Commodity finance is dead, long live commodity finance

John Basquill

Much of the commodity finance world has endured a gloomy few months. Faced with high borrowing costs and low price volatility, larger traders are preferring to use their own cash while smaller rivals remain frozen out – all against a backdrop of ever-growing sanctions pressure. But with alternative lenders waiting in the wings, and signs interest rates are stabilising, are reports of traditional commodity finance's death greatly exaggerated? *John Basquill* reports.

2022 was a remarkable year for commodity traders and their lenders. Propelled by price volatility and shifting supply chains in the wake of Russia's invasion of Ukraine, Trafigura, Mercuria, Glencore and Vitol each posted record profits.

Research by Sanford C Bernstein found that 11 of the largest traders, also

including BP, Shell and Total, doubled yearly profits to as much as US$77bn.

2023 was a different story, and as this issue goes to press, the mood in the industry for the coming year has taken a turn towards pessimism.

“After spectacular growth [in 2022], business has been much more subdued,” said a senior commodity finance banker, speaking under the Chatham House Rule at a late-2023 **GTR** event.

“We’re still growing, and we’re still adding customers, but we are looking at reduction overall in terms of utilisation and limits. There is also a nervousness around the credit side, and I think that’s reflected in most banks.”

One issue is that banks have continued to focus their attention on the larger end of the market.

This trend, sparked by a series of high-profile trade finance fraud scandals in 2020, has resulted in small and medium-sized traders struggling to obtain finance. Their larger counterparts, meanwhile, have continued to seal bumper deals, including heavily oversubscribed syndicated loans and working capital facilities.

One representative from a medium-sized commodity trader, speaking at the same event, said those scandals meant it “lost quite a number of banks, or they decided to reduce our trade lines”.

“Over the last few years we have been focused on gaining back the trust and confidence of the banks,” they said.

Another trader said lenders have largely “abandoned SMEs” and sought business from the “immensely successful” trading giants.

The difference now is that those larger traders are no longer looking to borrow on the same scale.

“There are a couple of reasons for that,” the commodity finance banker

said. "There seems to be a lot of liquidity within the trading companies themselves – they are quite cash-rich at the moment – which means that demand for financing from the banks has dropped.

"For a bank, we are restricted in what we can do by what the clients want. If the clients need us, then we're there – but I can't force a client to borrow money."

Interest rates

One of the main reasons for declining demand was the rapid hike in interest rates across the western world during 2023, as central banks sought to put a brake on inflation.

"There are a lot of people who have been used to very low interest rates for a long time," the bank representative said.

"With the cost of borrowing becoming so high now, it might work out a little cheaper for traders to use their own money rather than go to the banks.

At some point they will need the money, but because the cost is too high at the moment they're looking to hold back until they see some easing in the rates."

One of the traders noted at the event that companies with solid equity – including theirs – can utilise working capital "as a substitute for bank financing… and the result is that the bank services are fading away".

"Plenty of financial institutions are approaching us offering all sorts of services – bilateral, syndication, securitisation and so on – and the reality is that we don't really need it," they said.

Jean-François Lambert, a trade finance veteran and founder of bespoke advisory firm Lambert Commodities, says the sector is "starting to see the real effects of the interest rates rise".

Noting it can often take as much as two years to see the full impact of

dramatic monetary policy shifts, he suggests that it is possible slowing demand could soon start to push down commodity prices.

At that point, central banks might decide the time is right to lower rates again.

"If interest rates drop, we have a very different environment in the making," he tells **GTR**. "We'd have an environment where people see we have reached the top of the price money, where investors that have missed the boat at 5% will say 'too bad', and suddenly there will be much more hope."

Lambert adds that if demand does increase, supply is likely to remain constricted across several key commodities, resulting in prices that are more attractive to the trading community.

For instance, in energy, geopolitical tension could mean the supply of oil is kept low. Elsewhere, importers remain dependent on a small number of key markets for critical minerals, while agricultural production continues to be threatened by climate change.

"If that's the case, we should not bury our heads in the sand. Constraint of supply, demand doing okay; I think that might not be such a bad year after all," Lambert says.

Alternative lenders

One by-product of the higher interest rate environment has been a shift in demand for financing from non-traditional sources.

Non-bank trade finance lenders have historically been more willing to lend to SME commodity traders, but have charged higher rates for doing so. Now, with banks also looking to lend at a higher cost, the gap appears to be narrowing.

"For the last 15 years we've seen effectively the cheapest supply of money ever," said Waldo de Vleeschauwer, chief executive of non-bank

financial institution (NBFI) Artis Finance, speaking at **GTR's** annual commodities conference in Geneva.

"There was a real disparity between the dollar liquidity commodity traders could get from the banks, versus what they could get from the NBFI space."

"What we are seeing from our side is a lot better quality commodity trading businesses coming to the NBFI world and accepting a higher cost of finance, because it's now relatively on par with the banks on pricing. From my perspective, that's a positive event because it drives a bit more competitive tension between NBFIs and banks."

Peter Ryan, managing director, business development at US-based private lender Goba Capital, agrees there has been a market-wide drop in demand and utilisation for financing – but the agility and flexibility offered by alternative providers means they are uniquely placed to fill the gap.

"If everyone and their grandmother could borrow close to 2% or 3%, and I was knocking on doors suggesting double digits, you would often get that door slammed in your face," he tells **GTR**. "Now the gap has narrowed.

"We're seeing some Asia-based traders, for example – more established players with larger balance sheets – coming into this alternative space for funding diversity. We're definitely seeing more demand from those mid-tier sort of traders."

In some cases, large traders are looking to move into new commodities, such as expanding from energy into agri goods.

"Their banks have to view this as a new business, and say they can't support them until they've established a track record," says Ryan. "So they've got no other option. They either decline the business or go to alternative markets to source that working capital."

Another **GTR** event speaker, who specialises in providing commodity shipping services, suggests other actors might enter this market too.

“Maybe we’ll see… services providers like shipping lines being able to provide financing to their clients,” they said.

“I think that’s a very interesting opportunity. Some of the big shipping lines have something in the works or are seeing what they can do.”

Trade flows shift as sanctions bite

Lurking in the background is another pressure on commodities trade: the Russian sanctions regime. After governments across Europe and North America imposed major restrictions on facilitating trade in Russian oil, petroleum, steel and other key commodities, details are starting to emerge of just how profound the shift in commodity trade flows has been since sanctions were introduced.

According to an analysis of Russian customs data carried out by Swiss organisation Public Eye, there has been a wholesale relocation of oil trading activity from Geneva to Dubai, and to a lesser extent, Hong Kong.

Before the war, between 50% and 60% of Russian crude would typically be traded through Switzerland. By July 2023, that figure had dropped to just 5%, most of which is handled by Litasco SA – a trading house owned by Russian energy giant Lukoil.

As in the EU and G7, Swiss companies are allowed to facilitate trade in Russian oil, as long as it is not imported directly and is priced below US$60 per barrel. However, concerns over reputational damage and exposure to price cap fraud have prompted most western traders to move towards a total exit from Russian oil. By contrast, the share of Russian oil purchased by traders registered in the UAE and Hong Kong has risen from 3% in April 2022 to 81% in July 2023.

“Dozens of companies which operated from Geneva before the war in Ukraine have beefed up their presence or set up new entities in Dubai,” Public Eye says. “For the time being, the major Swiss traders hardly feature among the buyers of Russian oil. Their position has been taken over by small, little-known entities, some of which are close to the

Kremlin."

This trend has caused some concerns within the industry, with Public Eye warning in March 2023 that it believed some traders had maintained "a strong presence in Geneva to conserve their credit lines", despite the introduction of sanctions.

Global Witness said the same month it believed Swiss-linked Dubai traders were involved in sales of Russian crude oil "well above" the price cap.

Enforcement on the horizon

Against this backdrop, Geneva-based lawyer Patrick Eberhardt, a partner at Eversheds Sutherland's international trade and trade finance practice, believes regulators' attention could soon turn towards enforcement.

"The banks and traders that have come to me want to be compliant, of course, but there are market participants trying to take advantage of the situation," he said, speaking on a sanctions panel hosted by **GTR** in late 2023.

"Companies and subsidiaries that have been set up in Dubai to continue trading outside the sanctions requirements… are the ones that are now starting to feel the heat."

Eberhardt suggested banks could find themselves under the greatest pressure, noting that the Swiss Financial Market Supervisory Authority has already sent questionnaires to lenders to gather information on how they have implemented sanctions so far. And in Switzerland's case, penalties for potential breaches are not for the faint-hearted.

"Something many clients don't realise is that breaching sanctions in Switzerland is a criminal offence, it's directed against individuals, and it can result in a prison sentence," he said.

"On top of that, there is a provision that gives the right to prosecute not

only the person who breached the sanctions, but the entire vertical hierarchy that didn't put in place appropriate safeguards to prevent it."

Complicating matters was a rise in oil prices during the second half of 2023. Urals crude averaged well below US$60 per barrel until July, but rose to highs of more than US$80 in September and October.

As a result, there has been a greater incentive for rogue traders to attempt to circumvent the price cap mechanism.

"At the start, the oil price was below the cap, so those circumvention tactics were not deployed at the scale that they are now," said Charles Ike, vice-president at maritime intelligence provider Pole Star, speaking at the same event.

"A knock-on effect of that is we're seeing more vessels included in what is commonly referred to as the 'dark fleet' of vessels, used to circumvent the sanctions."

Authorities in the US have issued warnings to the market that those looking to evade the cap might provide fraudulent documentation, for instance by inflating shipping and other costs to mask the fact oil is priced above US$60.

Another legal expert, speaking at a **GTR** event, says expectations will be high that banks and traders have sufficiently scrutinised the information provided to them.

"The test will be in terms of documentation, and ensuring the attestations that are being provided are real. You need to have a reasonable belief in the legitimacy of the documents you're receiving," they say.

"I believe we could potentially see some quite high-profile enforcement actions. We've certainly seen with the Iran sanctions regime that the US in particular has taken very strong action when there have been breaches."