Worldwide credit squeeze triggers changes in commodities trading
Javier Blas

Higher counterparty risks mean some over the counter deals have moved to clearing houses, writes Javier Blas

The financial crisis is shaking up the commodities market. But while the focus so far has been on falling prices, the critical impact is centred on the market's plumbing: the over the counter deals, in which companies, investors and banks trade in private, bilateral contracts.

The crisis is generating a double problem. The collapse of banks such as Lehman Brothers has elevated counterparty risk as market participants fear that the other side of their deals could default on its obligations.

As a result, several participants have all but stopped trading with some counterparties. Jorge Montepeque, director for market reporting at Plaits, says that counterparty acceptance has become a huge problem.

"We have a situation where [oil market] entities will not trade with banks," he says. "The credit situation is endangering trading. The physical movement of commodities will continue, but with much lower demand."

In some markets and products, such as Asia-Pacific oil, the commodities' trading arteries are so clogged that dealing has slowed to a standstill. "Singapore's oil trading is in lock up," says a senior commodities official in Asia. "There is a rolling fear about credit risk."

Goldman Sachs, for example, did not fully participate yesterday at a critical price discovery mechanism for Asia-Pacific oil, known as the Platt's Singapore window. Morgan Stanley has also stopped reporting prices for several days at the same window, but continues trading on the physical market. In addition, with financial institutions hoarding cash, credit for trading is scarce. Michael Carter, director of credit risk solutions at Triple Point, a US-based company that designs trading software for commodities companies, says that people have discovered with shock that "credit lines for trading could vanish overnight".

The lack of credit is curbing liquidity in oil markets, making trading and price discovery more difficult -"hence the more volatile price swings", according to the International Energy Agency, the western countries' oil watchdog.

The problems are exacerbated by the fact that banks - which five years ago had a relatively small presence in the commodities markets with Goldman Sachs and Morgan Stanley as the only significant players - are today profoundly involved, both in number and in the depth of their financial and physical operations.

The combination of factors, coupled with the collapse earlier this year of Semgroup, a large player in the US physical oil market, and Bear Stearns and Lehman Brothers, has left commodities traders edgy.

As a result, some OTC trading is moving into public exchanges to benefit from clearing facilities. Thomas Leaver, chief executive of the Dubai Mercantile Exchange, says: "[There is an attempt] to mitigate the credit risk." But more importantly, a significant volume of commodities OTC business is moving directly into clearing houses, bypassing the exchanges.

Paul Newman, of Icap Energy, says that three years ago, virtually no OTC oil transactions were posted for clearing.

"Three months ago that figure was 10 per cent. Three days ago, the figure had become 50 per cent," he says. "Clearing [for OTC commodities] is not unique to exchanges."

Volumes at Nymex Clear-port in New York, a clearing system for OTC oil deals, surged 41 per cent in the third quarter compared with the same quarter a year ago.

The move goes beyond oil, as traders in metals and agricultural commodities report a similar trend to clear OTC deals to mitigate counterparty risk.

Ian Dudden, director of commodity derivatives at NYSE Euronext, with products ranging from wheat options to sugar futures, says: "We anticipate seeing increasing reliance on exchange-traded business, including OTC-related activity, given the core benefits of having a central counterparty."

Fonte: Financial Times, London, October 14 2008, Companies & Markets, p. 26.