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Q&A with J-F Lambert

J-F Lambert spent most of his career in international banking and trade finance, originally with Crédit Commercial de France, or CCF, and then with HSBC. He is now a consultant on trade and commodity finance and strategy for banks, companies and funds. He also teaches commodity market dynamics at Sciences Po in Paris and regularly lectures at the London Business School.

What has been the impact of the virus, lockdown and oil price war on financing for commodity traders?

As for any corporate or individuals, the challenges caused by the virus and the measures taken to ringfence its dire consequences are massive. With about half the world population in lockdown and most developed economy in a standstill, the shock is enormous.

What makes it even more challenging is that both supply and demand are affected, and that like in a low speed tsunami, the wave eventually reaches every shore.

In such a context, commodity trading faces three kinds of difficulty: a choc of demand, disruption on supply and, if the crisis lingers, increased counterparty risk. Whilst the volatility is high, these uncertainties prevent trading houses from taking full advantage of it.

In rough seas one needs a sturdy vessel. In terms of commodity trading, this means that only large trading houses can cope with the underlying risks: trading risks, liquidity risks in the face of margin calls or payment delays, and counterparty risks. Smaller players should err on caution: if they find themselves on the wrong side of the market, they may lack the financial muscle to absorb the shocks.

Are banks tightening their lending to traders?

Banks are tightening their exposures on every front. With regard to commodity trading, their reaction is to fly for quality, and be quite restrictive on everything else. This means that the ABCD+s will not be significantly challenged as they are able to communicate on their strategy, positions, liquidity and results with their mains banks almost daily if necessary.

Smaller players, unlike larger traders, often have slim liquidity and are often much less equipped to monitor their books and communicate effectively with the lenders. When this is the case, and in the current context, their banks will not be accommodative. In case of doubts or difficulty in assessing the market positions of their smaller customers, banks will not hesitate to reduce their lines.

Why would banks reduce lending to traders now if the traders are not directly exposed to lower prices? Don't lower prices make things easier for traders as they need less capital?

Unlike producers and end users, traders are not in principle exposed to the flat price.

So, in theory you are right. However, in real life things are somehow different. To ring fence the flat price risks, traders rely on hedges, whether on a book or deal basis. In the these volatile markets your hedging strategy is only as good as your ability to pay for margin calls. If you are not able to meet your margin calls, then your hedge vanishes and you are left exposed, potentially facing huge losses. Besides, if the logistical disruption on the supply side and potential counterparty defaults are significant, they could trigger losses both on the hedge and the trade.

For all these reasons banks will stick to robust traders (the large trading houses) and will certainly revisit their exposure to whichever company they might deem to be overstretched.

Have the risks of counterparty defaults increased and, if so, how?

The risk of counterpart default is rising as the crisis lingers. The world economy is in standstill. Oil demand has fallen 30 percent when it has been rising consistently for the past 30 years or so. China's ability to rebound is a moot point. Europe and America face the biggest economic crisis since WW2. In this context, defaults are bound to happen. Hence the nervousness of banks. Hence the reluctance of insurers to underwrite new businesses.

Are some commodities more impacted than others?

All commodities are affected, whether on the supply side, demand side or both!

Banks have long recognized that commodity trading is a critical activity. Rather than taking a global decision to pull out of one sector or another, banks are taking a close look at their customers and will direct their support to the fittest and most resilient ones. With others the time is not ripe to stage pull-outs, but to endeavour to ring fence their exposure by capping, reducing their limits or strengthening security packages. Strategic decisions will come later.

Finally, is finance the Achilles Heel of the commodity trade – the most vulnerable point of the system?

So far money has not been the issue. Huge and sudden imbalances between demand and supply, potential logistical disruptions and rising counterparty risks are at the root of the current difficulties for commodity players.

Having said that, the commodity trade relies on other people's money, in other words: bank money. Unless your bankers are comfortable, you can't trade. So, my humble advice to commodity traders is to be as transparent and forthcoming as possible with your financiers, whether in calm as well as (and even more so) in rough seas.

As a former banker I cannot emphasize this enough: doubt, misunderstanding and suspicion about a borrower's business will inevitably lead to the severance of the relation. All the more when we are witnessing the biggest recession since 1929.

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