Banks retreat from commodity derivatives

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Investment bankers admit they are unlikely objects of sympathy. Since the financial crisis, bankers have been subject to an overwhelming degree of popular criticism, possibly only approaching the level of hatred afforded to arms manufacturers, large pharmaceutical companies and the tobacco industry.

In response to the critical public mood, politicians have set in train a variety of regulatory reforms that will make it harder for banks to compete in commodity and energy derivatives. Consequently, bankers are in need of sympathy – and possibly even a hug.

"The financial crisis has changed the way banks regard energy trading and energy markets," said Lawrence Haar, director of commodity trading risk management at UniCredit, speaking at *Energy Risk Europe* in London on October 3. "I'm not going to tell you to hug a banker, but from the standpoint of energy companies looking for hedges, the role of banks is changing."

It is unclear where this leaves the rest of the commodity and energy market, including participants such as mining firms and utilities attempting to hedge their underlying physical exposures. While some observers believe banks will continue to pick up this business, others believe regulatory reforms are likely to push hedgers into the arms of less regulated independent trading firms and hedge funds – something that would be a bad outcome for regulators, they warn.

"Some of Wall Street's best commodities talent is walking off as stricter regulations inhibit trading and pressure on compensation limits pay," says George Stein, New York-based managing director at executive search consultancy Commodity Talent LLC. "Candidates are knocking on our door from the top shops who previously would not return our calls."

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In October, it emerged that Morgan Stanley and the Qatar Investment

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Authority, the country's sovereign wealth fund, were discussing the sale of part of the bank's commodity trading unit. Morgan Stanley chief executive James Gorman was reported as saying the bank was considering a different structure for the business – one that would allow it to reap some benefits from the unit, but also comply with regulatory constraints.

"Recent and pending regulatory changes requiring lending institutions to hold higher capital reserves are causing the cost of financing for the whole industry to increase at a time when traders are making more and larger investments," noted consultancy Oliver Wyman in a report released on September 17. "As a result, several European banks active in commodity trading, such as Crédit Agricole and Santander, closed their commodity trading arms recently. Others, such as Goldman Sachs, are moving away from cash-intensive financial trading into more physical trading."

In addition to those mentioned in the report, BBVA, Credit Suisse and Société Générale Corporate & Investment Banking are among other firms that have folded all or part of their commodities trading businesses during the past year.

Among forthcoming regulatory changes, Basel III is perhaps the most pressing of bank concerns. Drawn up by the Basel Committee on Banking Supervision in response to the financial crisis, the new capital framework will massively increase the level of regulatory capital banks are required to hold. It introduces a new common equity Tier I capital ratio of 4.5% of banks' risk-weighted assets (RWAs), while banks will also be required to build up capital conservation buffers totalling 2.5% of RWAs. On top of that, supervisors will be able to impose an additional discretionary buffer of 2.5% of RWAs, which is designed to reduce the pro-cyclicality of the regime.

Stable funding

Amid concerns about the accuracy of risk weightings, Basel III will eventually impose a minimum Tier I leverage ratio of 3%. Meanwhile, the framework seeks to improve banks' liquidity management by incorporating a set of minimum liquidity standards for the first time. They come in the shape of two new minimum ratios banks will be required to maintain: a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR). The LCR is designed to ensure banks have enough high-quality liquid assets to sustain themselves over a 30-day period of market stress, while the NSFR is meant to ensure banks have a minimum amount of stable funding during a one-year period.

Alongside these changes, Basel III clamps down on the type of instruments banks can deploy against regulatory capital requirements. The capital

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benefits derived by banks from things such as mortgage servicing rights, tax-deferred assets and investments in other financial firms have all been cut back, making enlarged capital requirements even more difficult to bear.

One aspect of Basel III that will have deep ramifications for energy and commodity businesses is a new charge for credit valuation adjustment (CVA). Effectively an explicit charge for counterparty risk, bankers say the CVA charge will be particularly fierce for longer-dated trades with counterparties that have less-than-perfect credit ratings. That is likely to penalise banks providing longer-dated hedges to commodity and energy market participants – a fact acknowledged by UniCredit's Haar: "CVA is a major part of the spread banks charge counterparties when they originate over-the-counter deals. We were looking at a hedging programme for a large coal producer at our institution… We already had loans to them and we were looking at hedging their output, but CVA killed the deal."

This regulatory capital burden comes in addition to Basel 2.5 – a revamped set of trading book capital rules that is already in force in Europe and scheduled take hold in the US from January 2013. Basel 2.5 consists of a variety of separate charges that combine to create a much higher charge for trading activities than that which existed before. Whereas banks previously calculated a market risk charge based on value-at-risk, banks with permission to use their own internal models are now required to calculate a market risk charge, an incremental risk charge for credit default and spread migration risk, a standardised charge for securitisations, a comprehensive risk measure for correlation trading books and a stressed VAR charge based on a one-year period of significant market stress.

Meanwhile, US regulators are working out how best to implement the Volcker rule – a portion of the Dodd-Frank Act that aims to outlaw proprietary trading. Defining what constitutes prop trading is tricky, particularly in OTC derivatives, where banks typically warehouse risk in order to facilitate client business. While regulators have not yet drawn the dividing line, the Volcker rule is already having a profound impact in some asset classes that are more "prop-driven", say market participants, including US power trading. These provisions of Dodd-Frank come in addition to rules requiring OTC derivatives to be cleared, which are mirrored in Europe by the European Market Infrastructure Regulation (Emir). As well as clearing, both sets of legislation entail a host of new reporting and transparency requirements.
The rules could not have come at a worse time for bank commodity and energy derivatives desks. Combined

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with a poor economic environment and muted volatility in some parts of the energy market, they are causing many banks to reassess their commitment to the business, according to market observers.

"Regulators are restricting banks from doing certain activities, and they are also raising the cost of doing certain types of business," explains Mandeep Sidhu, London-based managing director at energy consulting firm Opportune. "So you have the commercial opportunities that are not as abundant as they used to be, increased capital requirements and increasing pressure to manage operational expenses, which means banks will likely rationalise their portfolios and work out what they do and don't want to be doing."

When it comes to assessing which businesses they should be in and which ought to be left behind, it is not surprising that commodity and energy derivatives should be further down the pecking order than others, he suggests. "Most of the commodities business – especially with corporates and in emerging markets – tends to be capital intensive. It involves credit risk to smaller entities, many of which are asset-backed businesses."

The VAR figures reported by banks between the first quarter of 2011 and the second quarter of 2012 seem to confirm a trend of lower bank risk-taking in commodity and energy derivatives. Eight out of 11 major dealers surveyed by*Energy Risk* saw a drop in commodity VAR between the first quarter of 2011 and the second quarter of 2012. One of most precipitous falls came at Goldman Sachs, where the bank's 95% one-day quarter-end VAR declined from a huge $49 million to just $19 million. Bank of America Merrill Lynch sharply cut back its VAR over the same period – with the firm's 99% one-day average VAR declining from $23.7 million to $11.9 million. Credit Suisse also saw a large fall, with 98% one-day quarter-end VAR dropping from Sfr14 million to just Sfr2 million – although the Swiss bank's figures for the first half of 2011 are based on restated results, after it made changes to its VAR methodology. At Citi, the bank's 99% one-day quarter-end VAR plummeted during the same period, going from $27 million to $17 million.

From the first half of 2011 to the second half of 2012, UK-based Barclays reduced its 95% one-day average VAR by more than half, going from £14 million to £6 million. And at UBS, 95% one-day quarter-end VAR for energy, metals and commodities slumped from Sfr6 million at the end of the first quarter of 2011 to just Sfr2 million by the end of the second quarter this year. Both BNP Paribas and Morgan Stanley saw their VAR figures drop slightly during the same period, while JP Morgan saw its 95% one-day

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quarter-end VAR for "commodities and other" rise to $22 million in the fourth quarter of 2011, before declining to $12 million by the second quarter of this year.

Over the same period, two banks surveyed by Energy Risk actually saw their VAR numbers increase. From the first quarter of 2011 to the second quarter of 2012, Deutsche Bank's 99% one-day quarter-end VAR rose from €14.7 million to reach €23.7 million. Meanwhile, HSBC's 99% one-day VAR for foreign exchange and commodities grew to $28.8 million at the end of the first half of 2012, from $10.3 million a year earlier (see table 1). Third quarter figures were not available by the time *Energy Risk* went to press.

Apples and oranges

Market observers note that VAR figures are affected by market volatility and are therefore not a perfect proxy for the risk appetite of banks. They are also not directly comparable between firms, due to differences in the methodologies employed. Nonetheless, bankers admit there is a conscious effort underway to take less risk in commodity and energy derivatives.

"If you compare our VAR today versus a year ago, it is lower. Part of that is to do with market conditions and the other part is that we are changing our posture in order to serve our clients more effectively. It is less about taking risk in our trading book, than looking at how the risks we take best serve our clients," claims a London-based commodity head at a large European bank.

As Opportune's Sidhu notes, banks are facing increased costs across the board – and that affects more than just commodity and energy derivatives. However, in other areas of the derivatives market, banks have the ability to pass on increases in the cost of doing business to their clients, he argues. In commodities, they face tougher competition from a diverse range of other players, including the trading arms of utilities, hedge funds and independent trading houses, which are not subject to the same restrictions. That could limit their ability to pass on increased costs in commodity and energy derivatives, he says.

Banks are also facing tight restrictions on compensation and bonuses – a factor that has led many talented commodity traders to vote with their feet, say head-hunters. "Some of Wall Street's best commodities talent is walking off as stricter regulations inhibit trading and pressure on compensation limits pay," declares George Stein, New York-based managing director at executive search consultancy Commodity Talent. "Candidates are knocking on our door from the top shops who previously would not return our calls."

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The past year has seen a steady outflow of top traders from banks, with many gravitating towards independent trading firms. Prominent examples include Mark Sickafoose, former head of North American commodities trading at Citi, who joined Geneva-based trader Vitol in July; and Roger Jones, the former London-based global head of commodities at Barclays, who defected to Geneva-based trading firm Mercuria in May. "The major commodity trading houses are aggressively moving into the vacuum left by the downsizing on Wall Street," adds Stein.

Despite looming regulation and a less volatile energy market, the corporate hedging needs of firms such as miners, utilities and airlines haven't gone away, note market observers. They believe the cutback by banks is helping to precipitate the rise of hedge funds and independent trading firms, giving them easier access to top talent, capital and trading opportunities. The lull in bank trading could see them usurp the traditional role of banks as providers of hedging products, they assert, by driving trading activity and risk into a dark and less-regulated underworld. "Just like the emergence of the shadow banking system, with hedge funds and other firms building up pockets of unregulated risk before the recent financial crisis, we're starting to see the emergence of a shadow energy system," claims one London-based senior commodity trader at a large US bank.

Unregulated frontier

A London-based commodity head at a major European bank agrees: "Businesses are moving out of the regulated world and into the unregulated world – and commodities are no exception. The difference in commodities is that the unregulated world is already there, and existed before the banks," he says.

Other market observers say such arguments are self-serving and believe this scenario is less of a threat. They point to a number of reasons why commodity and energy hedgers might be reluctant to do business with independent trading firms, including counterparty risk. "Big oil companies and power firms like to deal with firms with good credit support and hedge funds rarely qualify, although a couple might. A lot of talent is going towards independent trading firms, but if firms in the energy industry are going to trade with them, they're going to have to deal with less strong credit," remarks Glen Swindle, founder and managing partner at Scoville Risk Partners, a New York-based energy risk advisory firm.

Another restriction is funding. Independent trading firms typically rely on short-term financing and don't have the balance sheet and lending ability of banks. Such issues are highlighted by the Oliver Wyman report, which claims

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independent traders will have to find a new approach to funding in order to effectively compete: “Traders’ financing costs are steep. With large amounts of debt and relatively small asset bases, traders cannot rely on a credit rating to secure financing in the capital markets directly. Instead, they often use their inventory as collateral for financing agreements or rely on short-term transaction-based financing tools to grow their turnover,” it notes.
While independent traders are experimenting with new ways of financing their business – by selling stakes to big investors or going public, for instance – it remains to be seen whether these efforts will succeed or create further difficulties, the report notes.

Meanwhile, market observers point out that banks aren’t the only ones having to cope with greater volumes of regulation. Many of the reporting and transparency requirements embedded in Emir, Dodd-Frank and other bits of new legislation will also touch trading firms, hedge funds and the trading arms of utility companies, although to a lesser extent than banks.

Despite this, UniCredit’s Haar said he believed specialised asset players with lower regulatory capital requirements would see their role in the market increase over time: “I see that as very important and I’ve seen several cases of that,” he said. “It doesn’t bode well.”

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