LME Insight

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SETTING THE GLOBAL STANDARD

Commodity financing: how hedging on-exchange can benefit both borrowers and lenders

The global commodities industry has typically relied on commodity financing deals because of many defining structural characteristics such as heavy initial capital investments, lengthy global shipping routes and long production cycles. This stands true of the metals industry as a number of tailored financial arrangements have been used for decades, if not centuries, including mine, trade and inventory financing. A common trait of these financial operations is that they aim at utilising now the future economic value of the company's assets, whether these already exist as refined material or are under development i.e. still need to be mined out of the ground.

Two of the ways in which some commodity financing deals, for example inventory financing and in-transit financing, can be executed are:

1. transfer of ownership, as in the case of a repurchase agreement (repo) – the creditor purchases the commodity with a commitment to sell it back at the expiry of the agreement
2. pledge of collateral without a title transfer – there is no transfer of ownership for the commodity pledged as collateral but the creditor has a right to the material if the borrower does not make the necessary repayments or defaults on the agreement. This can be likened to a real estate mortgage, where the deed to a house is not transferred to the mortgage lender, but the lender has a right to repossess the house if the borrower defaults on the repayments.

This article deals with the second type of financing agreement.

What risks are lenders exposed to?

As borrowers seek to utilise the future economic value of their asset(s), lenders are simultaneously exposed to a number of risks during the life of a financing deal such as credit risk, interest rate risk and collateral risk.

Lenders are experts in analysing and modelling credit risk, as this is the type of risk they wish to get exposure to when offering a loan. The lender's reward for assuming credit risk is factored into the price models that help determine the financing rates offered to borrowers. Interest rate risk is the opportunity cost of the lender to provide credit to a certain borrower, compared to other investments it could make with its available capital, and can be easily hedged in the fixed income markets.

Collateral risk describes the risk that arises from accepting an asset – whose value can move up and down – as collateral to guarantee the value of the loan.

While a lender may be willing to increase its credit exposure to a certain counterparty, uncertainty over the future economic value of the collateral being pledged may reduce their appetite. Lenders are not often experts in the underlying markets in which the borrowers operate and are usually not seeking

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exposure to the volatility of metal prices via their lending operations. To manage this risk, lenders often reduce the amount they will lend compared to the notional value of the collateral (or give it a “haircut”). The more volatile the price of the asset the higher the haircut is likely to be as lenders try to minimise their exposure to collateral risk.

Another way for lenders to manage collateral risk is to require the borrower to hedge the value of the collateral being pledged, so that, with a reduced exposure to price risk, they can apply a smaller haircut and loan more capital.

Managing collateral risk – the role of hedging

Benefits for lenders

Lenders have much to gain from requiring borrowers to hedge the metal pledged against their financing arrangement as this reduces several risks for the lenders themselves, allowing them to obtain better risk-adjusted returns on their capital.

First of all, hedging lowers the risk on the loan itself as the value of the collateral is guaranteed for the duration of the loan. In case of a default, and subsequent foreclosure, the value of the asset is not impacted by current market prices because the lender can sell it at the current market value and make up the shortfall via the hedge. This is the main reason lenders reward borrowers that hedge with lower haircuts.

Secondly, hedging could lower counterparty risk, as borrowers that hedge tend to be exposed to less price risk. This allows lenders to increase exposure to certain companies if they wish.

Benefits for borrowers

Hedging, especially when integrated in a financing transaction, can also bring many benefits to the borrower. A lower haircut means that more money can be borrowed in the same transaction, reducing the need for more expensive forms of financing such as unsecured debt or equity. This can lead to a more efficient use of working capital. For example, the additional working capital could be leveraged to provide more competitive payment terms to clients and suppliers, or invested back into the business/project. Furthermore, hedging generally leads to lower price-risk exposure and reduced impact of metal price volatility on margins. Businesses that hedge can focus more on their core business rather than on guessing future price moves of their assets.

OTC versus ETD hedging

Hedging of collateral used in financing deals can be executed in two main ways, using exchange traded derivatives (ETD) or over-the-counter (OTC) derivatives. While exchanges provide central marketplaces where several counterparties provide common liquidity and transparent prices, OTC transactions refer to bilateral deals that are usually limited to two counterparties. Below are some of the key issues to consider when structuring a hedge for a financing deal on-exchange or OTC and the implications of using either option:

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Consideration	Impact	On-exchange	OTC
Managing the margin requirements on the hedge	Having to manage initial and variation margins adds an additional consideration on a company's working capital	Initial and variation margins can be financed by the lender itself or by a third party via a tripartite agreement (TPA) for margin funding	OTC transactions often do not require margins, but are exposed to higher counterparty risk, which can result in much wider spreads in order to include credit value adjustment (CVA) charges
The hedge needs to match the financing (including any amortisation)	Over- or under-hedging the financing creates risks for both counterparties	Liquid on-exchange markets allow for adjustments of the hedge to match any changes in the financing schedule	OTC transactions are bespoke and can be tailored to the specific requirements of a deal. Any further adjusting would require the agreement of the counterparty
In case of a default the hedge and the loan should be exited simultaneously	Uncoordinated unwinding of the two could create unbalanced and unhedged positions	On-exchange positions can be closed out in the market with new counterparties	As the transaction is bilateral, appropriate clauses must be agreed upon at the beginning of the deal with regards to the unwinding process of the hedge in a default

Conclusion

Appropriate risk management practices allow for a more efficient allocation of capital and bring benefits to all sides involved in a transaction. Borrowers may be able to access more financial resources at a lower cost, therefore improving their capital structure. On the one hand, lenders are able to increase their exposure to certain companies and sectors, and on the other, reduce their exposure to risks they are not comfortable assuming – such as metal prices.

For more information on hedging on the LME please contact Alberto Xodo.

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