

Pre-export finance and prepayment

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Pre-export finance (PXF) and prepayment finance turn the trader into a lender to the producer. In a prepayment, the trader pays a producer, such as a steel mill, a mining company or a state oil company, in advance for future deliveries. The producer repays by delivering goods, which the trader sells. The trader usually finances the prepayment with a bank loan secured by an assignment of the offtake contract and of the proceeds of sale. The bank may take a direct pledge or assignment over the producer's export receivables. In a pre-export finance facility in the narrower sense, banks lend directly to the producer, secured by an assignment of export contracts with approved offtakers and by collection accounts outside the producer's country. The trader's role is then that of offtaker, sometimes with a participation in the loan. Public Eye reported that one large Swiss-based trader's prepayments grew from USD 700 million in 2013 to USD 5 billion in 2019. It also noted that such structures with state-owned producers raise corruption and transparency risks.¹

For Lugano traders, prepayment is common in the steel and coal trades with producers in Ukraine, Russia before 2022, Central Asia and Turkey, where the mill needs working capital and the trader secures an allocation of production. The risks are performance risk (the mill does not deliver), country risk (export bans, sanctions, war) and transfer risk (the mill delivers but the proceeds are blocked). Banks mitigate them through political risk insurance, through participation of export credit agencies and through tolling or offtake structures in which the trader retains title to raw materials processed by the mill. The war of 2022 showed the limits of these mitigants. Prepayments to Russian and Ukrainian producers became unenforceable or sanctioned overnight, and traders that had paid advances to producers in the region were left with claims that they could not enforce. Chapter G.II treats the sanctions dimension.²

1 Repurchase and inventory finance

A commodity repurchase agreement (repo) is a sale of commodities by the trader to a bank with a simultaneous agreement to repurchase them at a later date and a higher price. The difference is the bank's financing cost. Legally the bank becomes the owner of the goods for the duration of the repo, which gives it a stronger position in the trader's insolvency than a pledge. Repos are used mainly for metals stored in exchange-approved warehouses, where title passes through warehouse warrants. They are also used for oil and products held in tank storage. The economic substance is a secured loan, and accounting and regulatory rules may treat it as such.³

Swiss law makes inventory finance against goods held in Switzerland difficult, because a pledge of movable goods requires the transfer of possession to the creditor (Art. 884 ZGB). A pledge that leaves the goods with the debtor is ineffective, and a transfer of ownership with the goods remaining with the seller is ineffective against third parties if it is intended to circumvent the pledge rules (Art. 717 ZGB). For goods in a warehouse, a warehouse keeper who publicly offers storage services may apply to the competent authority for the right to issue documents of title to the stored goods, which confer the right to take delivery of the goods and may be made out to a named person, to order or to bearer (Arts. 482 and 1153 ff. CO). A pledge can then be created by pledging the receipt (Art. 902 ZGB). Most of the inventory financed for Lugano traders is, however, located abroad, in Black Sea, Mediterranean, Rotterdam or Asian ports. The acquisition and loss of rights in rem in such goods are then governed by the law of the place where the goods are located at the time of the relevant event (Art. 100 PILA). Where the goods are represented by a document of title, the law designated under Article 145a PILA decides whether the instrument represents the goods, and the rights in rem in both the instrument and the goods follow the law applicable to the instrument as a movable. If one creditor claims the goods directly and another through the document, the law of the place of the goods decides which right prevails (Art. 106 PILA). Banks rely on collateral management agreements with inspection companies, which control the warehouse on behalf of the bank and release goods only on the bank's instructions.⁴ The Qingdao metals fraud of 2014, in which the same stocks of copper and aluminium were pledged to several banks through duplicate warehouse receipts, remains the standard example of what happens when this control is illusory.⁵

2 Notes

1. Public Eye, Trade Finance Demystified (above), 26–27 (Trafigura's prepayments rose from USD 700 million in 2013 to USD 5 billion in 2019; Glencore's average annual pre-financing of USD 2.3 billion, 2014–2019). ↩
2. See Chapter F.I on the effects of the war of 2022 on the Lugano cluster, which reports that some firms went into liquidation. ↩
3. Commodity repos and their treatment as secured financing. ↩
4. CO, Art. 482, <https://www.droit-bilingue.ch/en-de/2/22/220-482-696.html>; PILA, Art. 100 and Art. 106, official English translation at [droit-bilingue.ch](https://www.droit-bilingue.ch/en-de/2/29/291-100-117.html), <https://www.droit-bilingue.ch/en-de/2/29/291-100-117.html> and <https://www.droit-bilingue.ch/en-de/2/29/291-106-123.html>. ZGB, Art. 717, Art. 884 paras. 1 and 3 and Art. 902; CO, Arts. 1153 ff.. ↩
5. Qingdao port fraud of 2014. ↩

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