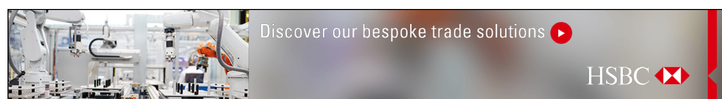


# Commodities lending: Blind man's buffer?

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*Systemic risk - not yet. But as more of the commodities market becomes concentrated in the hand of a few large traders, are bank exposure limits a workable buffer to an increasingly sophisticated set of market risks?*

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Former US Federal Reserve chairman Alan Greenspan opined that if an institution was 'too big to fail, it's too big'. It is an observation that has informed swathes of new banking regulation since 2008. But should the same thinking be applied to commodity traders given the growing domination of a few tier one traders?

In a 2012 speech the deputy governor of the Bank of Canada Timothy Lane suggested it should: "Just as the 2008 financial crisis revealed the need to assess the systemic importance of institutions that play a central role in financial markets, we should be asking the same questions about institutions that are interconnected with various commodity markets," he warned. And the recent plight of companies such as Transmar and Noble Group have resurrected concerns about the potential risks to financial markets posed by the decline of leading traders.

Unlike banks, traders are not subject to stringent capital requirements, even though they are major on-lenders to producers and suppliers of commodities. The arguments against imposing capital requirements on commodity traders are numerous: Commodity traders borrow short-term and lend short-term; traders do not pose the same systemic risk as banks due to the different size and models of the respective businesses – banks are more highly leveraged and borrow short-term to lend long-term; traders are not overly leveraged and do not engage in the same lending activity as banks to a comparable extent; and bank-like regulation could force companies to go public, reducing management incentive, and passing on greater costs to other parts of the supply chain.

Furthermore, the growth of on-lending by traders to producers is logical given the reduced bank appetite for commodities in recent years. But that facilitation has also meant many leading traders have become more highly leveraged. And although this is no indication that failure is intrinsically more likely, it does mean the intangible risk in commodities lending – which is effectively one-times removed from banks – is growing.

The issue has yet to hit systemic risk proportions according to Jean-Francois Lambert, founder of consultancy Lambert Commodities. The collapse of notable traders in the past - for example Metallgesellschaft - led to the development of better systems of management from traders. And those improvements aside, bank exposure limits have been the real buffer to potential fallout from commodity trader lending.

Furthermore, few of the major traders, other than those that have been engaged in building up asset bases, carry net-debt-to EBITDA levels beyond 5x-plus - levels that would raise alarm bells at banks. Trafigura's net debt to EBITDA was 5.4x last September. As of last June, Bunge's was 3.8x, higher than its rivals Archer Daniels Midland and Cargill at 2.48x and 0.9x respectively, but not alarming. And Louis Dreyfus' net-debt-to-EBITDA rose from 2.3x at the end of 2013 to 4.2x as of last June.

But with the global commodities market increasingly becoming concentrated in the hands of a few major traders, and given most definitions of systemic risk suggest that it is the interconnectedness of institutions which cause the greatest problems, a possible failure of multiple tier one traders would cause serious fallout for the bank market.

The risk to banks is real and growing. "Commodity market risks are getting more sophisticated and they are not properly understood, either by bankers or by auditors. Importantly, many issues can be avoided if banks are more rigorous and acknowledge that market behaviour has more impact on commodity trading than generally perceived," warns Lambert.

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