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Prospects for transparency-themed governance reform
The impact of banking sector reforms on the commodity trading sector

by

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The views expressed are those of the author and do not necessarily reflect the views of UNCTAD.
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The impact of banking sector reforms on the commodity trading sector

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The financialization of commodity markets

- Prior to 2000 investment banks were not active in financial commodities trading with the exception of Goldman Sachs, Salomon Brothers, and Morgan Stanley
- Large scale bank entry was facilitated from 1999 onwards with the abolition of the 1933 Glass-Steagall Act
- Large investment inflows came in 2 waves between 2005-2008 and then again post financial crisis in 2009-2010
- Trading in commodity derivatives overtook physical production by a factor of 20 to 30x
- The daily monetary value of financially traded gold contracts to this day still exceeds the amount physically mined annually
- The financial sector controlled 70% of the open interest in some commodity futures i.e CBOT wheat between 2006 and 2010
Implications

- Price swings in commodity markets became increasingly correlated to financial markets. Financial investors increased / reduced exposure to commodities due to price rises / drops in tandem with what were previously unrelated equity and fixed income markets.
- The rise in banking activity increased liquidity for hedgers but obfuscated market dynamics for market end users.
- Goods producers no longer were able to differentiate whether futures prices moved due to financial investors trading or economic fundamentals.
- Public perception began to grow against banks that their activity in commodity markets was somehow responsible for increases in food and energy prices, leading to shortages around the globe culminating in social unrest in particular the middle east and the Arab spring.
Equities, Copper, Crude Oil 2004
Pre investment flows uncorrelated
Equities, Copper, Crude Oil 2008 - 2009
During financial crisis correlated
Equities, Copper, Crude Oil 2010
Second wave of investor flows correlated
Equities, Copper, Crude Oil 2013
Investor flows abated uncorrelated
Regulatory response following the financial crisis

- Increase transparency and increase reporting requirements for all asset classes
- Move OTC trades onto exchanges and clearing houses to increase market transparency
- Tighten supervision and global coordination to avoid regulatory arbitrage between jurisdictions and trading venues
- Increase capital buffers and margin requirements for participants
  - Basel III (Global) - Banks
  - Dodd Frank (US) - Swaps dealers
  - MiFID II & Emir (EU) - Systemic financial institutions
Basel III. Global regulatory standard on bank capital adequacy

- A defining element of the financial crisis was a chronic lack of liquidity due to mistrust amongst investors and counterparties. After the crisis, regulators deemed that assets held by banks should be of "higher quality and more liquid" in case of emergency disposals and that bank wholesale funding should be of a longer dated nature to minimize the risk of having to renew it in times of crisis. To be implemented in stages until 2019

  - Maximum leverage ratio 3% Tier I
  - Minimum capital requirement 4.5% RWA
  - Minimum liquidity ratio (30 day and 1yr)
  - Capital conservation buffer 2.5% RWA
  - Minimum Total Capital 8% RWA
  - Additional 2.5% discretionary charge possible

- Increases level of regulatory capital banks must hold against loans
- Credit valuation adjustment for counterparty risk. Penalizes longer dated transactions and trades that involve credit risk to smaller entities and emerging market countries
- Reduces availability of letters of credits and syndicated loans for higher risk counterparties
Dodd-Frank

- Increases compliance and capital requirements
- Position limits including aggregation across international affiliates to prevent regulatory arbitrage
- Commodities business becoming more capital intensive
- Includes the much maligned Volcker rule. Ban on proprietary trading for banking entities. Limits ability to trade for own account up to 3% of Tier 1 Capital. Limits bank’s ownership/control of physical trading assets and storage. Impacts banks and financial institutions, not trading houses
- Banks to spin off commodity trading units and sell physical assets. Will result in fewer market makers and less hedging options for end users in the near term
- Creates new opportunities for trading companies
MiFID II Markets in Financial Instruments Directive

- Implementation 2016 / 2017
- Final rules for commodities to be published April 17th 2014.
- Will require central trade execution and price reporting
- Will tighten supervision for speculative trading in some commodity derivatives
- Restrict high frequency, algorithmic trading, and use of dark pools
- Banks required to identify and split businesses on a principal or agent basis
- Introduces commodity derivative position limits for banks and other participants
MiFID II Shortcomings

- Exemptions granted to powerful lobbies. Limits set nationally rather than on EU wide level.
- Complete position limit exemption for physically settled power and gas, (coal and oil exempt for 3 1/2 years from implementation date then subject to review)
- Physically settled agricultural commodities and metals non-exempt
- Hedging exemption for non-bank trading entities if hedging commercial activities but definition of hedging unclear
(Emir) European Market Infrastructured Regulation

- Scope - all OTC derivates trading in EU
- Requires OTC derivative transactions to be cleared on listed exchanges. Post trade clearing process into clearinghouses / central clearing counterparties to increase transparency
- Stringent trade reporting requirements, increased margin and collateral requirements
- Will reduce number of counterparties in derivatives markets
Banks face acute pressure to exit commodities

- Eroding margins, decreasing market volatility, reduced customer flows, rising complexity and compliance costs, increased capital requirements, political pressure to divest, and adverse publicity / fines from trading scandals are pushing banks out of the commodity trading business

  - In 2013 JP Morgan paid $410M to FERC to settle allegations of power market manipulation in California. The bank also faced a lawsuit the same year for manipulating the silver market (latter dismissed). Under pressure by the Federal Reserve to divest metal warehousing unit due to an aluminum warehousing scandal

- Aggregate annual revenues of the top 10 bank commodity operations fell from a peak of $14.5B in 2008 to $4.5B last year

  - PIMCO Commodity fund AUM decreased 25% to $14.4B March 2011
  - Schroders Commodity fund AUM decreased by almost 50% Feb 2014
  - CalPERS cut exposure from a peak of $3.5B to $2.4B 2014
  - Net long positions in commodity index funds dropped to $177B by Jan 2014
Banks exit

- Deutsche Bank significantly scales back commodities business citing "industry-wide regulatory change" on December 5th 2013
- Morgan Stanley announces sale of global physical oil business to Rosneft on December 20th 2013
- JP Morgan announces sale of physical commodities business to Mercuria on March 19th 2014
A brief comment on trade finance

- Trade finance supports about one-third of global trade
- 80% of letters of credit are denominated in USD. Providers heavily reliant on USD funding.
- Until recently French and Swiss banks held an 80% market share. Now down to 50%
- Financial crisis of 2008 was caused in part by excess bank leverage hidden in off-balance sheet “SPVs” designed to minimize capital requirements
- The leverage ratio in Basel III is a mechanism to restrict off-balance sheet items
- Regulators want banks to hold more capital against lending activities
- Increased capital requirements increase borrowing costs
- Trade finance is significant for international trade. Particularly for developing world
- Bank capacity to conduct trade finance was significantly impaired by original draft law
- Trade finance borrowings are short term in nature / self liquidating
- After significant industry lobbying, the leverage ratio (credit conversion factor (CCF)) was reduced in Jan 2014 from 100% to 20% as a specific exemption for trade finance
Market participation and roles change

- Banks exit... Oil majors and trading houses enter
- Number of commodity trading companies in Geneva double between 2006 and 2011 from 200 to 400
- BP, Shell, register as swap dealers under Dodd-Frank in 2013 become subject to minimum capital requirements and increased margin levels
- Vitol and Glencore join shadow banking sector. Provide $10B loan to Rosneft to help it acquire TNK-BP and become the largest publicly traded oil company in exchange for guaranteed future oil supplies. A type of transaction that previously would have exclusively been executed by banks
- Trafigura enters similar deal
Macro implications

- As banks exit/reduce participation, market liquidity will decrease. Transaction costs will increase as bid/offer spreads widen. Potentially increasing profitability for those participants remaining as long as they can properly manage the risks.
- Higher capital requirements for oil majors will increase the cost of holding inventory. Volatility will increase in commodity markets during times of stress due to reduced buffers as the newly regulated companies find ways to minimize the amount of money tied up in working capital.
- New laws could push business away from North America and Europe towards Asian exchanges/trading venues if regulatory regimes are not harmonized globally.
- Business will move out of the regulated world into the less regulated world. Increased capital requirements and regulatory reforms will concentrate activity away from regulated lending institutions towards the less regulated/less transparent trading firms.
Shift towards the trading houses

- Non-bank entities are subject to lower capital requirements and reporting requirements. Not subject to restrictions on employee compensation like banks.
- Many trading companies are privately owned and do not disclose financial results.
- Competitive advantages will accrue to trading houses and physical traders able to glean non-public market intelligence derived from operating across the continuum of the commodity supply chain.
- Physical players will need to expand their balance sheets. Find new ways to finance themselves and possibly their counterparties. Less reliance on collateralization and greater reliance on partnerships with co-investors, private equity, or spin-offs.