The role of banks in the commodity markets: bridging the expertise gap

Nic Brown, Head of Commodities research, and Pierre-Yves Hug, Senior Energy Sales, Fixed Income, Commodities and Treasury at Natixis, trace the evolving role of banks in commodity markets from financiers to major players, and post-2008

For centuries, banks have provided finance for companies wishing to produce and trade commodities. Traditionally, finance would have been extended to suppliers of commodities against letters of credit secured upon the goods they were shipping, with both vessels and cargo protected by insurance contracts. This trade finance and insurance was the lifeblood of the early financial markets, and helps to explain why, for many years, the Bank of England used a weather vane to assess the likely need for credit in London's money markets (depending upon whether the prevailing wind would be holding vessels back or bringing them into the port of London). In time, this trade-based credit was expanded to include project finance for overseas companies, including explorers, prospectors and mining companies.

In relatively recent times, the role of financial intermediaries in the commodity markets changed significantly. After the deregulation of financial markets in the 1980s, banks expanded their activities into a range of new markets, offering their clients both broking and market-making services in markets including the London Metal Exchange, International Petroleum Exchange, Marché à Terme International de France and Chicago Mercantile Exchange. This allowed banks to help their clients, whether producers or consumers of commodities, to hedge their potential exposure to unexpected falls or rises in the price of a wide range of commodities.

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In the 1990s, following the repeal of the US Glass-Steagall Act, commercial banks were encouraged to leverage up their own balance sheets in the same manner as a new breed of aggressive trading firms, and they became major players in the rapidly expanding markets for crude oil and other commodities, using proprietary trading strategies which had been developed in the foreign exchange, money and interest rate markets.

During this period, investors too gained a new interest in these expanding commodity markets. Encouraged by research from Gary Gorton and Geert Rouwenhorst, which demonstrated how commodities offered a brand new asset class with returns equivalent to equities but with zero correlation, a further surge of interest in commodities was generated.

Since the financial crisis struck in 2008, much of this financial edifice has been torn down. Proprietary risk is once again being separated from traditional banking activities, and the capital needed to support it is being more prudently assessed. Concerned that the decentralised networks of over-the-counter (OTC) derivative transactions could become a systemic problem, just as they did in the wake of the Lehman bankruptcy, regulators are encouraging clearing and settlement via fully collateralised central counterparties. The effect of speculation upon commodity prices is being questioned by politicians, concerned at the dangers of unacceptably high food and energy prices. As a result of these factors, many banks are returning to their roots as hedgers of risk and financiers of trade and investment projects, acting on behalf of customers rather than pitting themselves against them.

Some banks have chosen to refocus on core businesses; downsizing, closing or selling their

Banks became major players in rapidly expanding markets for crude oil in the 1990s

commodity businesses. Others have pulled out of trading in agricultural commodities. For most banks, proprietary trading in commodities has become a thing of the past.

But it would be wrong to shut down entirely many of the useful services that banks can provide to their clients in commodity markets. We at Natixis firmly believe that there is a role we can play in commodity markets which not only benefits our clients, but also offers a wider public good in terms of fostering greater market and economic efficiency.

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Trade finance remains an essential part of the macroeconomic system. In project finance, we are more easily able to lend to our clients if we and they are protected by an adequate hedging strategy versus unexpected falls in the price of underlying commodities being produced. Similarly, end-users of commodities are more secure if their businesses are protected from unexpected increases in the price of key commodities which they consume.

In the world of fully collateralised, centralised clearing and settlement, companies are deterred from implementing adequate hedging strategies due to the need to provide cash margining against their hedged exposure, since price risk becomes outweighed by an unacceptably high liquidity risk. In this environment, banks can mitigate much of the liquidity risk for their clients by running trading books in which hedging positions for producers and consumers broadly balance out against each other.

Overly complex derivative products may have been partly to blame for the financial crisis, but it would be wrong to discard entirely the use of OTC and structured products. For many clients, their exposure cannot be hedged by simplistic positions in underlying commodity futures, particularly where risks relate to physical aspects of their business that cannot easily be replicated by liquid futures contracts. In these circumstances, banks can add genuine value by tailoring risk solutions to their specific clients' needs. Where clients are exposed to the risks of inflation, for example, a commodity-based product may offer a simple and elegant solution.

The last decade has taught us much about the commodity markets, and we remain committed to putting this knowledge to good use for the benefit of our clients. ■