Le dernier mot

Jean-François Lambert asks whether commodity trading is really understood at its heart, and applauds improved transparency from major trading houses

Do we really understand commodity trading? Seasoned bankers will answer in the affirmative. However, in the midst of a commodity rout, markets, analysts and regulators have challenged the sustainability of major commodity houses.

Tough questions have been asked in banks by credit departments and by senior management under pressure by board members in light of press coverage of Glencore and Noble's tumbling share prices.

Misunderstandings

Invariably, the lines of questioning have been pretty similar across all institutions.

- Can commodity traders sustain profitability, even as commodity prices fall?
- What if they are on the wrong side of the market?
- Do we really know what they are doing with our money?
- Are they trading physicals or merely playing with paper?
- Can they sustain such high leverage?
- Finally, they are asking the question: what if other banks pull out?

Bad timing

It's tough times for traders, not to mention their banks:

- In 2014–2015 commodity rout, commodity prices lost on average 34% of their value at their peak in 2014.
- The risk perception has definitely increased with producers shelving investments and axing people in many parts of the world – and China is on a harder landing course.
- There is pressure on banks for ever more capital requirements, leading them to constantly re-evaluate the risk return profile of their books.

Facts beyond perception

If we take a step back and reflect on the *raison d'être* of a trading house, we might take some solace. As Greg Page, the former CEO of Cargill, put it in 2013: trade is all about managing supply chains, sourcing key commodities where they are produced, and bringing them in a timely fashion to where they are consumed.

If trade is divorced from the management of supply chains, then its purpose is lost. Trading is a physical business, and the key talent of commodity houses is to manage what they call 'optionalities'. This is the timing of a transaction, the choice of origin versus destination, as well as quality, transportation cost and duration, hedging, financial cost, and counterparty risk. Their key concern is to ensure supply is provided whilst mitigating the risk profile of the supply chain.

Sophisticated models are developed by large trading houses to continually monitor their value at risk (VAR), keeping it generally rather low, and always within their committed cash availability. So, in practice, what does this mean?

Commodity houses can make very good money when commodity prices are low. These profits hinge on how far the forward curves allow them to protect future deliveries, which remain the sole finality of a commodity trader. Financial instruments are absolutely key to building and optimising a buy/sell book.

One can imagine the value of trading, if all was effected on a strict back to back basis. Unlike hedge funds, trades translate eventually into physical delivery. Their financial requirements are mostly short term and a mix of working capital and committed lines to ensure financial instrument capabilities, but also mainly self-liquidating in the nature of trade finance.

Encouraging leads

In a very welcome initiative, the commodity finance industry put together a comprehensive paper on the capital treatment of commodity finance, which will be sent to the Basel Committee.

Whatever their response might be, we should be proud that, for the first time, common ground amid a fragmented industry so far has been built, and that it has provided the regulators with an articulated rationale for some much deserved improvement in capital treatment.

Also encouraging is the attitude of the major trading houses, which have adopted a very transparent stance, both publicly and bilaterally with their bankers.

However, much more needs to be done and bankers, analysts and ratings agencies also have a duty to get a deeper understanding of the commodity trading dynamics. The major trading houses are ready to support this journey, as it should prove to be a win-win exercise eventually. Sharper questions will lead to a better risk understanding, in which commodity trading will gain more gravitas.

Jean-François Lambert is a consultant on commodity finance. He is the former global head of commodity and structured trade finance at HSBC and can be contacted at jflccf@yahoo.com

P95_TFR_Vol19_Iss04_SinglePage.indd 97 2/22/2016 10:18:23 AM