Le dernier mot

Jean-François Lambert asks why capital requirements have not receded in line with falling risks associated with trading commodities

We all have heard the expression 'mark to market', which depicts how a position (or an exposure) should be constantly revisited to ensure that its reflection in the books of a company (or a bank for that matter), is as accurate as possible. What we have not heard about is the expression, 'to mark to risk'.

Yet, in the banking industry, this is how capital requirements are assessed. Capital is marked to risk in the sense that, when a counterparty's credit risk deteriorates, a given exposure on that counterparty will require more capital. The logic is sound – more risk on the books means more capital needed. Since capital is a rather finite commodity, the consequence of a risk deterioration results in the combination of reduced exposures and higher pricing, thus ensuring an appropriate usage of a limited resource.

Conversely, when risk improves, less capital is required and banks are therefore encouraged to finance more business. However, due to borrowers' tendency to be more liquid, competition gets fiercer and since all banks are governed by the same dynamics, this often means reduced margin for lower utilisation.

All the Basel architecture hinges on this logic. But, how does this work in the real world? We have a perfect case study in the commodity finance business. After all, risks improved considerably from the 1990s to 2005, as the super cycle roared. The 2008 financial crisis suddenly stopped this, albeit briefly, but it is only through the 2015 rout that concerns spread on commodity supply chains risks, particularly in the energy and metals sector (the Qingdao fraud did not help in assuaging the general concerns).

Regulators reassessed every large bank commodity portfolio, leading several of them to revisit their caps across commodities. Risk deterioration was not true across supply chains though. It is fair to say that the rout put many producers in a difficult position and jeopardised several aggressive oil reserve base lending structures and mildly competitive mining project financing.

Traders, on the other hand, who are traditionally less exposed to flat price risks, came through that period rather unscathed. They were nevertheless also affected by the worries. However, despite banks withdrawing, they did not suffer from a major liquidity crunch as cheaper commodities required fewer bank lines; a natural adjustment.

Since then prices have rebounded. Producers are in much better shape and trading shows its resilience every day. Risks have receded too. In this environment you would also expect capital requirements to recede, but they have not. And this is the crux of the issue. Reactions are swift when risk is perceived to have deteriorated. When risk is suspected to have improved, banks need evidence, notably through financial statements, which are only available several months after the fact, which banks need further time to investigate. Besides, a specific counterparty's risk may well have improved, but what about the general environment? Again, today's world is a case in point.

At last month's Financial Times commodity global summit in Lausanne, only a handful of participants did not dwell on general concerns about the rise of geopolitical risks, from protectionism to tensions between countries, unheard of since the first part of the last century. Their perception of risks was not positive. And yet, when looking at the economic indicators, everybody agreed we are in a better place than we were three years ago. World growth is accelerating, emerging markets are recovering in the wake of China and India, and while trade stats are bad, the WTO (see page 13) has said they should improve this year under the combination of a better economic environment and stronger commodity prices.

Objectively, the world is getting better. Subjectively, it is getting much worse. When it comes to capital allocation, which of the two will win? Facts, or perception? Perception will probably win, and is why the Basel guidelines, however theoretically perfect, will fail year after year in real life to deliver sound business growth – capital requirements will not improve anytime soon.

At best, they could stabilise as governments get more vocal, frustrated by their limited ability to influence their own economies. The concern expressed in the US is particularly good news, and hopefully will be relayed elsewhere.

In the meantime, trade and commodity supply chains will have to make do with limited bank capabilities, and banks themselves will need to innovate to reduce their costs and keep their return on capital afloat while supporting trade. This will work as long as commodity prices do not rise again, pulled by a new commodity super cycle. Such is the paradox of present times, where too much good news would be a concern for the banking industry. Summer is nice but beware after autumn, because winter is coming. The cause of unintended consequences or simply the wrong focus?

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