TREASURY

Commodity trade finance at the crossroads

BY PAUL GOLDEN

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Fraud, commodity prices and concerns over defaults have created a perfect storm for commodity trade finance – and the capacity of trading firms and finance funds to support the market remains unclear.

Commodities trade finance revenue pools continue to decline: revenues from institutional clients and corporates with annual sales turnover in excess of $5 million were down from $2.4 billion in the first half of last year to $1.7 billion for the first six months of 2020, according to data from Coalition.

Unsurprisingly, the decline was particularly pronounced in the second quarter of this year, with $700 million of business done compared to $1.2 billion in the same period of 2019. Some estimates for the decline in commodity trade finance revenues this year suggest banks could see their income fall by almost two-thirds.

Jean-François Lambert, Lambert Commodities

In the wake of BNP Paribas suspending new commodity trade finance deals, Jean-François Lambert, founding partner of commodity trade finance consultancy Lambert Commodities, describes the withdrawal of ABN Amro as a worrying development.

“ABN Amro was a very active player, supporting both mid-size and major trading houses,” he says. “Through its relatively large network it has been financing commodity supply chains across the world.”

The big question now is whether other major players will follow suit. There is every possibility of a liquidity squeeze as lending becomes more restrictive – and commodity traders need ‘other people’s money’ to support their trades.

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> **JOHN MACNAMARA, CARSHALTON COMMODITIES**

Eric Li, head of global transaction banking research at Coalition Development, observes that although a few banks have ventured into this market in the last few years, mainly in Switzerland, he doesn't anticipate any more newcomers while prospects for the sector remain uncertain.

Eric Li, Coalition Development

“There are two factors that dictate whether a new player would find this industry attractive,” he explains. “Firstly, whether and when client demand will recover – which is closely correlated with commodity prices and the global liquidity situation – and secondly, whether pricing will recover.”

Lambert agrees that the cost of funds will rise across the board and warns that smaller traders may struggle to maintain existing bank lines. “This may trigger alternative finance interest but this is likely to be limited,” he says. “Trade funds are also affected by the overall risk deterioration and the effect of supply chains dislocation, and investors will err on the side of caution.”

Tradeteq CEO Christoph Gugelmann agrees that many trading firms will struggle to access competitive terms in this environment, particularly if they are small and with limited credit history.

It is not uncommon for commodity trading houses to support their supply chains, particularly in situations where banks would not fund these counterparties. John MacNamara, an industry veteran and CEO of consultancy Carshalton Commodities, questions what they do with all that dirt-cheap unsecured revolving credit facility money.

Christoph Gugelmann, Tradeteq

“The banks were already steered away from financing SME traders by Basel III – never mind the threat of Basel IV – so the big traders have been financing those further down the food chain who couldn’t get such cheap money from banks for a long time now, and that is only going to increase as the big European banks pull back,” he adds.

Li is not convinced that trade finance funds will attempt to increase their share of finding. “As the outlook for the commodity market remains uncertain due to the possibility of a second or even third wave of the pandemic, most trade finance funds are still very cautious,” he says. “They might get involved if there is a 'fire sale' situation and pick up some distressed assets, but we haven't seen any major exposures shift yet.”

Dislocation of expectation

MacNamara, who is also chair of the London Trade Roundtable, reckons interest from trade finance funds will increase but refers to the dislocation of expectation around pricing.

“All the funds are more expensive than any of the banks (even the small ones) and traders are still baulking at embracing this sort of hit to their cost model – not least because trading margins in commodities are actually pretty thin – so there has to be some shift in that pricing paradigm for the funds to get up to serious volumes,” he says.

John MacNamara, Carshalton Commodities

He reckons overall funding costs will go up, but that there won't be a sudden jump to double-digit lending margins. "At the same time there is a 'back to basics' movement on issues such as monitoring and control of the transaction, while many participants are also looking to technology to produce better solutions to the risk of fraud," he adds.

The CEO of a UK-based specialist commodity trading firm says he does not expect new players to enter the market in the short term. "I expect the established banks to expand to fill the gap, but with pricing adjusted to more properly reflect risk and less of the 'race to the bottom', where regions/market sectors were overbanked and competition led to lax controls and overly cheap risk premia," he says.

While acknowledging that the major commodity trading firms will use their ability to finance as a hook to give them an advantage over firms like his, he also suggests that producers will want to have access to other options "to keep the market honest".

In August, Sberbank structured its first trade finance deal through its subsidiary bank in Switzerland. The deal was with Egypt's General Authority for Supply Commodities and also involved the International Islamic Trade Finance Corporation.

Evgeny Kravchenko, head of trade finance at Sberbank, acknowledges that the commodity finance market is going through a tough period. However, he is convinced that deals can be done if high quality, thorough due diligence is undertaken, there is a focus on transactional commodity flows, and banks focus on core markets.

"Problematic incidents in our industry have happened in regions that are not the main focus of the bank's operations," he concludes.

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