Markets

Europe's Banks Fall Out of Love With Commodity Traders

By Jack Farchy, Isis Almeida, Andy Hoffman, and Ruben Munsterman
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- Banks are scaling back their commodity trade finance business
- Trading houses face higher costs in hunt for new funding

Marc Rich *Photographer: Joe Schildorn/Patrick McMullan via Getty Images*

In this article

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When Marc Rich needed $100 million to buy Iranian oil and kickstart what would become the world's largest commodity trader, he went to French bank Paribas. When a group of traders needed cash to take over Vitol and turn it into the largest oil trader, they turned to Dutch bank ABN.

For the past half century, a small group of European banks has financed the trade in natural resources, forging a symbiotic relationship with the commodity traders that put them at the heart of an enormous expansion in global

CL1
WTI Crude
43.13 USD/bbl.
▲ +0.52 +1.22%

BNP
BNP PARIBAS
36.09 EUR
▼ -0.48 -1.31%

0326910D
HIN LEONG TRADING PTE LTD
Private Company

NOBL
NOBLE GROUP LTD
SGD ▼ +null +null%

INGA
ING GROEP NV
6.81 EUR
▲ +0.00 +0.04%

commerce.

Now that trend is in reverse. ABN Amro Bank NV announced it would quit commodity trade finance. BNP Paribas SA is reviewing its involvement and may shut down its specialized unit, Bloomberg reported earlier this month. Rabobank Group is also reviewing the business. They are not alone: after a string of collapses and scandals that have handed the banks billions of dollars in losses, almost every leading lender is looking again at its presence in the sector.

For the commodity traders, accustomed to paying for cargoes of oil, metals or agriculture worth tens of billions of dollars using dirt-cheap bank lines, the European banks' shift may be a moment of reckoning, raising costs, forcing them to look for new forms of finance, or squeezing out smaller companies from the industry altogether.

"Commodity finance as we know it today will not be around in a meaningful way five to 10 years from now," says Walter Vollebregt, former head of metals and minerals trade finance for Rabobank, who is now an industry consultant. "Trading companies are hardly ready for what is to come."

A dozen commodity trading executives told Bloomberg News they expected the pullback by European banks to raise their financing costs. While some larger trading companies believe they will benefit from a shakeout of the industry, others fear a rush for the exit by the banks could hurt everyone.

Colonial Roots

European banks' involvement in the commodity trade has its roots in the continent's colonial history. One of ABN Amro's predecessor companies was the Netherlands Trading Society, founded in 1824 to trade coffee, sugar and tea in Asia. Many French banks got involved in the trade via France's former colonies in Africa.

The modern business of commodity trade finance took off when Paribas started financing pioneers of the oil trade like Marc Rich from its Geneva office in the 1970s. By using the cargoes of the commodities being financed as security, traders were able to get financing at a cost only marginally

more expensive than the banks' own funds.

But while that may have been viable when all was going well, a series of blow-ups has rocked the industry. Most notably, fuel oil trader Hin Leong Trading (Pte) Ltd. collapsed in April amid allegations of fraud, leaving 23 banks on the hook for $3.5 billion.

"It does not help that the low interest rate environment forced them to provide the service for less fees and they all tried to increase volume to make up for the lower income. To increase volume you have to unfortunately start dealing with lower quality counterparts," says Ernesto Leon-Gambetta, a former head of soft commodities at Noble Group, who traded coffee for more than 30 years and is now retired.

Coalition Development Ltd., a consultancy, estimates that the banking industry's revenues from commodity trade finance dropped 29% in the first half of this year. "In the past five or six years, with the provisions, the bottom line for the large European commodity banks is zero or negative," said Vollebregt.

Herd Effect

The recent losses are not the only problem. Ever tighter bank regulations -- including Basel 4 -- make the commodity trade finance business less attractive, according to Jean-Francois Lambert, a consultant and former trade finance banker. "Every bank has to reassess its portfolio," he said. "The herd effect is going to be significant."

Source: Barcroft Media via Getty Images

Netherlands-based ING Groep NV is one of the sector leaders, with just over 20 billion euros of exposure at the end of June. It remains committed to commodity trade finance, but is being more cautious about its lending to the sector.

“Over the course of the years, you see that the structures have been weakening to some extent,” Chief Executive Officer Steven van Rijswijk told investors. “We are reintroducing the strict structures.”

Among the French banks, Societe Generale SA is also tightening risk controls and has taken a step back from Asia with the closure of its Singapore office. Natixis SA, too, has reduced its exposure to energy and natural resources trade finance, Chief Financial Officer Nathalie Bricker said.

“Banks are being much more selective clearly, as probably they always should have been,” Steve Kalmin, Glencore Plc’s chief financial officer, said this month. “There is a contraction, there is I would say a flight to quality.”

Traders Squeezed

The cutbacks are already squeezing some smaller and medium-sized commodity traders. One commodity trade finance executive said his clients’ use of his credit lines, which is typically around 35%, had almost doubled since June.

“This is going to affect by and large all the tier 2 and tier 3 players,” says Lambert. “They are going to face a situation where unless they have the perfect balance sheet, the perfect systems, the perfect governance, then they are going to find it increasingly difficult to borrow.”

Soft commodity firms are particularly worried about the exit of French banks, many of which finance smaller exporters in top cocoa producer Ivory Coast.

Executives at several medium-sized trading houses said they were looking to expand their pool of lenders, while others

are paying extra fees to secure committed lines from their banks. Some are even considering if they could survive without bank financing altogether.

While some Swiss banks are still interested in expanding their presence in the sector, few others are looking to fill the gap left by those departing. That suggests that traders will have to tap more expensive non-bank financing, or simply trade less.

Even among the giants of the industry, there's a recognition that costs will rise. Companies including Trafigura and Mercuria, two of the world's five largest oil traders, have offered "Covid-19 premiums" to lenders in recent deals, effectively increasing the interest rate they pay.

Limit on Growth

Most executives at larger trading houses are currently relaxed about the situation, arguing that their ability to access broader debt and equity markets should give them a competitive advantage over smaller players. Nonetheless, after five years in which oil trading volumes at the top three traders have risen 70%, any further growth looks unrealistic. The coronavirus-induced demand slump is part of the reason; but so is the retrenchment by the banks.

Ultimately, unless many other banks follow the path of ABN Amro, the impact on the flow of commodities around the world may be minimal. But consumers and producers will pay through slightly less efficient markets.

"If tomorrow there is no more bank to do trade finance, you can issue bonds, you can increase the equity. You have other ways to get finance," said Jean-Pierre Adamian, chief executive of metals trader Transamine, adding that his company currently has plenty of bank financing available. "They are maybe a little more expensive, but it's the same for everyone. At the end the producers will pay."

But the traders' sangfroid may quickly disappear if oil prices rise significantly. Low prices mean each cargo is worth less, and that's eased the funding requirements just as banks have been pulling back. If prices increase, so will traders' need for finance.

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"If suddenly the oil price jumps from $45 to $80, then for sure we will have a problem for everybody," Lambert said.

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