

A few comments on the current crisis

Over the past few weeks, I have been solicited to provide views on the current crisis. This document appends various questions and my suggested answers.

1. What has been the impact of the virus, lockdown and oil price war on financing for commodity traders?

As for any corporate or individuals, the challenge caused by the virus and the measures taken to ringfence its dire consequences is massive. With on or about half the world population in lockdown and most developed economy in a standstill, the choc is massive.

What makes it even more challenging is the fact that both supply and demand are affected and that like in a low speed tsunami, the wave reaches every shore, eventually.

In such context commodity trading faces 3 kinds of difficulty: a choc of demand, disruption on supply and if the crisis lingers, a much-increased counterparty risk. Whilst the volatility is high, such uncertainties prevent trading houses to take a full advantage of it.

In rough seas one needs a sturdy vessel. Translated into commodity trading, this means that only large trading houses can play with such a market and cope with the underlying risks: Trading risks, liquidity risks to face margin calls or payment delays, and counterparty risks. Smaller players should err on caution as if on the wrong side of the market, they will simply lack the financial muscle to absorb the chocs.

2. Are banks tightening their lending to traders?

Banks are tightening their exposures on every front. With regard to commodity trading, their reaction is to fly for quality and be quite restrictive on everything else. This means that ABCDs and top Oil traders will not be significantly challenged as they are able to communicate on their strategy, positions, liquidity and results with their main banks almost daily if necessary. Smaller players, unlike larger traders, are exposed in such market condition with often slim liquidity and are often much less equipped to monitor their books and communicate effectively with the lenders. When this is the case and in the current context, their banks will not be accommodative. In case of doubts or difficulty to assess the market position of their smaller customers, banks will not hesitate to reduce their lines.

3. Are smaller traders more impacted?

Yes, certainly unless they can demonstrate a very good command on their supply chain. Mind you though that 'smaller trader' does not mean the same thing in Energy where they are certainly very exposed in such market, or in agri, where notwithstanding the ABCD's, there are a few very sound players between 5 and 10bn\$ turnover. Such Agri trading houses, when they have a good command on their supply chain and a resilient strategy can thrive as, no matter what, demand on food and agri will not face a significant downturn with 7.6bn people to feed and c.3 bn out of them stranded in cities.

4. Why would banks reduce lending to traders now if the traders are not directly exposed to lower prices? doesn't this make things easier for traders - who need less capital?

Traders in principle are not exposed to flat price. Unlike producers and end users. So, in theory you are right. However, in real life things are somehow different. To ring fence the flat price risks, traders rely on hedge whether on a book or deal basis. In markets like the one we are witnessing (full worldwide recession, supply and demand affected) price movements can be extremely volatile and your hedging strategy is as good as your ability to pay for margin calls. If you are not able of making good large margin calls, then

your hedge vanishes and you are left fully exposed, facing huge losses potentially. Besides, and as mentioned in 1, the logistical disruption on the supply side on the one hand and potential counterparty defaults on the other, if significant could trigger losses both on the hedge and the trade.

For all these reasons banks will stick to robust traders (the large trading houses) and will certainly revisit their exposure on whichever company is deemed overstretched.

5. Have the risks of counterparty defaults increased and, if so, how?

The risk of counterparty default is rising as the crisis lingers. The world economy is in standstill. As we saw oil demand has fallen by 30 pct. when it has been rising consistently for the past 30 years of so. China's ability to rebound is a moot point. Europe and America face the biggest economic crisis since WW2. In that context, defaults are bound to happen, hence the nervousness of banks, hence the reluctance of insurers to underwrite new businesses. If another evidence was needed, prices are on the rise.

6. Are some commodities and related lending more impacted?

All commodities are affected, either on the supply side, demand side or both! All sectors of the economy are hit in effect. Besides commodity trading, tourism, transportation, banking, automotive industry... Banks have long recognized that commodity trading was a critical activity, upstream to most supply chains. Rather than taking global decision to pull out of one sector or another and as we are amid the thunderstorm, banks are having a very close look at their customers across all industries and will endeavour to direct their support to the fittest and most resilient ones. With others, time is not ripe to stage pull-outs but to endeavour to ring fence their exposure by capping, reducing their limits or strengthening security packages. Strategic decisions will come later.

7. How has Singapore tried to attract commodities traders? Incentives / tax breaks etc?

There is nothing untoward or complacent in how Singapore attracted commodity traders. This was part of a wider scheme to make the city state a key hub for trade flows and the offering through the Global Trader Program offering reduced tax rates for several years. Ireland did the same with US companies offering them a very attractive foot in the door of EU...

8. **How would you describe regulatory and legal oversight of commodities traders in Singapore?**

It is neither worse nor more complacent than everywhere else. The fundamental issue is the lack of understanding of what commodity trading is about. A mix of physical and paper trading is very difficult to understand and monitor if sitting outside the company. Auditors and even commodity bankers are not often well equipped to understand and assess market risks which is why the more experienced banks do regular audit of trading houses involving market risks specialists.

9. **Do you believe that regulators and or legal authorities oversight played any role in these scandals?**

They do but at their own pace. When a company is privately owned, there is so much what you can do. Auditors form the first line of scrutiny and control. There is a lot to be done to improve the standards there.

If the company is listed, then it is expected that the exchange brings an extra level of scrutiny and control. Unfortunately, a famous case has shown it did not happen.

10. **What about the role of auditors in Noble and Hin Leong (Deloitte)? Did they perform their duties and what about regulatory oversight of the auditors?**

Post-mortem analysis will tell for Hin Leong. As far as Noble we have seen that neither the auditor of the company nor the independent auditor who audited the long term contracts and their valuation in 2015 had a clear view of the nature of the business. To quote the latter report *“Overall, we note that Noble has adopted an approach to valuations which is consistent with the Relevant*

Criteria, in all material respects. Indeed, in some aspects of the model construction (such as the development of discount rates and development of counterparty credit risk curves), Noble has an approach which is more sophisticated than that of many non-financial companies.” We all know how this ended.

I cannot appreciate the regulatory oversight of the auditors but would suspect it is no different than in other international financial hub.

11. How will this impact Singapore, one of the world's biggest commodity trading hubs?

Obviously, the track record for Singapore is not very good, OW in 2014, Noble in 2018, Coastal in 2019, Agritrade and Hin Leong this year. Having said that, it is difficult to blame the City State for each and every privately-owned group going under. Where I see the problem is with banks which are so instrumental in supporting the commodity industry. In the context of the current economic crisis, they are bound to revisit their risk portfolios, scrutinizing individual names, sectors and geographies. If banks, whether local ones or international groups, were to retrench significantly from the commodity sector in Singapore, this could possibly threaten the position and the ambitions of the City State as one of the world biggest hub.

12. How can the industry prevent something like this happening again? Is digitisation the answer?

Commodity trading demand skills, systems and governance. Therefore this business is increasingly left to large established players in their respective markets. Only these trading house have the means to manage complex books and positions and can rely on a big enough liquidity buffer to absorb market shocks. Hin Leong was not an oil trader per say. Their reputation was built on shipping, storage, blending and distribution of products in the region, not on prop crude trading. When markets move in such magnitude, such groups are totally unequipped to manage possible shocks.

Digitalisation may bring some degree of control when it comes to managing collaterals pledged to banks for instance. But to buy/transform/sell physical commodities, one needs to hedge and build sophisticated strategies on futures markets. How aggressive such hedging strategy will never be prevented by digitalisation. It will be within the trading houses by governance, processes and control. It is also kept under check externally, by the quality of the dialogue/audits etc that their banks need to undertake. Obviously, this is the case between the larger trading houses and their financiers. It is probably less so with the smaller players.

13. **As global demand for energy plummets and a key player like Hin Leong having folded, where does this leave Singapore's oil trading sector and it is as resilient as authorities in the city-state claim?**

The regulatory oversight in Singapore is not worse or more complacent than in other major financial hubs. The fundamental issue is the lack of understanding of what commodity trading is about. A mix of physical and paper trading is very difficult to understand and monitor if sitting outside the company. Auditors and even commodity bankers are not often well equipped to understand and assess market risks which is why the more experienced banks do regular audit of trading houses involving market risks specialists.

Having said that, the way the Hin Leong crisis is to be managed by the authorities is critical. To remain a key commodity hub, and besides offering a favourable tax incentive program to traders, Singapore needs to ensure the banking industry remains vibrant. After 3 major incidents recently (Coastal, Agritrade and now Hin Leong) and a few more in recent history including a listed company, Banks will undoubtedly revisit their exposure and appetite. Without a very supportive banking industry, the commodity sector will struggle to remain a key industry in Singapore. In the wider context of banks being under stress facing a worldwide recession and if the City-State does not step in a way or another in actively helping to solve this local crisis, it is unlikely that post crisis, banks and especially international ones will remain as forthcoming as they have been with the commodity sector in Singapore.

14. Amidst the global oil oversupply, how unprecedented is the demand for supertankers to be used for storage, and are there enough vessels to meet storage demand in the coming months if prices remain at unsustainable lows?

So far large trading houses still can charter vessels if paying the right (these days very expensive) price. However, and if demand does not pick up in the next few months, the problem will not only be the availability of storage to enjoy the contango but one of unprecedented imbalances potentially driving the market to unchartered territories. If this happens it would be because the worldwide recession has spread and that it could linger. That would be a catastrophic news for all of us, personally or professionally, well beyond oil price considerations.

15. In the aftermath of the stunning negative oil price crash, what happens next? Do you see the oil price collapse as something that will be relatively short-lived with markets bouncing back relatively soon, or is it an early warning sign of turbulence to come?

As said, it all depends of the ability of the economy worldwide to rebound. This is likely after all, considering that half the world is under voluntary lockdown. We should be able to ignite an engine that was shut down intentionally. China is doing this as we speak. Europe and the US should follow-through in a few months. If this happens, then the oil consumption will resume and rise again. Maybe not to 100mbpd, but enough to rebalance the market (with the help of supply cuts probably). Oil could then rise slowly back to the 30-35\$pbbl level.

However, the uncertainty surrounding the Covid19 remains high and whilst I am hopeful economies can go back online sooner rather than later, this scenario can be easily derailed. As Keynes put it “the expected never happens, it is the unexpected, always”.