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Policy Brief

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Changes in the commodities market*

Part 1: prudential regulation and disengagement of the banking sector

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Summary

Western banks are gradually withdrawing from the commodities market. Two main reasons can explain this refocusing: an increase in regulatory constraints and lower profitability. This withdrawal seems to benefit large international traders and banks in emerging countries that demonstrate their legitimate interest in this area.

How will the commodities market be organized in the future? This is a relevant question because of the considerable changes currently taking place in the commodities market. Among these changes is the gradual withdrawal of Western banks. Deutsche Bank has separated from its physical trading activity in energy, agricultural products and basic metals, while Credit Suisse announced the sale of its commodities trading unit to focus on its precious metals brokerage business and international trade financing. The same tendency exists in the UK with Barclays, which is now focused on precious metals and petroleum derivatives, as well as the Royal Bank of Scotland. The situation at French banks seems more uncertain. Nevertheless, because of the sanctions imposed by the US court for embargo violations, since January 1, 2015, BNP Paribas cannot offset its oil trading and gas financing activity through its subsidiary in New York, and relies on Bank of America since December 8, 2014. Across the Atlantic, the situation is no different: although Morgan Stanley recently redeveloped its trading unit, it sold its physical oil market activities to the Russian oil giant Rosneft, while JPMorgan Chase sold its physical commodities market activities to the Swiss group Mercuria Energy. The Goldman Sachs bank presently remains active on the commodities market but it wants to reduce its scope of action by selling its London Metal Exchange (LME) metal storage activities, which are considered non-strategic and a source of legal disputes. Amid suspicions of price manipulation, the bank is no longer among those responsible for fixing platinum pricing since December 1, 2014, which it had been involved in since 1989.

*This analysis of changes in the commodities market will be extended in the next two Policy Briefs: one dealing with international trading companies, the other on producers and end users.

This disengagement raises even more questions as banks play an essential role in financing and assisting commodities producers and end users, as well as international trade. They respond in fact to short-term financing requirements pertaining to the purchase and sale of raw materials, carrying inventory, ensuring the proper settlement of transactions, and providing market solutions such as derivatives to manage the price risk arising from these transactions. To understand this, it is necessary to look at the regulatory changes affecting bank financing and investment activities. In the case of the EU, it must indeed anticipate a major change by imposing stricter prudential requirements than those prevailing today. Operating since 2006 under the European regulation capital requirements directive (CRD), the European translation of the Basel II principles, European banks must respect the McDonough ratio, which requires that the ratio of their risk-weighted assets and their capital is not less than 8%. In other words, for one hundred euros granted, the bank has to fund eight, the remaining funding may come from investor deposits, interbank loans or those made on the financial markets. Three types of risk are thus considered: market, operational and credit. The first pillar, called minimum capital requirement is complemented by two other main banking supervision principles: an individualized prudential supervision giving authority to banking authorities to increase the scale of the necessary capital if justified by an establishment's profile risk (Pillar II) and an increased duty of financial communication by banks (Pillar III).

“On assessing the market risk of commodities, Basel III hardly changes over previous agreements”

Insufficient to prevent the 2008 financial crisis, the operational implementation of the first pillar was substantially revised in the Basel III framework agreements established in December 2010 and in effect until 2019. They aim to strengthen international banking stability by increasing the level and quality of the regulatory capital of credit institutions and by introducing two new prudential ratios that aim to increase the capacity of these assets to deal with short and medium term liquidity crises. The liquidity coverage ratio (LCR) enables banks to ensure they have enough liquid assets to cope with a crisis, for example, a run on deposits and unprecedented withdrawals on credit lines granted. Moreover, the scale of assets that the bank may hold is defined in terms of the equity it owns: the ratio between the total assets held by a bank and its own funds, called the "leverage ratio," must be greater than 3%.

How does this regulatory change affect the commodities market? The legal complexity of these agreements and the diversity of banking activities linked to the commodities market (commercial financing, investment, risk coverage) require a careful response to the question. On assessing the market risk of commodities, Basel III hardly changes over previous agreements: the capital charge for directional risk is equal to 15% of the net position, buying or selling, and an additional charge of 3% of the gross exposure is imposed to protect against other types of risk. However, the LCR penalizes commodity trade finance, which is in part based on the use of short-term transactional trade credits: they appear in the ratio denominator and as a counterpart they require banks to hold more liquid assets. This trade finance is also entered in bank off balance sheet positions and, in the new regulatory framework, is seen as an important source of leverage. It is therefore included in the calculation of the leverage effect with a conversion factor equivalent to 100% credit. The capital requirement is, in other words, similar to that of the commitments entered on the bank's balance sheet. Finally, most banks operating in the commodities market are large international banks: as such, they may increase systemic risk and must therefore pay a capital surcharge.

Basel III is not the only regulatory constraint on banks' commodities business. The European Market Infrastructure and Regulation Emir (EMIR), which entered into force in August 2012, is the European translation of the G20 Pittsburgh Summit commitments in September 2009. Noting that the lack of transparency concerning Over-the-Counter (OTC) derivatives was one of the aggravating factors of the 2008 crisis, this regulation requires that such instruments be traded through a central clearinghouse instead of directly between stakeholders. The stated goal: improve knowledge of the stock and valuation of goods traded and thus limit the counterparty risk that, in extreme cases, can feed a systemic risk. The consideration of such a regulation for the banking sector is obvious: a greater legibility of their margins. The United States adopted the Volker rule, in the Dodd-Frank Act, which in large part appears to explain the stop of commodity-related activities. Taking effect in July 2015 and aiming to protect the American investor from speculative activities by banks, it proscribes such commodities-based derivatives trading activities for the bank's own account, and increases oversight on hedging.

> "From traditional bank run to fund run, some observers are already worried about the systemic risk that may arise in the investment fund sphere whose role in financing is tending to increase."

The financial climate is a second explanatory element. If we hold to the analyzes of the London firm Coalition, revenue from commodities at the ten largest investment banks fell by 14.1 billion dollars in 2008 to only 4.5 billion dollars in 2013. Less profitability and more equity required: the impact of commodity activities weighs on the bank's return on equity (RoE) and leads to a refocusing towards more profitable activities in terms of committed equity capital. Obviously, the overall fall in commodity prices seen since in mid 2014 is not likely to slow down this process.

This Western disengagement benefits the large trading companies, as well as banks in emerging countries. The South African bank Standard Bank has recently completed the sale of its commodity-related activities to the Industrial and Commercial Bank of China (ICBC), the main shareholder since 2007, while the Indian bank Kotak Mahindra Bank acquired a 15% in the capital of MCX Stock Exchange in the early second half of 2014. By recruiting the former general manager of the Chinese company Noble Group and, in its wake, a significant number of traders, the Brazilian bank BTG Pactual has meanwhile clearly stated that it wants to play a key role in the trading of these products. It has recently been approved by the LME to engage in metal warehousing activities in Singapore, having obtained those of Detroit, Michigan and Owensboro, Kentucky in the United States. The dynamic seems so clearly established in the BRICS[1], but it is not impossible that other emerging countries will soon follow this path, like Chile, the largest copper producer and exporter that can rely on sound macroeconomic policies and a healthy banking sector. This is a long-term strategic direction that the Moroccan banking and financial ecosystem might consider. In the short term, however, investor reluctance, which has plunged the market valuations of companies exposed to the metals and energy markets, be it banks in emerging countries, traders or mining companies, should limit both the will and the capacity of action by these players. It now remains to be seen what form the commodities market financing activities will take in the near future. From traditional bank run to fund run, some observers are already worried about the systemic risk that may arise in the investment fund sphere whose role in financing is tending to increase.

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[1] Following the oil price fall, recent statements by Kaushik Basu, World Bank Chief Economist, announcing 2015 lowered global growth expectations from 3.4% to 3% largely fueled a significant decline in the price of certain raw materials, notably copper and iron ore.

[2] Brazil, Russia, India, China, South Africa

About the author

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