

Credit, counterparties and the fragility of the trade

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The thin margins of the physical trade are accompanied by large exposures. A trader that buys a cargo of oil worth fifty or a hundred million dollars and sells it to a refinery on thirty days' credit bears, for the duration of the voyage and the credit period, the risk that the buyer will not pay, that the bank that issued the letter of credit will fail, or that the cargo will be lost. A trader that finances a producer through a prepayment, advancing money against future deliveries, bears the risk that the producer will not deliver. A trader that holds positions on the futures exchanges must provide margin when prices move against it. A sudden movement can therefore require large amounts of cash at short notice.¹

The history of the industry contains many examples of traders that failed because these risks materialised: through the default of a large counterparty, through fraud in the documents on which financing was granted, through a price shock that triggered margin calls the trader could not meet, or through the withdrawal of the banks that financed it. The failure of Petroplus in 2012, described in Chapter II, and the series of fraud cases in commodity finance in Singapore and elsewhere in 2020 showed that the trading business can be fragile despite its size.² The largest traders have responded by building up their own capital, diversifying their sources of financing and, in the case of Glencore, by integrating into production. For the practitioner, the fragility of the trade means that the documentation of every transaction, the verification of every counterparty and the security of every financing must be taken seriously. Part E examines these questions.

1 Notes

1. Craig Pirrong, "The Economics of Commodity Trading Firms", white paper, University of Houston, March 2014, research financially supported by Trafigura, bauer.uh.edu (PDF): counterparty credit risk

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managed through credit limits for each counterparty; a firm that hedges a cargo must cover a loss of value on its futures position immediately through a variation margin payment, which creates liquidity needs. See also the Geneva volume, Part H. ↩

2. Global Trade Review, "ABN Amro to exit trade and commodity finance after losses", 12 August 2020, gtreview.com: Hin Leong Trading (Singapore) collapsed in April 2020 after its founder disclosed about US\$800 million of undisclosed losses; ABN Amro's exposure of about US\$300 million contributed to its exit from commodity finance. The Agritrade International case is not covered by this source. Treated in Part E. ↩

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