Le dernier mot

Trading houses may be more vulnerable to flat price risks as they evolve, and auditors and banks need to be on their guard to evaluate risks, particularly at the medium-sized houses, says Jean-François Lambert

I recently moderated a discussion at a European conference on the thorny question of whether commodity traders are too big to fail. The discussion gathered a surprisingly large audience. This was quite telling. Worries about the potential failure of large trading houses were not simply a regulator's nightmare. It soon became clear that that the audience's concern was not the systemic dimension, but the sheer vulnerability of commodity traders.

Traders' failures and collapses are not just stories from the past. Everybody remembers names like Metallgesellschaft – the German company whose aggressive hedging strategy did not weather a violent market swing in the early 1990s. André & Cie – the trading position nobody was controlling at the Lausanne headquarters of the 120-year-old company in 2000. Then, of course, there was Enron – the loss-making speculative positions dressed as attractive accounting profits in Houston in 2001.

Interestingly, these three bankruptcies had common features: adverse market movements, aggressive trading, poor accounting standards and little or inadequate risk management processes. Put simply, the governance of the three companies was not rigorous enough to cope with trading in rough seas, while the control mechanisms exerted by the key external stakeholders were, at best, inappropriate.

As markets struggle to get back on their feet after the commodity rout of 2015, it is not surprising that practitioners are nervous. There have been violent swings from iron ore to crude oil and from sugar to cocoa. But, until the end of 2016, when most markets were already regaining some colour, there had not been any major bankruptcy. Since then, the collapse of a US cocoa trader and a stark profit warning in coal trading for a listed company in Asia have shaken that confidence.

The perception was that trading had become more resilient. Hefty profits during the supercycle had helped commodity merchants garner stronger capital buffers. Risk management and governance in large trading houses had also considerably improved. Position monitoring, valuation processes and systems have in many instances become similar to the ones banks developed to supervise their trading desks activities successfully.

Besides, there is a widespread belief that traders are not affected by flat price risks. Traders, by nature, play on volatility and because they are nimble and mere intermediaries, they are just exposed to basis risk, trading spreads and hedging flat price risk. This may be true in principle but there are nuances. The good old principle of Philipp Brothers "do business, don't invest" as quoted by the late Claude Dauphin, founder of Trafigura, is over. Traders (and not only the large ones) have been acquiring assets to boost the value they endeavour to add along their supply chains. Many have become industrial companies, to various degrees, acquiring production and processing capabilities. In doing so they have increased their exposures to flat-price risk. Bunge or Dreyfus are vulnerable to the sugar price because of their production capabilities in Brazil. Glencore is affected by copper or coal which they mine (and much less so to crude oil which they simply trade).

Risk management is also a case in point: while the major trading houses have all developed tight processes to monitor their market risks (from individual daily stop losses, to real-time portfolio valuation, value-at-risk modelling and other quantitative models), this is far from being the case for the medium-sized traders. The Transmar bankruptcy at the end of 2016 in the US showed how primitive the risk management processes were within this group.

Are key stakeholders, such as auditors and commodity bankers well enough trained to understand, effectively assess and if needed, challenge such processes? Probably not. Misevaluation of long-term contracts or large losses allegedly caused by market distortions show that audit standards and lenders' vigilance is too low. Particularly in times of high fluctuation of market prices.

Such is the real systemic risk of a sector which has become ever more sophisticated and complex. There is a lack of understanding of market techniques and of the interaction between financial and physical markets by auditors and banks. Why does this matter? The auditors' responsibility is enormous. By certifying accounts, auditors pledge to provide a fair picture of the company's activities. If they cannot value the books at their correct price for lack of understanding or market data, they are exposed to a massive reputational risk. Banks rely on the accuracy of such information. But, and beyond credit risk assessment, they should also form an independent view of the risk management governance, systems and processes of their customers. This is not going too far, it is critical. After all, understanding one's customer's businesses and asking the right questions is the best way to get the right answers. This is Banking 101 to build long term and safe partnerships.

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