Banks Pulling Out of Commodities … But for How Long?

The trickle of banks leaving the commodity space has become a veritable flood. Over the past six months some of the biggest global banks have announced plans to either dramatically scale back operations or exit the physical trading business entirely, leaving the space increasingly in the hands of specialized merchant banks—e.g., Mercuria and Tudor Pickering—and industry players such as Rosneft and Glencore. The reasons for the mass exodus are well known—increased regulatory scrutiny and political pressure/lawsuits, higher capital requirements as a result of the new Basel III framework, and lower profits thanks to reduced volatility and sliding prices in recent years—but less obvious is the potential impact on commodity prices and investors. In our view, the recent turmoil is unlikely to have long-term ramifications on the sector, but short-term effects are more unpredictable. Our expectation is that things will sort themselves out relatively quickly; our biggest worry is that an exogenous shock hits before things fully play out, exposing markets to price dislocations without the market infrastructure to adequately handle them.

How Did We Get Here?

As is so often the case in finance, the current bank exodus has been driven mainly by the merry-go-round of government regulations leading to corporate reactions and lobbying, followed by further regulations, causing additional reactions. Rinse. Repeat. In short, the combination of the Gramm-Leach-Bliley bill—which repealed the Glass-Steagall–mandated separation between banks and investment firms—and actions taken in the heat of the 2008 crisis—most notably granting bank holding status to JPMorgan and Goldman Sachs—resulted in certain financial firms effectively controlling access to physical commodities, thus encouraging them to create artificial shortages and boost prices.

Commodity Trading Activity at the Ten Largest Global Investment Banks

Bank Holding Company FY13 Total Net Rev US$	**Current Status of Commodity Trading Activity**
JP Morgan Chase $96.6 billion	Agreed to sell entire physical commodities unit to Mercuria Energy Group for $3.5 billion in March 2013; will still provide vaulting and trading of precious metals
Goldman Sachs $34.2 billion	Remains committed to these businesses, but as of May 2014 it is "exploring a sale" of Metro International Trade Services
Morgan Stanley $32.4 billion	Agreed to sell physical oil-trading division to OAO Rosneft in December 2013, but retains its large power and natural gas desks
Barclays $28.2 billion	Pulling back from the majority of its physical commodity activity as of April 2014, including agriculture, base metals, and energy
BNP Paribas $38.8 billion	Announced in early 2014 that it was "very strongly committed" to its commodity business, which includes base and precious metals, energy, and soft commodity derivatives
Deutsche Bank $31.9 billion	Announced exit from trading agriculture, base metals, coal and iron ore, and energy in December 2013; will continue to trade derivatives and precious metals
Bank of America $92.8 billion	Closed its European power and gas sales and trading operation in January 2014, but will remain active in the US power and gas markets
Citigroup $76.4 billion	Aims to capitalize as rivals withdraw from the business of trading physical assets by moving into agricultural commodities by the end of 2014
Credit Suisse $25.2 billion	Remains committed to commodities and sees "strategic opportunities" as banks retreat from the field
UBS $27.7 billion	Has been scaling back commodities presence since 2012; as of March 2014 is conducting an internal review of its precious metals business

In one widely publicized example, Goldman Sachs bought a network of Detroit aluminum warehouses called Metro International Trade Services in February 2010, at which point the average wait time for an aluminum delivery from the network was about six weeks. Over the next few years the amount of aluminum in the warehouses rose substantially—from 850,000 tons in 2010 to 1.5 million tons in 2013, up from a mere 50,000 tons in 2008—to represent about a quarter of all aluminum stored in warehouses overseen by the London Metal Exchange; wait times, meanwhile, skyrocketed to an average of 16 months, thus driving up prices. According to some estimates, Goldman and other banks may have profited as much as $5 billion over a three-year period from this artificial boosting of prices.[1]

The activities of Goldman (and others) generally appeared to follow the law, but as Matt Taibbi put it in a piece for *Rolling Stone* earlier this year, "while they may have been following the letter of the law, they were certainly violating the spirit." In response, new regulations including Dodd-Frank and the Basel III accord have imposed restrictions on banks' commodity-related activities, and several major banks have been hit with lawsuits and stiff fines.

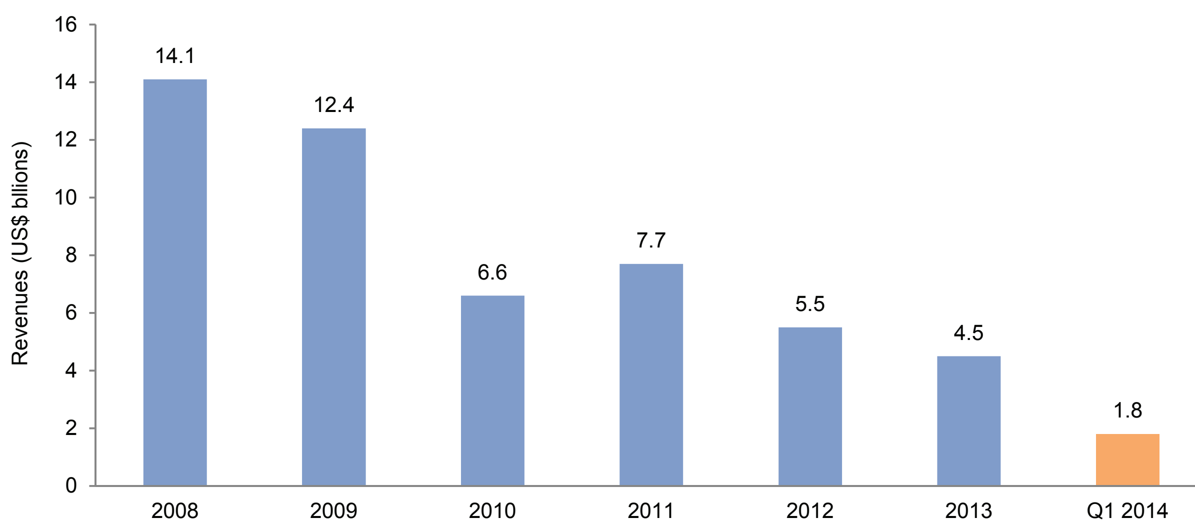
[1] Reuters reported on May 20 that Goldman was actively shopping the Metro unit.

Commodity Trading Lawsuits & Fines Levied Against Ten Largest Global Investment Banks

Bank Holding Company	Lawsuit About	Fines*	Status
JP Morgan Chase	Fixing energy prices	$400 mm	Agreed to pay a $400 million settlement with the Federal Energy Regulatory Commission for manipulating power markets in California and the Midwest in 2010 and 2011
JP Morgan Chase	Fixing silver prices	---	The 2nd US Court of Appeals found that silver investors failed to show that JP Morgan Chase & Co. conspired to drive down the metal's price, and the price fixing lawsuit should be dismissed
JP Morgan Chase	Fixing aluminum prices	---	Sued over claims it restrained aluminum supplies and drove up prices. JP Morgan Chase & Co. plans to contest the lawsuit
Goldman Sachs	Fixing aluminum prices	---	Sued over claims it restrained aluminum supplies and drove up prices. Goldman Sachs & Co. plan to contest the lawsuit
Morgan Stanley	Exceeded speculative position limits in soybean meal futures	$0.2 mm	Agreed to pay $200,000 to settle civil charges it exceeded speculative position limits in soybean meal futures for two days while attempting to hedge a commodity index investments
Barclays	Fixing gold prices	$44 mm	The director of the precious metals desk exploited weaknesses in the system to profit at a customer's expense. Barclays is also one of the five banks accused in the consolidated gold price fixing case
Barclays	Fixing energy prices	$488 mm	Facing a lawsuit by the Federal Energy Regulatory Commission over alleged energy price manipulation. The $488 million fine is on hold while Barclays challenges the lawsuit
Deutsche Bank	Fixing gold prices	---	Accused of manipulating the London gold fix benchmark along with four other banks in a consolidated case. As of May 13, Deutsche Bank has announced it will no longer participate in the fix
Deutsche Bank	Fixing energy prices	$1.6 mm	Agreed to pay a $1.6 million settlement to resolve Federal Energy Regulatory Commission claims that an energy-trading unit manipulated markets in 2010
Bank of America	---	---	---
BNP Paribas	Grain export fraud	$234 mm	Sued by the US government in 2011 over allegations the bank aided a grain export fraud scheme involving commodity payment guarantees provided by the US Department of Agriculture
Citigroup	---	---	---
Credit Suisse	---	---	---
UBS	---	---	---

* Fines are agreed to, on hold, named in a lawsuit, or paid. See status for additional details.

It is true that banks' commodity profits have also fallen sharply in recent years. According to the research group Coalition, commodity-trading revenues of the top-ten banks fell 18% last year to $4.5 billion, down roughly two-thirds from their 2008 record of $14.1 billion; this reversed in first quarter, with revenues up 26% year-over-year to $1.8 billion. However, this seems more of a secondary reason for banks to exit, or even simply a convenient excuse given the stepped-up regulatory pressure. Indeed, it seems noteworthy that the two banks facing the biggest fines (Barclays and JPMorgan) have arguably beaten the fastest retreat.



Et tu, Banks?

We are most concerned, of course, with the potential impact on commodity prices/ investors. As noted, we expect the long-term effects to be next to nil; the dance between banks and regulators is a permanent part of the ebb and flow of capital markets, and we see nothing in the current situation that suggests a fundamental change to the business. Players such as Barclays and JPMorgan are extremely unlikely to stay out of commodities forever.

The most likely outcome is one in which banks exit the business or scale back for a time (three years? five?), then re-enter when outrage over recent excesses has cooled. Goldman's decision to seek a buyer for Metro seems a clear signal that the pendulum has swung fully to the side "against" bank involvement in the sector. That said, a plausible case could be made this will not last long—the resurgence in money-losing IPOs and securitized debt, as well as the US government's current push to loosen standards for home loans, are stark reminders that memories have become ever shorter in recent years.

Further, at least part of the void left by departing banks looks to be filled by … other banks. As firms like Barclays and JPMorgan leave, others are openly stating their intention to either maintain or expand operations (e.g., Citigroup, Credit Suisse, and Goldman Sachs, notwithstanding its decision to shop Metro), while still others see the situation as an opportunity to gain a foothold in the business (e.g., CIBC, Macquarie, Standard Chartered, and Wells Fargo).

What Could Go Wrong?

We are clearly entering a period where banks will play a more limited role in commodity trading, raising the prospect that an exogenous event (e.g., a China crash or geopolitical crisis) could roil markets during, or even after, this transition. As Chip Register, managing director of Sapient Global Markets and a veteran of several merchants, recently noted, merchants "lack the credit-worthiness and often the technology and processes to support the big deals done to manage risk for large commercial lending or project financing deals, or even sometimes just plain portfolio hedging many producers and consumers transact as a matter of due course."[2]

More specifically, the issue is whether there are adequately large, well-capitalized, and willing parties to stand on the "other side" of a trade during a market dislocation. Many in the energy industry specifically cite the aftermath of the 2001 Enron collapse as an example of banks stepping in to fill the void and preventing a far worse outcome. As Register recalls, "They had big balance sheets, big risk appetites, and the ability to mobilize globally within hours to avert a larger crisis. Sure, they made money doing it, but when the markets (and the world) needed a hero, they were there."[3] One can easily conjure scenarios that would roil markets today—wars in Asia, the Middle East, or Ukraine would certainly qualify—and stress the existing infrastructure in hard-to-predict ways. While new entrants could prove equal to the task, their smaller size and shallower pockets make such an outcome less likely.

The Bottom Line

The growing bank retreat from commodity-related activities is merely another act in the perpetual tussle between banks and regulators, and we fully expect banks to re-enter the space when conditions—both regulatory and in the markets—are more favorable. While timing is of course unknowable, the return (and in some cases official encouragement) of 2007-style excesses, which were themselves less than a decade removed from the late 1990s tech bubble, suggests banks' commodity "exile" may be shorter than many assume. ■

[2] Chip Register, "Some Banks Haven't Given Up On Trading Commodities. And That's a Good Thing," *Forbes*, April 29, 2014.
[3] Ibid.

Contributors

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Exhibit Notes

Commodity Trading Activity at the Ten Largest Global Investment Banks
Sources: Bloomberg L.P., Coalition, Financial News, and Thomson Reuters Datastream.
Notes: Numbers in parentheses show total net revenues for each banks; ordering of banks is by revenues from commodity trading as ranked by Coalition as of December 31, 2013: (1) JP Morgan Chase & Co.; (2) Goldman Sachs & Co.; (3) Morgan Stanley; (4–6) Barclays Plc, BNP Paribas SA, and Deutsche Bank AG; (7–10) Bank of America Corp., Citigroup Inc., Credit Suisse, and UBS AG.

Commodity Trading Lawsuits & Fines Levied Against Ten Largest Global Investment Banks
Sources: BBC, Bloomberg L.P., *New York Times*, and Thomson Reuters Datastream.
Note: As of April 30, 2014, ten banks and brokerages have been fined a total of $6.0 billion for manipulating the Libor interest rate in a scandal that dates back to 2005.

Commodity Revenues of the Ten Largest Global Investment Banks
Source: Coalition.

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