Le dernier mot

Commodity trading houses, because of their upstream position in the value chain, control a significant share of commodity flows and these are financed by a very small number of banks. Does this represent a systemic risk, asks Jean François Lambert

A few years ago, in the midst of the supercycle,[1] I gathered ten representatives of the largest trading houses in Geneva and combined their respective turnovers. These ten companies were contributing some 7% of overall worldwide trade flows of merchandises as calculated by the WTO.

Considering that commodities, in their broad definition, in other words, the one used by trading houses and bankers which includes both primary (iron ore, crude oil) and secondary commodities (steel and gasoline), represent some 25% of the worldwide merchandised trade flows, this meant that these trading houses were actually commanding 28% of the whole commodity flows. This is a huge share. However, the strategic importance of the trading houses is not limited to managing commodity flows – how much of the remaining 75% of goods trade flows could even exist without the 25% upstream?

Strategic or not?

Consider now how many banks actually have a leading role and genuine expertise in supporting these firms? Twenty, maybe 30? And this generously includes some large banks but de facto passive participants behind around ten so-called commodity finance banks. Consider now how many banks support the remaining 75% of trade flows? Probably 10,000 at least, as very few commercial banks ever open a letter of credit, and most issue a letter of guarantee. But only around three or four of actually put this activity at the centre of their strategy.

One of the most strategic activities on this earth is handled by a handful of companies, themselves supported by even fewer banks. There is a massive problem in the making here. The dependence of trading houses on short-term bank financing is of equal proportion to the one of banks depending on their customer deposits to support the economy, by ways of infusing liquidity in the system. Put bluntly, trading houses, like banks, rely on other people's money to add value to the real economy.

Unbeknownst

At the very least, this strategic linkage should be acknowledged by the banking community. One might imagine that such activity would have been prioritised, or that banks would have engaged with regulators to draw their attention on what commodity trading entails, and would have promoted dedicated capital efficient models.

None of the above has occurred. Financing trading houses is a rather marginal business for large banks, and one which is seldom understood beyond the front lines, rarely with risk functions and certainly not grasped at all amid the compliance flocks.

This leaves the trading houses dancing under a volcano. There's no smoke coming out yet, but there are definite signs of activity underneath. Can they curtail their over-reliance on the banking industry as the main source of liquidity? Could commercial banks survive without personal banking revenues? No. Nor will trading houses find a large alternative pool of funding outside the banking sector anytime soon. Alternative finance solutions are scratching the surface but cannot address the bulk of the liquidity requirements of large trading houses.

Banks have been struggling to redefine their strategies amid regulatory pressure and desperately flat interest rates, and are constantly reassessing the return of their various businesses versus ever growing capital requirements. Who can today be sure of a bank's strategy tomorrow? Certainly not bankers themselves.

Wake-up call

What can be done? A good start would be acknowledging the issue. A first attempt was made earlier this year by the Association for Financial Markets in Europe. This good effort now needs to be completed.

Just as the ICC Trade Registry has captured trade finance flows[2], a specific tool needs to be built which would track commodity trade flows, defaults and performance. Second, the trading houses themselves should take their fate in their hands. Trafigura released a very good guide earlier this month[3], but where is the contribution of other large trading houses?

This is no longer the time for isolated initiatives. Third, the dependency of trading houses on the banking system is no longer viable – convincing investors to support the most strategic trade flows is critical. The current interest rate environment should press them to explore new avenues to optimise their cash position. In the meantime, trading houses and their bankers will keep dancing in the fond hope that the volcano does not erupt.

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References

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