & Donors

than Food Procurement & Distribution?

Why was Malawi Government interested in a risk management approach?

- Concerned about local price increases
- Concerned about regional (S.African) price increases
- Concerned about private sector's ability & willingness to bring in commercial imports
- Concerned about response to humanitarian appeals

➢ Wanted a back-up plan in case any of the above went wrong

Estimates of Malawi needs – 2005-2006

Scenario	Price Level	Humanitarian needs
#1	Local prices 18-25 Mk/kg	270,000 MT
#2	Local prices >30 Mk / kg	350,000- 400,000 MT

The Product

- A call option
  - Gives Gov't the right but not the obligation to buy
  - Gives Gov't protection against prices moving up
  - Provides capped price level for imports….if and when they are needed
  - Can be triggered (exercised) in tranches

The Contract

- 60,000 mt of non-GMO white maize
- Average capped purchase price was below $300 / mt
- Premium cost to lock in that price: below 10%
- SAFEX price base + fixed transport costs to Malawi to give price protection in local, delivered terms
- Customized to give flexibility

Impacts….

- Deliveries moved well
  - Better performance than other tenders
  - Stronger counterparties involved - Standard Bank has better capacity to overcome transport constraints – was able to make changes in routing
- Market prices moved up
  - Prices in Dec/Jan were USD $50-90 / mt higher than ceiling price locked in through the option contract
  - Zambia importing at significantly higher prices than Malawi

Impacts….

- Some of the volume was borrowed from commercial markets to feed humanitarian programs due to problems with other deliveries
- Some of the volume went through ADMARC and was sold at subsidized prices
  - (Subsidized price level could have been protected with similar contract if done earlier in July /August)

Lessons Learned so far:

- Government sees value
  - as a contingent import strategy (worked when other mechanisms failed)
  - for positive public messaging, i.e. as one of the things government was “doing” in response
  - as learning experience – want to look at other applications such as reselling to traders and for more cost effective management of strategic grain reserve
- Donors/WFP see value
  - potential reduction of costs
  - better planning tool
  - to help maximize value of food aid dollar
  - as learning experience – want to look at other applications

Lessons Learned so far:

- Product itself is well-received in the market
  - combining SAFEX + transport removes basis risk for buyer
  - increased use of SAFEX good for regional trade integration
  - big traders/banks very interested & willing to do it elsewhere

Lessons Learned so far:

- Private sector likes the approach because:
  - provides a good signal about gov't intent
  - too many risks for local traders to import commercially (policy, market, credit, logistics, price) but option provides a mechanism for gov't/donors to help finance & mitigate risks and turn it over to the trade when exercised
  - local traders like the idea of gov't / donors buying options then reselling them to traders to handle logistics/ distribution
  - local traders willing to make agreements on where they would sell commercially through options-based arrangements
  - big traders / banks willing to manage SGR under leasing arrangements if they could write option contracts on product stored in Malawi/Zambia

Limitations

- In General
  - Has a cost; generally 8-10% of price level protected
  - Is somewhat complex – requires capacity building (but not long term)
  - Requires planning
  - Requires cash in advance for payment of premiums
  - Doesn't solve problems of transportation constraints
  - Counterparty risk exists

Some Conclusions

- Governments have difficulty giving up interventionist policy without good alternatives
  - Market solutions exist, make use of financial structures
- Donor interventions can be just as disruptive to the market as government
  - Need new mechanisms which transfer business to local traders
  - Donor investment in risk management strategies may help maximize value of food aid dollar
- Better coordination and ex ante planning needed overall so not always operating in crisis mode with very high costs