Commodity trade tech: The new key to making the margins

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The changes that technology will bring to the commodities space are manifold. What can commodity trade finance expect from new technology and, more importantly, is it ready for it?

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The combination of artificial intelligence, improved algorithms and blockchain technology looks set to transform the commodities space. Proprietary information, the market edge that traders once enjoyed, is becoming a thing of the past as access to information grows. And the fintech mantra is that digitisation will be the key to maintaining margins in an increasingly transparent market with fewer arbitrage opportunities.

While all agree change is inevitable, there is a divide in the industry's thinking on what post-digitisation trading will look like. In an October 2016 report entitled 'Reimagining Commodity Trading' consultancy Oliver Wyman suggested that the world's largest commodity traders would become 'global titans' based on current performance and the benefits of digitisation.

Conversely, others claim that the transparency spawned by digitisation will lead to a more level playing field and new, nimble, digitally capable firms taking up positions within the commodity space.

Mihai Andreoiu, a trade and commodity finance advisor - formerly of Deutsche Bank in Geneva - tells TXF: "Current thinking on technology and innovation remains fragmented. It will take evident risk management or quantifiable efficiency gains for the commodity trading industry to move towards a new standard such as blockchain ledgers."

For those that do – and some already are – the benefits of blockchain will be the market edge that proprietary information once was. Back office costs will be significantly reduced for traders that digitise fastest, and those savings will up trading margins.

This has been proven, to some extent, by Mercuria and Trafigura, which have already completed blockchain transactions. Trafigura ventured into blockchain within oil with the help of Natixis and IBM earlier this year. And Mercuria closed a deal involving ChemChina, ING and Societe Generale – although the transaction was between parts of the company's existing network and, according to a TXF source, was completed on paper beforehand to ensure the viability of the trade.

Mercuria's co-founder Marco Dunand noted at the time that if the industry managed to standardize blockchain contracts, oil trading would become safer, while costs associated with physical transactions and their financing would decline.

Change is on the way

These changes will start to come sooner rather than later. According to a recent poll by Chain Business Insights, just over 40% of respondents plan to implement blockchain within the next year, and one-fifth intend to implement the technology within two years. The suggestion is that delta-hedging positions, managing fleets of vessels, optimizing credit risk, aggregating internal and external intelligence on cash flows, among other things, will be left to machines in the near future.

Crude oil futures and US gas are already close to the stage of being termed 'hyperliquid' with faster based trading becoming the norm. The traits of such a market include the use of 'big data', decision making made by algorithms, and greater standards of accessibility to information. Other markets such as gold, silver, EU power, and iron ore are all on their way to being hyperliquid as well.

The monetisation of stocks in transit will revolutionise knowledge of who owns what and when, according to Jean Francois Lambert, founder of Lambert Commodities. "Banks and traders will have to change the way they conduct business. There will be more visibility on commodity flows so trading will become more challenging as shared market information improves." For example, the ability to assess and view goods whilst in transit could lead to the possibility of physical commodities being financed or changing hands whilst aboard a tanker. Similarly, Letter of Credit (LoC) deliveries will no longer take around 30 days, reducing costs but also allowing for alternative funding sources to quickly and effectively finance different commodity flows.

Digital dominance?

Digital dominance?

More transparency has been a market trend for many years now and greater access to information is only set to continue. This has made making margins in some markets more difficult, with refined metals particularly hard hit. As Andreoiu notes: "A direct consequence of technology is increased transparency which has meant fewer arbitrage opportunities. As large traders continue to grow their market share, it is smaller niche players that have traditionally relied on proprietary information that are feeling the pain."

Many traders foresee a world in which artificially intelligent automation within defined systems will become the norm and make more of the routine decisions.

Alternate traders may also emerge. For example, Oliver Wyman's report highlights the chances of global online providers challenging on energy - as commodity trading becomes more automated and energy consumption more homogenous, providers such as Amazon, Alibaba, Uber, Google, and Baidu could enter the market.

Others believe further consolidation is on the way. "The smaller names need to have a logistical or financing value proposition to supplier and/or buyers to stay in the game," says Andreoiu.

Whatever the outcome, most business is likely to be via data networks rather than trading hubs in the future. The immediate challenge for physical traders is to balance the efficiency and cost savings generated by technology against the loss of their traditional trading edge – proprietary information. But with transparency set to continue to grow, that balance will inevitably tip in favour of digitisation - the only uncertainty is when.