The commodity of trust

Ouida Taaffe explains how fraud sparked a wider shake-up in commodity trade finance and looks at what the future holds for the sector

Because trade finance is short-term and collateralised, it has long been a low-risk business. Between 2008 and 2011, when many companies were suffering from the global financial crisis, the average default rate per transaction for large banks in short-term trade finance was 0.02 per cent. During the same period, the average loss rate was 0.01 per cent, according to the International Chamber of Commerce.

The loss rates stayed low even as the world economy and trade finance grew. China became a member of the World Trade Organisation in 2001, turbo-charging globalisation and the commodities super-cycle. In the five years to 2008, the real prices of energy and metals more than doubled, according to a 2012 research paper by Bilge Erten and José Antonio Ocampo: 'Super-cycles of Commodity Prices since the Mid-Nineteenth Century'. During the same period, the real price of food commodities increased by 75 per cent.

When the global economy contracted after the global financial crisis of 2008, commodity prices fell, but they soon came roaring back, at least until recently. Why then are ABN Amro, BNP Paribas, Rabobank and Société Générale all either re-evaluating or exiting commodity trade finance?

Who's trading naked?

The primary trigger for the shake-out in commodity trade finance was fraud. The collapse of the oil trader Hin Leong in Singapore in April 2020, which cost banks more than $3.5bn, is one of a number of scandals that have chilled bank enthusiasm for commodity trade finance. Hin Leong was not alone in pledging the same collateral to several banks.

Gianluca Romeo, director, primary rating analyst at Fitch, the credit rating agency, notes: "Trade finance exposure is typically concentrated in a relatively small number of counterparties so, until banks see sectoral defaults, they can have a false perception that their risk is limited."

Dominic Broom, chief executive of Fineon Exchange, a trade finance platform, says: "What fraud cases often demonstrate is that, unwittingly, some banks do not have collateral. The answer is not more regulation, but more transparency through digital traceability of goods."

Fraud is not the only problem that commodity trade finance faces and that regulation struggles to address. The oil price and the Covid-19 pandemic have also made banks take a harder look at their strategy in trade finance.

"I believe it is fair to say that in the middle of a crisis – and the pandemic combined with the oil price shock earlier this year [2020] was a double hit for the commodity industry and its lenders – stakeholders have become more cautious," says Sandra Primiero, global head of natural resource finance at Deutsche Bank. "But we see a continued willingness to finance clients in the commodity industry."

Marc Auboin, economic counsellor at the World Trade Organisation, points out on a recent podcast that, historically, trade finance is structured around a few colonial banks, so the banking network is "overgrown in terms of core clients". At the same time, Asian banks have entered the market and gained share.

> *Tightening the rules won't be effective without an international framework to check the life cycle of a trade*

The start of a broader reset?

Is this the start of a broader reset in commodity trade finance? "The difficulty is that all banks assess risk in the same fashion," says Jean-Francois Lambert, founding partner of Lambert Commodities, a trade finance consultancy. "So it all depends on their respective return on risked capital. Risk has gone up in commodity trade finance, so every bank will be compelled to reassess its strategy." He points out that banks such as ABN Amro and BNP Paribas have been active in commodity trade finance for a long time "so their exit is definitely a concern and a wake-up call".

Lambert says that what drives the uniformity of approach at trade finance banks is regulation. "Once regulators start asking questions, all banks will be compelled to review their portfolios as the risk perception has gone up," he says. "The end effect will be that many of them will tell their regulator they are going to shrink commodity trade finance at least a bit."

That raises the question of whether the attitude of regulators to commodity trade finance will change. "I would

expect a tightening of regulations," Romeo says, "but it won't be effective if it's not accompanied by an international framework that can check the entire life cycle of a trade. For example, the derivatives market has a standard framework set out by the International Swaps and Derivatives Association."

But even if regulation compels banks to re-examine their commodity trade finance business, the outcome need not be an exit. "The good news is that some banks have, in terms of absolute numbers, a very profitable commodity trade finance business," says Lambert.

> *Trade finance needs expertise and a network of banks. It sounds like a plain vanilla business, but it's not*

That may be why there are reports of new trade banks, from China and capital-rich regions such as the Middle East, and of increased opportunity for existing players. "We see some banks becoming more active, and the commodity finance market is de facto very fragmented," says Primiero. "It's too early to say whether this is an ongoing trend or partially to support local economies. But trade finance requires expertise and a network of banks. It sounds very much like a plain vanilla business, but it's not."

She points out that barriers to entry will make it difficult for new partners to enter the market, and that is before they deal with all the local and global regulatory requirements.

Supply chains reshaped in Asia

Asia is home to 60 per cent of the world's population, so it has a central role in commodities. China alone accounts for over 50 per cent of the world's demand for metals and it is the second largest user of oil globally. But China is also an important commodity exporter. For example, it is the world's largest producer of phosphates.

As a region overall, Asia has long had a relatively heavy reliance on trade finance. Research from the Bank for International Settlements says that in 2011, Asia accounted for more than half of overall trade finance exposures, but only around 35 per cent of merchandise trade.

Why is trade finance used more in Asia? The Bank for International Settlements suggests some reasons, including longer supply chains, new trading relationships and weaker contract enforcement in some Asian countries. But it points out that those factors also apply to South America,

which doesn't show the same heavy use of trade finance. Other reasons involve differences in regulation and legal frameworks. Letters of credit, for example, can be a cheap way to finance working capital in some Asian countries.

But global supply chains are undergoing a "tectonic shift", according to research from Bank of America. More than 80 per cent of the 12 global sectors it surveyed are moving at least some supply chains to other locations. That will include reshoring, moving out of China and more. This is because of factors such as tariffs, national security, ESG (environmental, social and corporate governance) concerns and a fall in the labour cost differential between emerging market countries and elsewhere because of increasing automation. And that is before Covid-19 makes people examine the potential fragility of long supply chains.

What all of that will mean for commodity trade finance in Asia is still in flux, but it seems clear that fintech will be an increasing part of the solution.

The paper trail goes cold

The pandemic lockdown has shone a harsh light on many things, including the documentation of trade finance. There have been calls for many years to change the sector's reliance on paper but little movement, mainly because change demands global coordination.

When Covid-19 suddenly made it impossible physically to deliver trade documents, digital communication was the only solution. Banks devised work-arounds, based on trust, and also found an increased zeal for digitalisation. Changes to the Bills of Exchange Act, to allow edocs in trade finance to be treated as negotiable instruments, now look feasible within two years. Given that English law underpins much of global trade, that would be a big breakthrough. Before the crisis, people talked about a much longer time frame.

The reason why the digitalisation of trade finance is both a great prize and a huge challenge is only partly to do with the current legal requirements to have paper documentation and wet signatures. The sector is also complex, with many rules. Getting it right means knowing your customer (KYC) and your customer's customer. It's about tracking and tracing and checking, and about the ability to enforce contracts globally. That means a lot of moving parts.

"The issues that have arisen in commodity trade finance highlight the need for robust KYC and business processes," says Broom. "Where institutions have fallen foul of fraud, it was because they didn't have full visibility over the underlying transactions."

He says it's possible to track collateral, "although not at all times". "There are trusted agents at all ports and specialist firms that undertake warehouse assessments. You just can't take shortcuts if you want to be sure that the promised collateral is your collateral."

Fintech in trade finance

Technology holds out the promise of bringing transparency and traceability to trade finance. Platforms such as Trusple (a contraction of "trust made simple"), which was launched in September 2020, produce a smart contract that digitally "collects" and verifies the information it needs. It is run by Ant Financial, the Chinese technology giant, on its proprietary blockchain technology, Antchain. Its bank partners include BNP Paribas, Citi, DBS, Deutsche Bank and Standard Chartered.

Trusple is one of several blockchain initiatives in trade finance. Contour, which aims to be the first global trade finance network, linking buyers, suppliers and banks across all geographies and industries, went live on 5 October, 2020. It lists 16 bank partners, among them Citi, HSBC and Standard Chartered.

But can technology conjure away the challenges of commodity trade finance? They are, after all, global – and sovereign entities are involved. The Monetary Authority of Singapore, for example, is in talks with the Hong Kong Monetary Authority on digitalising trade between the two cities. Singapore launched its own Networked Trade Platform in 2018 and is looking at changing its legal framework to allow some edocs to be treated as negotiable instruments. Many jurisdictions are likely to want their platform and rules to be central.

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Some commodities are also potential flashpoints in themselves. Demand for cobalt, for example, which is used in lithium-ion batteries, is expected to grow sharply and countries are stockpiling it because few can mine it in sufficient quantities. Around half of global reserves are in the Democratic Republic of the Congo.

The need for commodity trade banks will not go away any time soon but the question is whether banks must be in commodity trade finance to be well-positioned in trade finance more widely.

Primiero says: "There is no strict 'must' in my view. But which business in the real economy can cope without commodities? You need aluminium for wind turbines, steel for machines, energy for production and heating, etc. Consequently, as long as you finance companies, financing the trade flow of commodities from and to them should form an integral part of a bank's product offering." ■

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