Commodities

March 2012

New horizons in trade finance

The market for financing commodities trades, long dominated by a handful of European banks, is becoming more restrictive. Major players have been tightening rules to exclude certain categories of commodities deals and reduce trade finance as a proportion of their total book of business.

The “Basel III” agreement will significantly increase the capital adequacy buffers all banks are required to hold. Basel III is an international agreement between banking regulators, overseen by the Bank of International Settlements, a group of the world’s central bankers. The underlying theory is that the 2008 banking crisis was caused in significant part by liquidity failures, and that if banks are required to keep sufficient reserves, a systemic crisis is unlikely to recur.

The international banking industry has responded with intense lobbying, complaining that forcing banks to maintain minimum capital levels will raise the cost of lending by keeping funds lying idle. Trade finance is particularly susceptible to the impact of Basel III because it requires high levels of capital reserved for low-risk business. Defaults in trade finance transactions run at less than 1%, and levels of non-recovery are even lower. For this reason it is a low-fee business for banks, and the obligation to maintain substantial reserves against trade finance transactions is likely to make them uneconomic.

Regulators have responded to this lobbying by making changes aimed at reflecting the risks involved in trade finance more fairly. The “sovereign floor”, which provides that the creditworthiness of a trade finance counterpart cannot exceed the creditworthiness of the country where the goods are bought, has been abolished. The one-year maturity floor, requiring banks to risk-assess transactions on the assumption that funds will be committed for at least 12 months, has also been abolished for letters of credit. (In practice, few trade finance transactions have maturity dates beyond 80 days.)

However, Basel III by itself cannot fully explain the current reduction in trade finance volumes. It has not yet been finalised or come into force: states are obliged to give it effect from 1 January 2013, with full implementation by 2019.

Ironically, trade finance may be less popular amongst bankers due to its relative safety. In challenging economic times, banks are under increased pressure to generate shareholder value. Because trade finance is low risk, the margins are also low. Trade finance departments are finding it increasingly hard to compete for funds in their own banks with other investment banking activities offering higher risks and returns.

An additional factor is that commodities transactions are almost all denominated in US Dollars. For European banks to lend US Dollars they must hedge their Dollar exposure. The weak Euro makes hedging transactions more expensive.

If trade finance becomes more difficult and more costly, commodities trading will be squeezed and commodity prices will increase. One option may be to release the stranglehold of the US Dollar on global commodities markets. If the biggest traders agreed to move to another currency for trade in certain commodities, or even an agreed basket of currencies, the rest of the market would surely follow. Commodities prices would be relieved of the volatility caused by FOREX fluctuations, an often overlooked cause of price spikes. Trade finance would also become cheaper without the hedging costs involved in international banks investing in a single currency.

Another option is to expand the market in trade finance. Banks in emerging markets could take a role, particularly where countries, such as China and India, have an interest in moderating commodity prices or where countries, such as Brazil and Russia, are exporters of commodities with an interest in facilitating the commodities trading market. Emerging market sovereign wealth funds might have similar interests.

Finally, traders could start financing themselves, or each other. Larger traders could provide funds to smaller ones, to keep the market liquid. It is arguable that they would not be bound by Basel III rules.

Whatever solutions are adopted, the world of trade finance could be about to change.

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New African Mining Codes

The recent introduction of the Angolan Mining Code is one of a number of similar developments in African mining states. Zambia and Guinea have introduced new laws and regulations, and DR Congo is reviewing its 2002 Mining Code. Existing and prospective investors should consider the implications such changes may have on any mining activity currently underway or contemplated.

The Angolan Mining Code applies to all mining activities, from extraction to processing and development. It replaces several existing laws and regulations, and aims to provide a consolidated and structured code for the domestic mining industry. Certain provisions seek to increase the interest of the state in Angola's natural resources: in return for granting mining rights, the Angolan state will obtain a stake of at least 10% in companies conducting mining activities.

Africa is recognising its increasing attraction for foreign investors. In the 1990s and 2000s, many mining states were either emerging from a prolonged period of civil war, or adjusting to democracy following the end of de facto one-party rule. The focus of regulation was on attracting foreign investment, often offering generous tax exemptions and low royalty payments on exports. Following a decade of increasing stability, that focus is changing. Many African governments are now aiming to increase controls in the mining sector, and to provide benefits for local communities affected by mining activities. This is being achieved by

a combination of tighter regulation of foreign investors and restrictions on tax exemptions. Existing investors with mining rights may also be subject to more stringent regulation.

The mining codes of Angola, Zambia and Guinea all demonstrate this shift in focus. For example, whilst Angola requires a minimum 10% participation in mining companies, Guinea requires a 15% free interest, and an option for the state to buy a further 20% stake, allowing a possible overall state interest of 35%. DR Congo is expected to introduce similar regulations following its review.

With Guinea and Angola rich in diamonds and gold, and Zambia having the largest copper exports in Africa, there is scope and appetite for new investors to establish a presence in these jurisdictions. However, mining projects require a large initial cost outlay for the necessary surveys and licensing procedures, not to mention equipment for exploration and extraction. In light of this, uncertainty about the effects of new regulation may cause concern.

A necessary first step is to carry out a comprehensive due diligence process, updated at regular intervals, encompassing all intended activities within the relevant jurisdiction. This allows investors to establish what regulatory requirements are in place before any significant cost outlay has been incurred. The process can also reveal the practical effect of the implementation of laws and regulations in practice.

Existing and new investors would also be wise to incorporate as many protections as possible into any contracts entered into with any state. For example, a stabilisation clause may protect investors from future changes in the law which could have a detrimental impact on the financial viability of a project. For investors with an established presence in countries that have either introduced new mining codes or are reviewing existing codes, it may be prudent to revisit contractual arrangements with the state to take account of future risks and the effect of any new regulation.

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GAFTA Contract Reprints - 1 April 2012

On 7 March 2012, GAFTA announced several changes to its contracts, which will come into force on 1 April 2012.

FOB contracts

The first change is of particular note, since it is a response to the Court of Appeal's decision in *Soufflet Negoce SA v Bunge SA* (13 October 2010), which was reported in the October 2010 issue of this Bulletin. The Court of Appeal held in that case that although cargo holds must be typically clean before a shipowner may issue a notice of readiness under a charterparty, clear words are needed if this requirement is to be incorporated into a FOB sale and purchase contract.

With this in mind, GAFTA has added the following provisions to all their FOB contracts:

"Vessel(s) to be clean and fit to receive the goods and to load in accordance with the custom of the port of loading unless otherwise stipulated".

North American strike terms

Changes have been made to "Strikes and Other Causes in Delay of Shipment" clauses in GAFTA contracts 27, 30 and 31, which are the Canadian and American grain contracts. It will no longer be a requirement that relevant events are certified, and the stipulation that certification will be final has been removed.

Arbitration Rules 125

An oral hearing may now be granted on terms the Tribunal or Board of Appeal consider appropriate.

Optional Clauses Contract 131

In Optional Clauses Contract 131, new "Stowage Bags" option clauses have been included for CIF and FOB contracts. References to stowage bags have been removed from other GAFTA contracts.

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Recent publications

There have been a number of recent HFW publications which may be of interest to our readers.

Hazel Brewer has prepared a briefing for commodities traders chartering vessels which travel through waters subject to Australian federal law. Recent changes to the law mean that alongside the master and vessel owner, slot, voyage, time and demise charterers all now face potential strict liability in the event of discharge of oil from a vessel. Andrew Williams has written an article on the effect of the commodities boom on port infrastructure. Brian Gordon and James Donoghue have prepared a briefing on recent changes to Indonesian mining law.

If you would like to receive copies of any of these publications, please contact mailings@hfw.com.

News

HFW promotes three to Partner

The firm is delighted to announce three internal promotions (effective 1 April 2012) across core sectors of focus, including aviation, insurance and logistics. The firm's Dubai office is boosted with the promotion of Sam Wakerley, specialising in shipping, trade and insurance (marine and non-marine), while in London, Edward Spencer, an aviation insurance specialist, and Justin Reynolds, who focuses on logistics and multimodal transport, are welcomed to the partnership.

Conferences & Events

ISDA Master Agreement and Schedules
HFW Geneva
(10 April 2012)
Brian Perrott

Coaltrans China
JW Marriott Hotel, Beijing
(17 April 2012)
Richard Wilmot, Andrew Carpenter and Trevor Fox

Argus European Biomass Trading
London
(19-20 April 2012)
Rory Gogarty, Chris Swart, Damian Honey and Rebecca Lindsey

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