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Trading challenges debated

Metal Bulletin recently partnered with OpenLink as sponsor of a roundtable meeting offering senior metal trading figures an opportunity to discuss some of the main challenges faced today. This summary report identifies key strands of their debate

On a beautiful late-May day, in a small private dining room near the top of a skyscraper in the City of London, some of the most influential people in today's metals industry and trade gather. The sky is clear blue, the weather is warm. There are panoramic views across the City to the horizon, but those present will be looking inwards today to discuss metals trade and industry issues.

Metal Bulletin has partnered with trading and risk management software solution provider OpenLink to bring together a select group of key metal market participants, each with a different perspective on the challenges faced, and each with a different insight into them. The Chatham House Rule has been invoked before discussion begins, so no names of the participants are given in this report – just an indication of the industry or market sector in which they are engaged.

Overall, broad agreement on what the challenges are emerges, but not necessarily a consensus on how they should be addressed. This is a summary account of the discussion, covering some of the most keenly felt and hotly debated issues in the market.

Regulatory issues

The theme that recurs the most is regulation: those present agree that, in its various guises, it is putting a great deal of pressure on the metals trade.

The London Metal Exchange itself, in its role as both a quasi-regulator and a trading platform, finds itself in an interesting, even difficult position. "You have the [international regulators], and a lot of market participants who see regulation as a huge problem for their business," an exchanges expert says. "The challenge for an exchange is thinking about how much regulation should be absorbed, which is a significant cost, and how much should be passed on to members."

The difficulty, he says, is in striking the right balance. A price administrator or any trading platform cannot be seen to be a "light touch".

LME members are therefore faced with the possibility of regulatory burdens being passed on to them by the exchange, as well as pressures from new European legislation, such as the European Market Infrastructure Regulation (EMIR), according to a participant working for a trading company.

It is EMIR, he adds, that is particularly ill-equipped to address the issues specific to the metals industry in Europe. "In reality, has the application of EMIR made the trade industry clients' relationship with brokers safer? No, it hasn't," he says.

"It's made availability of credit more difficult and more expensive. It's concentrated the number of brokers that can get credit under the regulations to a smaller amount – it's now banks and financial institutions principally. From a trade perspective, I think it's had the reverse effect [to the one intended]," he adds.

Indeed, the introduction of EMIR may be responsible for the recent reduction in financial players in the trading space, a participant at a financial institution says – good news for those left, but presenting a reduction in the number of counterparties available.

Further downstream, meanwhile, the cost pressure created by such regulation is less keenly felt, a participant connected with an aluminium consumer says. "We're fixed through our supply business. The cost is probably there, but it's not transparent. We see an offer come through from a supplier who may be dealing with [a large financial institution] but generally we're going through our suppliers, so it doesn't make a massive amount of difference to us. Is there a cost element? I'm sure there is," he says.

A participant from a manufacturer of downstream products adds, however, that the effect of EMIR is still being played out. "We're still in that evolutionary process. There are still a lot of question marks over who's going to absorb the cost," he says. "Credit, for us, is a huge issue. We find it very hard to work without credit. It's going to be a big headache."

It will be smaller downstream manufacturing companies who bear the brunt of the cost, the trading company participant adds, and the financial institution participant agrees. "It's made it far more onerous for smaller players. We take a lot of responsibility for getting them through the regulations... it's just made everything so much more complicated," he says. "Sales people and traders are spending so much more time on paperwork and ['know-your-customer' work], which makes everything more expensive."

Regulation as a concept is not the problem, the participants agree – metals markets should be subject to the same level of governance as any other – but they believe those devising and implementing it do not have a full enough understanding of the dynamics in metals markets.

A participant from a brokerage adds that LME members themselves are, in effect, having to perform the function of a quasi-regulator, as those at regulatory bodies lack the necessary closeness to the market. "Either they don't know how to do it or, very cleverly, they've outsourced it back to us. We have to be our own creator of structure and our own policeman in order to ensure that things are managed properly," he says. "We also have to be our own judge and jury by confessing to mistakes, so we end up getting fined by the guys who aren't doing the work in the first place."

There is genuine anger, he says, about the way regulatory structures have changed in the UK, especially in recent months and years. "The UK authorities have become puppets to European infrastructure" the brokerage participant says. "Their understanding of the issues is so alien to what the rest of us understand. It's remarkable. At the moment, [concern over] market abuse seems to be pretty much above everything else that's going on. They believe the whole world is abusing the market."

Much of this is to do with highly publicised cases such as the LIBOR fixing and the gold price rigging scandals, creating what some see as a culture of excessive monitoring. Regulators are preoccupied with the prevention of market abuse, the brokerage participant adds, and he believes this close scrutiny is now out of proportion.

"I don't have a problem with a clean, legal, transparent marketplace. The problem is that transparency is actually almost disappearing. The number of participants [on exchanges] is reducing and the number of transactions finding their way off-exchange is growing," he says. "It's cheaper, it's easier and it's less cumbersome. There will be brokers who will say, 'we will give you credit, but don't [use] the exchange because we can't afford it.'"

This has led to a migration of business into Asia, the financial institution participant says, and away from the watchful eye of the CFTC, the FCA and other western controls. In the west,

furthermore, there will only be more regulation coming down the line, according to a participant with a metals investment company.

"Regulators in Brussels want a full equity regulation system in place for everything. In commodities, questions like what's insider knowledge and what's specialist knowledge are being asked. If your mine has stopped producing, is that something you can trade on? Does that affect [metals] prices?" he says. "The whole thing becomes chaotic. There are only three or four large metals traders in the world and yet you are limiting the size of their positions. I don't know how that can happen... you're getting rid of everything that's worked and putting in a system that was built for another market."

The effect, he agrees, will be to transfer liquidity to the east, to Shanghai and Singapore especially, and the exchanges expert supports this view. "European legislation is having the effect of creating a more difficult place to trade... and the US have equally onerous rules," he says.

One such requirement is the necessity for US-domiciled banks to reference prices on US exchanges in order to hold commodities. "There will be leakage to other markets... there are a number of people who don't trade outside London, but there will be plenty of people who will have mobile capital," he adds.

Indeed, the market may already be "down the line", the downstream products manufacturer says. Gone are the days, he says, when it would be possible to have a brief discussion on a transaction or a financing requirement, and reach a decision almost immediately afterwards. Now, he adds, banks have their own, often intricate compliance procedures, which must be followed and add a considerable amount of time to the process.

One issue now faced by banks and financial institutions more than ever is the need to avoid major spikes in profits and losses, according to a participant at a second financial institution. "You are in a lose-lose position. You can make ok money, but you can't take the amount of risk you would have taken ten years ago," he says.

The ability to take on risk has also been reduced by the prospect of huge fines, according to the metals investment company participant, especially in relation to gold pricing. "Why would you, as a bank, take part in the gold fix? There's no money in it and you [could] be given a billion-dollar fine," he says.

Equally, the downstream manufacturer says, those seeking finance are finding themselves falling at the last hurdle when funders are held back by increasingly strict internal controls.

The withdrawal of banks from metals has had a bigger impact than when they were entering the market, according to the brokerage participant. Banks' entry into the market created liquidity and competition, he says, and those seeking finance were almost spoilt for choice. Now, however, along with the consolidation

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Views explored in the City of London

within the space, banks are taking a much more selective approach to their client base.

"It's putting all the pressure on the residual community. While the opportunities are more plentiful than they were, the smaller [brokers] are having to satisfy a voracious appetite from a huge audience," he says. "They can't do it. I don't know what's going to have to give. I would like to venture that we've not seen anything yet on costs rising... there's going to be wholesale culling of people not producing the right results for people taking the risks."

Among banks, following the exit of players from the metals space, those left are asking whether they should be focusing on other markets, the participant from the first financial institution says. Larger players, at the same time, can be much choosier about the people they work with, he adds.

They are in a position to "cherry pick", the brokerage participant adds, and do not have to be as competitive to stay afloat. "We need to ensure we're still making returns on capital that the bank has allocated to the commodities space, and if we're not, then we won't have a commodities business. Regulation definitely eats into margins," he says.

The Chinese component

Another theme on which participants were united is that of the importance of China. As growing numbers of market participants head east, there are numerous lessons to be learned about the way business is done there, according to the metals investment company participant. "Trust is a big deal. You've got to be physically in China. It's difficult, but you've got to find the right partners. The rule of law is difficult to rely on if you get to a position where you need to go through the Chinese courts as well," he says.

Indeed, because of compliance implications, some banks are becoming more cautious in their approach to China, the participant with the first financial institution adds. "We don't have huge direct Chinese exposure, particularly since the financial crisis. Banks have become much more conservative," he says. "Risk and compliance departments can't understand and don't know much about the financial background. They won't deal with [China]." Because of the necessity of building trust and forging relationships, furthermore, straightforward financial analysis is not enough.

At the same time, despite the potential problems associated with the ever growing nature of the Chinese economy, there is still great potential. "It was one of the attractions when the LME was considering going to an eastern owner, rather than a western owner – they saw the potential of doing business in [that part] of the world," he says.

Because of the risks attached to moving east, moreover, it is extremely important to have a base on the ground in China, according to the trading company participant. "In China, you are either in there, or you aren't. You've got to be on the ground, constantly," he says.

The downstream products manufacturer agrees: because of the pace at which the Chinese economy is developing, it is necessary to be present there, particularly given the potential influence of Chinese consumption power.

By the same token, especially in the wake of the MF Global bankruptcy, Chinese companies are looking to build their presence in the west. "After MF Global had its problems, Chinese [companies] accelerated their approach to London. It told them they have to be in London. A lot of them don't wish to operate through western brokers or western banks," the trading company participant says. "In a few years, there might be more Chinese members [of the LME] than category I and category II western members." The increase in Chinese presence in London will not happen overnight, however: Chinese members will work slowly, the exchanges expert adds, building infrastructure and taking on staff with experience of the exchange. "You have to be cautious when trying to build market infrastructure and preserve option value as well," he says.

Funds in China

"In March last year, with the big fall off in copper, [Chinese funds] came to the LME. It was Shanghai leading the LME rather than vice versa," the first financial institution participant says. "They got into large positions and a lot of big funds sold Shanghai heavily, and then two months later, they were still trying to sell. They lost a lot of profit from the initial move in January."

This has not slowed their interest in metals, however. Chinese funds continue to be extremely active, the trading company participant adds, and their influence is only likely to grow.

The situation is similar to that witnessed after the birth of commodities funds ten to 15 years ago, according to the brokerage participant – and this may be dangerous. Those trading in the early days were very successful, he says, but they became victims of their own success.

"The more they were trading, the more money they were managing, and the pressure on them to create bigger results was getting bigger," he says.

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"They took bigger and bigger positions and then we went through a period where funds were collapsing. There are a lot fewer people trading commodity funds now than there were five years ago."

This brings the conversation to the nature of funds in China: part commodity trading advisor (CTA), part hedge fund. They are also very well capitalised and inclined to speculation, meaning western markets may struggle with their presence, according to the brokerage participant. "I don't think western markets will be able to handle it. Some of these guys make [certain western funds] look tiny," he says.

For downstream players, the recent swings in prices, linked to the Chinese funds, have been a particular problem, the downstream products manufacturer adds. "If you are a manufacturer and you are seeing $1,500 to the downside, that volatility is the biggest killer. It's not the price itself," he says. This has led to an uptick in longer term hedging from manufacturers, in the view of the first financial institution participant, including one company hedging nickel out to 2023.

Part of the issue, the exchanges expert says, is that there is a risk of contagion of volatility from the Shanghai Futures Exchange (SHFE). "The limit down feature effectively shuts down the market when it's 5% down. You can go and hammer the price and then there's contagion into the LME at an illiquid time of day that has ramifications throughout the day," he says.

There may be two approaches, he adds: one would be to create more segregation between markets, while the other would be to embrace the connection and try to dilute in a broader pool of liquidity. "If these guys were playing directly on the LME, at a liquid time of day, would that be a better or worse scenario? That needs to be considered," he says.

Trading at a more liquid time of day would mean a major shift in base metals prices could potentially have a less pronounced impact, as more buyers would be present, the downstream products manufacturer adds.

This is the point at which a position limit may be useful, according to the exchanges expert, as volatility may be diluted if it does not come from a single source; the participant with the second financial institution agrees.

The aluminium consumer participant states, meanwhile, that the presence of these funds in the market may not be as negative as some believe it to be. "A lot of people in our environment think funds are bad and shouldn't be in commodities. We don't subscribe to that," he says. "You do get opportunities to hedge long term. We just need to have the right tools to be able to take advantage of that."

Premium contracts

The prospect of premium contracts on the LME remains a hot topic, although the launch has been pushed back to November to coincide with the launch of LMEmercury, the exchange's clearing platform. "The premium contracts were proposed initially in that original 2013 consultation by producers who didn't want warehouse reform," the exchanges expert says. "They said just provide people with a way of hedging their risk – that's the real problem. It's not about the all-in price, it's about lack of visibility and hedgability of the premium."

The decision was eventually made to bring in premium contracts in addition to warehouse reform – most notably, the introduction of the linked load-in/load-out rate – but there have been various delays. Chief among these was the consultation on other measures that could have an impact on contract implementation.

In the meantime, however, the premium component of base metals prices, and especially aluminium, has become less significant. Indeed, although there has been a small uptick in recent weeks, aluminium premiums globally have fallen markedly since late last year. In the case of European daily duty unpaid premiums, for example, levels peaked in November 2014 at almost $427 per tonne, and dropped as low as $95 in May 2015. "That may well mean [the contracts] don't do the volume that the exchange had hoped for," the exchanges expert adds.

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The issue, according to the first financial institution participant, was that aluminium premiums became a much larger component of the price than ever before. The uptick emerged in the wake of the surge in interest in warehousing deals after the global financial crisis, which led to huge delivery queues, peaking in 2014. "We fundamentally didn't understand what the premium was any more when [the duty paid in-warehouse Rotterdam] premium got to $520 per tonne. I refused to try to forecast it," he says. "I knew what it was historically and what the drivers were, but why should it have been $520 rather than just a question of insurance and freight costs?"

To a certain extent, premiums have already unwound as queues have declined and spreads have begun to shift away from huge contangos, especially on the long-term forward curve. But the idea behind the LME's premium contract is the same: to increase transparency and discoverability, while also offering protection against unexpected spikes.

Users of aluminium are already aware of the need to try to protect against volatility, furthermore: the aluminium consumer participant adds that premiums are now commonly referenced in supply contracts. "It's a risk within a contract that needs to be managed if there's a way to manage it. If we have the opportunity to do that, we would look to lock it down," he says.

There are questions over whether there will be much uptake on the contract now that premiums have shifted away from all-time highs, but the brokerage participant suggests it may be a "slow burner".

According to the trading company participant, however, the contract may be "doomed to fail". "The producers and the consumers were saying, 'if only we had this premium contract, the queues would disappear'. It wasn't true, but it was out there. That doesn't mean it was right to launch an actual contract," he says. "When it's high, consumers want to hedge, and when it's low, producers want to hedge."

The aluminium consumer participant disagrees, meanwhile. "We will put together a contract with a [packaging] supplier. The LME price and a premium will be in there. They will say, 'what range has that moved in for the past year? Does it fail to meet hedge effectiveness criteria?'" he says. "It is considered within hedge effectiveness, even with a softer premium."

The exchange must also have an eye on other markets where price and premium spikes may be an issue, the manufacturer of downstream products adds. "If copper goes to $12,000, what [will the industry] be faced with? What structure would it need to have in place? Let's not get it into an aluminium situation. Let's use our best efforts to make sure markets are orderly if and when it comes along," he says.

The choppiness of the market, which it may not be possible to predict, makes it difficult to manage risk, the second financial institution participant adds.

Conclusions and possibilities

It is clear that systemic and systematic change will be needed in the metals space in the coming months and years. The industry also survived the crisis and "performed remarkably well" through it, the metals investment company participant says, but it may not fare so well during any ensuing crisis. "By changing the regulatory environment, there is a threat to liquidity and pushing business into unregulated areas. We risk doing badly during the next crisis," he says.

But the outlook is not necessarily as bleak as it may seem, according to the brokerage participant. "I think there are still opportunities for new people to come in... It's not an easy business to develop, but it's still remarkably interesting," he concludes.