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The cost of the Fed’s scare story on commodities

John Dizard on the problems of banks not lending to a problematic asset class

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Usually physical commodities prices increase at a faster rate towards the end of an economic expansion, and there is evidence that such a move has already begun. We have seen “surprise” increases in shipping rates, natural gas prices, cocoa, coal and iron ore.

What is different this time is the unwillingness of the large banks to increase their lending against commodities collateral. This is likely to lead to much greater volatility in commodities prices, and more frequent breaks in global supply chains. What should be modest price increases will turn into price spikes and even physical shortages.

The banks have the liquidity to do the lending, but many of their commodities lending staff have left. Most importantly, they now lack the willingness to increase their commodities exposure, because top management and boards believe increased commodities lending carries unacceptable political risk.

Post-crisis lawmakers and regulators have effectively threatened to beat bank managements senseless if they dare to put any more commodities on their balance sheets, or increase their lending for commodities “speculation”.

The US Federal Reserve's most recent proposed rulemaking on bank participation in the commodities markets said it would address the "potential legal, reputational, and financial risks posed by such activities, particularly those that can result from an environmental catastrophe". Clearly, the Fed regulators had just been to see Deepwater Horizon, the recent Hollywood film documenting the explosion of an oil rig in the Gulf of Mexico.

If there is no more bank financing for commodities, that means there is less inventory financing. So the end users of commodities have to finance any price increases with even tighter supply chains and their own cash equity, which is risky and expensive.

The big trading houses, such as Trafigura, Glencore, Mercuria and Vitol, have revolving credit facilities from banks to support their activities. These are relatively cheap, but cannot be infinitely expanded. In a volatile and rising price environment, the big traders will increase the rate at which they turn over their assets, rather than rashly expanding their balance sheets.

Someone has to win from the tightening of commodities-secured credit, and there is a small but growing sector of non-bank-secured trade finance lenders who raise their money from institutional investors such as pension funds and insurers.

Alternative trade finance funds are estimated to have less than $10bn in assets collectively, against at least $2tn of bank-intermediated trade finance. It was the post-crisis pullback of the banks from trade and, in particular, commodities-based finance, that has allowed the alternative trade finance people to grow even to that level.

The alternative trade finance funds lend to smaller trading houses or manufacturers, and typically offer annualised rates of 8-12 per cent, or even the mid-teens, for secured claims with no more than 180 days maturity. It is a labour-intensive business, since the trade lenders must have clear documentation on both ends of a given self-liquidating transaction, and need to know their customers.

For those alternative trade and commodities lenders who follow the classic rule book, losses are low. Nicolas Clavel, the chief investment officer of Scipion Capital, an Afrocentric trade finance company in London that oversees $150m of assets, says: "Our [realised] losses are about half a per cent a year over the past nine years. That did not increase during the crisis, though capital dried up and our book had to shrink. We will have done an average return for our investors of close to 9 per cent, without leverage and net of our fees."

Commodities finance veterans from the banks and trading houses are setting up more funds to take advantage of the banks' retreat under fire. Kristofer Tremaine, previously global head of commodities at PPG, is the founder of Kimura Capital, a new commodities lender based in London.

He says: "With costs (mainly professional services), the hurdle to entry as a new business is great. We have no loans beyond 180 days and we give our investors 180 days liquidity, so if we had mass redemptions we would just cancel our facilities and return the money. It is a very safe strategy from an exit perspective."

Given the hands-on nature of non-bank commodities lending, Mr Tremaine and his partners intend to limit Kimura to a "single-digit billion [AUM dollars] business." This is consistent with the growth path of other non-bank trade and commodities lenders.

But he adds: "What does scare us is that you have the lowest [bank] lines granted for commodities finance ever, which is a knock-on effect of the legislation. If there is a 30 or 40 per cent rise in commodities prices, you will get a liquidity crisis."

It was politically rewarding to crack down on bank lending for commodities when prices were falling, since the full-cycle economic cost of the consequent increased volatility was not apparent. That economic cost will become apparent, soon.