Finance concerns to the fore

Alexander R. Malaket, CITP, shares a few impressions and observations from the 2011 Global Commodities Forum, hosted by the United Nations Conference on Trade and Development in Geneva.

The second annual Global Commodities Forum (GCF) took place at the UN in Geneva, 31 January – 1 February 2011. The event, organised by Rouben Indjikian, executive director of the GCF, was presided over by Ambassador Luis Manuel Piantini Munnigh, president of the Trade & Development Board at the UN Conference on Trade and Development (UNCTAD), and opened by senior leaders in the global trade system, including Pascal Lamy, director-general of the WTO and Dr. Supachai Panitchpakdi, secretary-general of UNCTAD.

The two-day conference, which included plenary sessions and three parallel streams, covered a wide range of topics related to commodity trade, from security to market conditions and volatility to policy and regulatory issues, across agriculture, mining, energy and numerous other themes and subjects.

Trade and commodity finance figured prominently in the conference, both in its own sessions and panels, and as a key topic linked to other dimensions of the exchange of commodities under current and evolving market conditions.

As with many other areas of activity involving international commerce, considerations related to financing

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– including, specifically, commodity trade finance and issues related to Basel II and Basel III – figured prominently on the programme at the 2011 GCF.

Lamy reminded attendees that commodity price volatility is at the top of the agenda at the G-20, noting also that volatility has tended to be worse in closed markets, and that the "legacy of colonial patterns of trade" has contributed to the challenges which the WTO seeks to address through effective, long-term oriented rulemaking.

Ambassador Ali Mchumo, managing director of the Common Fund for Commodities noted the call from the G20 for greater transparency (and more robust data) around global commodity trade.

Bank capital under scrutiny

In the context of these high-level issues and observations, as well as similarly materials ones around oil, energy, agriculture and the rest of the "commodities universe", the finance discussion illustrated similarly critical concerns and equally material observations.

Jean-Francois Lambert, global head, commodity and structured trade finance & supply chain at HSBC in London, noted that: "…business is shaped more than ever by regulation, and the focus currently is on bank health rather than the potential benefits to the real economy". Lambert observed further: "We spoke, historically, about risk and return. Now, we must add "capital" to the equation, because of the impact of Basel II and III and the impact of capital adequacy requirements on the transactions we seek to undertake."

Trade finance – including commodity trade finance – has lost its status as the 'preferred child' in lending under the BIS regulations, and current requirements force a focus on counterparty risk, losing sight of the unique mitigation mechanisms available in trade finance structures. Clearly, this counterparty focus implies a disadvantage in the context of developing and emerging markets (what we now call the 'new economies') trade, and by extension, a dilution of the effectiveness of 'aid for trade' initiatives which may rely on private sector capital, as well as development efforts more generally as they are linked to commodity trade.

Less than 50% of banks are currently in compliance with what seems to be being proposed as Basel III capital ratios. Peter Sargent, head of transaction banking, Europe, at ANZ based in London, noted the impact of reducing access and increasing cost of capital for banks operating in the trade arena, while governments across the globe continue to pin hopes for economic recovery, on healthy trade flows. "Something," noted Sargent, "has to give."

James Parsons, portfolio manager at Bluecrest Capital in London remarked on the opportunities for banks to shift trade finance exposure from their balance sheet to non-banks and investors, noting specifically the benefits of such strategies on bank capital in light of current and emerging regulatory requirements.

Describing this type of symbiotic dynamic, Parsons confirmed the persistence of a perennial trade finance problem: "When we speak to investors, the first forty minutes of a forty-five minute presentation is often focused on explaining what trade finance is", which helps explain in part, why specialist trade finance funds are enjoying some momentum, while other attempts to sell trade finance risk, such as "making them look familiar – like bonds", are perhaps less effective.

John Turnbull, global head of structured trade and commodity finance at SMBC in London took the opportunity to remind conference attendees of the robustness and adaptability of trade finance, noting: "Trade finance has always found a way to respond to new challenges, and the current (and anticipated) regulatory challenges are no exception. Problems, such as were encountered in Brazil, are more commonly a matter of operational or transaction error, than they are about the fundamentals of trade and commodity finance."

That said, panel members agreed that there are billions, perhaps trillions of dollars of non-bank capital available, which could sustain and facilitate commodity trade, and wondered, how this capital might be attracted to the business of financing international commerce. For some, the issue in trade finance is not about (lack of) liquidity, but rather, about the need to create more capacity.

Support for trade finance

Supporting organisations such as development banks, regional institutions and others have made a valuable contribution to the state of trade finance and by extension, to the flow of commerce across the globe, including among the so-called 'new economies'.

In reference to the dynamic between banks and export credit agencies, John MacNamara, managing director and global head of structured commodity trade finance at Deutsche Bank in Amsterdam observed: "The requirements anticipated in the context of Basel III are generating questions about the ways in which banks will use risk insurance going forward. Some banks may shift to the secondary markets in lieu of using insurance (or as a material supplement to insurance options), as a direct result of the new leverage ratio, which puts greater focus on the banks' balance sheets than has been the case to date.

"A fundamental concern for trade financiers, is that the use of insurance does not, in the planned approach, give leverage relief. While there is an improvement from the perspective of 'risk weighted assets', the improvement is not necessarily commensurate with the erosion of margin resulting from the cost of the insurance premium."

At the same time, however, Anthony Palmer, deputy chairman, BPL Global based in London, noted that the private insurance market – historically referred to as the PRI or political risk insurance market, but increasingly now covering commercial risks as well, has grown and emerged from the crisis stronger. "The PRI market has weathered the economic turmoil well and is in good shape," said Palmer. "Although one insurer exited the market, there were six or seven new entrants, and we have experienced a rise, rather than a contraction, in capacity."

"We suffer," noted one panel participant, "from the ignorance of others", in facing adverse consequences arising from capital adequacy rules imposed on trade➤

➤ and commodity finance by the regulators at the BIS, and others engaged in shaping the regulatory realities faced by trade financiers today.

One suggestion arising from the panel on the 'emerging regulatory environment' in trade finance was to ensure broad involvement in shaping and informing the evolution of the Basel regulations – extending beyond banks and financial sector providers, national regulators, UN agencies such as UNCTAD, industry associations such as the ICC and BAFT-IFSA.

Stakeholder involvement should incorporate the views of corporate end-clients, and other stakeholders. Such an argument would extend logically to insurers, particularly in the private sector, as well as to development finance institutions and regional agencies whose access to trade finance is likely to be adversely affected by inappropriate definition and application of regulatory requirements to trade finance.

Dr. Supachai noted in his remarks, that: "Commodity booms and busts have been a regular feature of international commodity markets for generations. However, the recent emerging phenomenon of the co-movement of all commodities has started to place certain policy restrictions on countries, in terms of their efforts to diversify their commodity sector. When commodity resources and markets are well managed and regulated, risks such as price volatility and commodity dependence can be lessened, and several notable country examples attest to this, such as Botswana, Mauritius and Brazil. These countries have also successfully used technological innovation to diversify and upgrade their commodity sectors.

"To begin addressing some of these issues, it is essential to mobilise support and dialogue between high-level policy makers, business leaders and other commodity economy experts.

The importance of collateral, and of the regulatory context around commodity trade and trade finance, was highlighted by several exchanges in the regulatory panel, including detailed presentations by Matthieu Delorme, COO of Cotecna in Geneva and Marc Lapointe, regional vice president, EMEA, at Certispec Service, in Cameroon.

Relatedly, Gilles Thieffry, partner at GT Law in Geneva, observed in remarks on Basel II and III, that: "To the extent, that LGD [loss given default] estimates take into account the existence of collateral, banks must establish internal requirements for collateral management, operational procedures, legal certainty and risk management process that are generally consistent with those required for the standardised approach."

Further, Thieffry observed that it will be critical for the industry to be able to distinguish between "proper" trade finance and toxic, off-balance sheet "waste", in order to avoid the possibility of a five-fold increase in the cost of capital related to trade and commodity finance.

The excellent record of trade finance

Trade finance's excellent historical record of low loan losses, was highlighted in remarks by Andrew Cornford with the Observatoire de la Finance in Geneva. Cornford noted in a paper entitled *'A note on available information concerning trade finance'*, submitted to the GCF, that data collected through the ICC-ADB Trade Finance Default Register appears to support those assertions, convincingly.

The register's data covers over five million trade finance transactions with a combined value of $2.5 trillion and suggests incidents of default of about 1,400 transactions, or less than 0.02% of the total, with off-balance sheet transactions showing default in 110 out of 2.4 million transactions, with average recovery rate of 60% on transactions in default status.

Ultimately, discussions and presentations at the GCF reflected a desire to engage in candid dialogue, even as participants championed a variety of positions, interests and perspectives on commodity trade – an area of global importance, increasing strategic importance and impact on economies across the full spectrum, from mature to 'new economy'.

The multi-stakeholder approach promoted by the organisers of the GCF can and should apply equally to shaping the business of trade and commodity finance, as relates to the evolving regulatory context, but also more broadly, as relates to the long-term direction and value proposition of trade and supply chain finance across the globe.

Those who lead the business of trade finance, and those charged with its regulation and oversight, do not have the luxury of ignoring the imperative for a thoughtful, solution-oriented, well-informed and equitable dialogue – on a multi-stakeholder basis – around the future of trade and commodity finance.

It is not hyperbole or exaggeration to state explicitly that the world is depending on decision makers to get this right, as the implications of financial regulation in international matters extends across the globe.

Rouben Indjikian, executive director of the Global Commodities Forum, noted: "Before [the GCF] the main problems of commodity markets and economy were discussed in a very compartmentalised manner within sectors (energy, minerals and metals agriculture, forestry, fishery) and professional groups (producers, traders, financiers, regulators, consumer groups). However, increasing correlations between commodity prices and interdependence of commodity markets call for a more integrated approach. Therefore, more networking between main participants of commodity economy is necessary to identify common problems and seek better solutions for the global commodity economy.

As with other sectors of international trade and global commerce, trade and commodity finance must take its place and find its voice in considering and shaping these major issues – and at the GCF, it appears, some positive steps have been taken in that direction. ■