Stand out for the right reasons

An opportunity not a threat: How commodity traders can turn new capital rules to their advantage

Many commodity traders have greeted the proposed Basel III capital rules with alarm. But if managed efficiently, the capital charges could be much lower than many think. They could also create opportunities to broaden trading activities and prompt senior management to rethink strategy.

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Time to rethink capital

Many commodity traders have criticised planned new capital rules, believing they will severely erode profitability. But a closer examination of the latest developments shows that they actually stand to gain from the changes.

Higher regulatory capital charges have forced many banks to scale back or even completely withdraw from commodity trading. Gaps in the capital net have allowed commodity firms to step into the breach. As their activities don't attract the capital loading faced by banks, these firms have been able to deliver strong profitability despite the challenging economic climate.

Plans to bring these commodity firms into the capital net as part of the Markets in Financial Instruments Directive II (MiFID II), a new European regulatory initiative, have therefore been greeted with strong criticism from the sector. By designating commodity contracts as financial instruments, just like a financial derivative, commodity firms would face the same capital rules as banks.

Market discussions have highlighted what many believe will be a huge capital hit. The European Federation of Energy Traders believes that each commodity dealer could need to raise up to $6 billion in additional capital[1]. Many market participants fear that higher capital charges will drive down returns and force them to scale back trading in the same way as banks have done. Market liquidity would suffer as a result. There has even been talk of moving some trading activities, especially oil, out of Europe[2]. The scale of the furore means that the changes planned in 2018 are likely to be put back to 2020.

Alleviating the impact

Yet these evaluations of the impact fail to take account of the flexibility in the application of the rules and some very important shifts in capital regulation under the so-called Basel IV.

According to our analysis of a typical energy commodity portfolio, the new Basel capital standards will result in significant savings for regulatory capital, thus helping to sustain returns within commodity trading businesses. In particular, more granular treatment of commodity exposure, along with enhanced risk sensitivity to allow for better recognition of hedging, could lead to a 30-40% increase in capital efficiency compared to Basel III for a typical commodity portfolio.

To take advantage of these opportunities, it will be important to improve data, bring in more capital management expertise and build and maintain a new modelling and governance infrastructure. In this way, capital regulation will bring greater rigour and discipline into risk management processes for commodity trading. We're also likely to see a shift f lanket capital demands to a more risk-sensitive approach, which distinguishes between different types of commodity. It would be possible to structure the portfolio to create additional capital efficiencies.

Some traders may want to take up an investment licence ahead of the planned changes to take advantage of the capital benefits and broaden the range of market activities they can pursue. These include taking proprietary trading positions and providing portfolio management services to clients. This can be an important strategic consideration for senior management who are looking for ways to diversify their business model in the face of a challenging economic environment.

1 'Energy Traders Seen Needing Billions in Regulation Shakeup', Bloomberg 1 October 2015

2 Financial Times, 23 September 2016

Case study

Applying the levers of capital optimisation

To illustrate the potential for capital saving when comparing between the current Basel III capital framework and the new Basel IV, this case study focuses on a hypothetical company we've called Comtrade.

The company

Comtrade is a typical high volume commodity trading firm, dealing in a broad portfolio of metals and energy. It trades with airlines, major international and national oil, gas and metal companies, utilities and exchanges. Its operations span a number of legal entities. In most years, it has been able to sustain double digit returns. Part of its competitive advantage stems from its low capital demands. But when the MiFID II rules come into force, it would need to register as an investment firm trading in financial instruments and face the same capital rules as a bank.

The challenge

The risk that a counterparty fails to meet its obligations (counterparty credit risk) is set to be one of the biggest contributors to Comtrade's overall regulatory capital under the new rules. Failure to curb the capital costs could cut profitability or even lead to losses. Yet unlike counterparts in financial services, Comtrade doesn't hedge its counterparty credit risk exposures. This is exacerbated by the current low commodity price environment, which has spurred rating agencies to put a negative outlook or downgrade many of Comtrade's counterparties. What can Comtrade do to control capital demands and sustain profitability?

The levers

1. Netting of inter-company deals

Internal trades between Comtrade's entities are subject to capital charges. Bringing them into the same netting agreement (effectively a single settlement that offsets all the obligations) could reduce its capital charges by up to 10%.

Capital saving 10%

2. Risk-weight optimisation

The calculation of capital for a counterparty depends on its credit risk weight, which is determined by its credit rating. If Comtrade settles through a recognised exchange, this would require less capital than one of its corporate clients, for example. If the counterparty is a member of an exchange, how can the credit risk weight be evaluated most accurately in this case? The better understood the exposure, the less of a capital cushion that needs to be put aside. This underlines the importance of effective risk evaluation capabilities in curbing capital demands.

Capital saving significant. Level depends on precision of risk modelling and evaluation

3. Collateral treatment

The Basel IV rules are more risk-sensitive and potentially allow for increased capital relief from collateral holdings. In particular, the new framework allows Comtrade to explicitly model collateral agreements for OTC derivatives (Credit Support Annex terms) and takes closer account of margined transactions through a central clearing house or exchange.

Capital saving significant. Level depends on trading strategy

4. More effective offsetting

The Basel IV rules would allow Comtrade to claim much more capital relief from offsetting long and short positions with the same counterparty and within the same hedging set. The way hedging sets are grouped is also more specific and risk-sensiti , the rules only distinguished between precious metals and other commodities. The updated framework differentiates between energy, metals, agricultural and other commodity trading acti ties. As a firm with substantial trading volumes with multiple long and short positions within the same netting agreement (e.g. exchange trading), we anticipate that Comtrade's credit exposure could come down by as much as 50%, w translate into a 30% capital saving.

Capital saving 30%

Seizing the opportunity

At first glance, the capital rules for commodity trading may appear onerous. But we believe the new capital regime offers opportunities to improve risk and capital management and gain the benefits from more transparent risk management processes, as well as the added flexibility of being able to perform a broader range of business activities.

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Our approach to risk and regulation

Alert

Protect

Adapt

Repair

St

longterm growth and profits for your business. With our help, you won't just avoid potential problems, you'll also get ahead.

We support you in four key areas.

- By alerting you to financial and regulatory risks we help you to understand the position you're in and how to comply with regulations. You can then turn risk and regulation to your advantage.
- We help you to prepare for issues such as technical difficulties, operational f lure or cyber attacks. By working with you to develop the systems and processes that protect your business you can become more resilient, reliable and effective.
- Adapting your business to achieve cultural change is right for your customers and your people. By equipping you with the insights and tools you need, we will help transform your business and turn uncertainty into opportunity.
- Even the best processes or products sometimes fail. We help repair any damage swiftly to build even greater levels of trust and confidence.

Working with PwC brings a clearer understanding of where you are and where you want to be. Together, we can develop transparent and compelling business strategies for customers, regulators, employees and stakeholders. By adding our skills, experience and expertise to yours, your business can stand out for the right reasons.

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