The *renaissance* of STCF

John MacNamara sets out the framework that makes up structured trade and commodity finance and how its constituent parts all come together

Structured Trade and Commodity Finance (STCF) is one of those 'minority sport' headings covering certain types of commercial lending activity which, as an expression, will be instantly recognisable to the cognoscenti working at commodity corporates and at many banks. However, in contrast to other parts of the corporate loan market, it is a much less standardised market – not even the word order of the heading is standardised across all banks, never mind the makeup of which structures count as STCF and which should be excluded.

Nevertheless, there is broad agreement that this long-established and in some ways quaintly old-fashioned product suite has become increasingly useful in the post Financial Crisis world, not just because of the credit and market risk mitigation it offers, nor even because of its popularity in syndications with corporates, banks and other non-bank financial institution (NBFI) investors, but also because it can help address many of the issues raised by compliance functions as lenders now all grapple with 'non-financial risk' on top of the more familiar focus of simply getting repaid.

What is included as STCF?

A long time could be spent on this topic, because the market view seems to depend on where one sits. The Wikipedia definition of STCF is: 'cross-border trade finance in emerging markets where the intention is to get repaid by the liquidation of a flow of commodities'. However, this is a rather dated assessment, written in the last millennium and published in 2001. It also dates from before Basel II and before the Financial Crisis.

In the LMA 2013 book entitled 'Developing Loan Markets',1 the chapter on pre-export finance (PXF – in the sense used in the LMA template for PXF), defines PXF as: 'a method of corporate lending where repayment is structured around future export revenues'. However, clearly there has been some 'mission creep' since the last millennium and STCF should not be seen only in terms of PXF. In order to look for something more recent to explain the scope of this product group, current specialist media websites like 'TXF Data', from the eponymous media group specialising in trade and export finance, bring together the following products under the heading of STCF:

- PXF/prepayment finance (PPF);
- borrowing base finance (BBF);
- reserve-based lending (RBL); and
- RCFs for commodity traders and producers (normally unsecured).

In terms of the traditional commodity cognoscenti, it is probably the last category which is the most troubling, since this is neither 'structured' nor 'trade' nor 'commodity' finance, and so it is effectively no different from any other type of unsecured corporate loan, except that it is made to a 'commodity corporate'. Purists may well therefore exclude this, but more on evolution later.

Thus there are two basic types of loan products in STCF: performance-based lending (also called 'performance risk finance') and asset-based lending (also called 'asset-based finance').

PXF and PPF facilities are both 'performance-based lending' structures where classically, as defined above, the credit is structured around an export contract between an exporter (the seller) and an off-taker (the buyer). The proceeds of the exports are typically used to enhance the repayment of the loan and the credit risk of the borrower can be monitored through the due performance by the borrower under the export contract. Meanwhile BBF is the most commonly used structure for 'asset-based lending', and RBL combines elements of both.

The nature of the reliance on the strict legal enforceability of collateral means that BBF is predominantly preferred in developed markets, while the potential for the performance-based lending to combine with security over 'offshore cash flows' (in the sense of the capture, offshore, of export proceeds as the mechanism for securing repayment) means that these structures are preferred in developing markets. In some countries, most notably in China and the US, a financing structure similar to a PXF is used, with the difference that financing is structured around a domestic sales contract and not necessarily based on exports (so 'pre-delivery' rather than 'pre export'). This is a reflection both of the size of these economies and the lack of concern lenders have about currency inconvertibility in these two countries.

The last 20 years

A STCF practitioner working in the mid-1990s was in the middle of the Asian crisis (1996/1997), had seen the Iranian default, and was soon to experience both the Russian Moratorium (1998) and yet another Brazilian devaluation (1999). Those particularly experienced in the market had also probably been around for the Latin American sovereign debt crisis of the 1980s.

Consequently, and unsurprisingly, STCF products at that time were very much focused on mitigating 'country risk' and specifically 'transfer risk' which, by and large, the 'performance risk' products did quite well, so long as the borrower did not actually go bankrupt, at which point the 'performance risk' suddenly became 'payment risk' after all.

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A decade of 'commodity super cycle' later, however, and the world looked very different. Ever higher commodity prices saw a mass transfer of central bank reserves to the commodity producing countries, leaving even the US only just inside the top 20 by FX reserves (according to the World Bank) while at the 2008 peak, the top five included Russia, Brazil, and of course (still number one today by a very long distance) China. At this point, fears of Russian or Brazilian transfer risk (never mind Chinese) had all rather receded.

China, of course, has always been something of a special case. Two decades ago, with the Chinese economic recovery just starting, China was embarking upon its journey towards becoming the 'workshop of the world' and pretty rapidly became the largest importer of almost all commodities on the planet, and certainly of steel, coal, copper, aluminium, soya, eventually oil, and a whole host of other commodities.

This, of course, was one of the major planks in the so-called super cycle because the Chinese seemed to have an insatiable appetite for everything and, as the argument ran, eventually everything would run out. Higher prices and central planning, however, incentivised the growth of Chinese commodity production, particularly in the space of technically specified commodities – i.e. the ones which are made rather than simply dug out of the ground – and the results have been nothing short of heroic.

In 2002, Russian aluminium was churning out approx 4.5mn tonnes of primary aluminium, to China's 2mn tonnes. In 2015, Russia produced 3.6mn tonnes, according to public sources, while Chinese production, depending on whom you believe, was anywhere between 31.6mn and 38mn tonnes. It has been a similar story for steel, where the Chinese now produce over half of everything. In copper, while not outright number one, they are in fact number two after Chile, having overtaken more traditional names like the US, Peru, Congo and Australia, having doubled production in the last 10 years alone. The big importer now has such huge domestic production that it flips into surplus across a number of commodities and has started exporting, with dramatic effect. Today, one cannot really say one is 'in STCF' unless they have at least a toe in China.

Where the STCF market stands today

Looking to 2016, TXF data from the 'TagMyDeals' website (which enjoys widespread participation across the commodity banks to track who is financing what and from whom) shows that, during the first half of 2016, there was a major shift in the location of STCF deals: 60% of the market currently resides in Europe and North America. By contrast, the developing markets are demonstrating decidedly low volumes, with the whole of Latin America accounting for just 2.3% of transactions, and Africa a mere 0.5%. This has prompted some to question whether the 'elephant' PXF and PPF deals of old were really mammoths, and have therefore become extinct.

Equally worrying for the structured end of the market is that nearly 70% of the volume collated by TXF is represented by unsecured deals, typically RCFs, for traders and producers. While it is tempting to argue that it is entirely possible to miss 'elephant' structured deals during the course of a six month window, nevertheless, given that there are individual and very large commodity traders out there with RCFs to the order of US$17bn plus, it is easy to see how the RCFs now overwhelm even the jumbo PXF/PPF, the largest of which (and in a different oil price environment, back in 2013) did not exceed US$8.4bn.

Critics may see this significant proportion of unsecured lending into the commodity trader/producer client segment as a form of 'product erosion'. Certainly, some of the longest-standing STCF borrowers have long ago seen their structures 'lighten' significantly as lenders became more confident in their track record, and the great African STCF names like Cocobod and Sonangol enjoy an enviable absence of transactional encumbrance. The commodity traders of course have taken this drive to abandon security to new heights with their entirely unsecured RCFs, and yet one may also say there are 'traders' and there are 'Traders': the top-tier Traders today are of a wholly different order of financial magnitude from the more timorous beasties of 20 years ago, and frequently make more profit than most of their banks.

That said, RCF volumes have halved over the last 12 months and, as ever in the commodity world, it seems there is a cycle in these things: yes, the prettiest big boys still get away with unsecured jumbos, but just as RCF volumes come down, so some borrowers, particularly among the producers, now have to offer security to get the best rates, or even just to get the liquidity at all, rather than risk being publicly snubbed by the unsecured market. The TXF data puts the market share for structured deals for producers at a more balanced 44%.

Where is STCF heading?

The STCF market remains a stubbornly successful corner of the modern financial landscape. The basic design still works pretty well, and continues to survive commodity price volatility, geopolitical events, and massive regulatory change. Stick around long enough in STCF and you will see plenty of competition from easier ways of doing things, whether from the bond markets or even the plain vanilla 'loan', but traditionally, when all that goes horribly wrong, and those alternatives are no longer available, then the good old fashioned STCF product starts to look like quite an attractive solution. If anything, the latest changes to the global landscape leave STCF looking uniquely well equipped to travel this terrain.

Commodity prices at the time of writing are quite decently up on the lows at the end of 2015, yet the popular perception, shared apparently by regulators, is that they are 'dangerously' low, meaning that banks should consequently avoid over exposure. That said, it is probably better to lend against commodity collateral or flows after a price correction than before, and at the same time, it is worth remembering that those well established in the sector have seen all this before. At the very least, the sector now enjoys a wealth of easily accessible data as was never the case before, and banks can generally show both that commodities were being produced and traded when prices were at outright historical lows, and were also being processed and consumed at the historical highs. Everything is relative, but commodities do not go away.

There has, however, been a big shift in what is meant by 'country risk', and the ability to predict geopolitical crisis seems to diminish by the day. Few saw the Crimean crisis coming in 2014/2015 and the consequences for many STCF facilities in Ukraine are still being worked through (although interestingly, PXF lenders have generally been able to preserve some sort of priority over bondholders and other unsecured or unstructured lenders, at least by tenor, so that PXF gets repaid first). With China, even in a 'not growing quite so fast as usual' year, the country still enjoys by far the greatest central bank reserves in the world, and therefore STCF lenders tend not to worry about China in terms of transfer risk or liquidity (the 'Asian crisis' was a long time ago and was not really China anyway).

The big opportunity however for STCF, is to rise to the challenge set out by regulators, not just to mitigate the traditional targets of credit risk, market risk or country risk, but also to address the new focus on non-financial risk, with possibly the best solutions available to any form of investment. The STCF market ought to perform rather well here. STCF has always been about knowledge. The great thing about the commodities space is that there is a huge amount of data. Commodity pricing is easily discovered. There are established patterns of trade and market norms. Production, shipping, storage and even processing and consumption are all matters of record.

The now 'old' Basel II language about banks needing 'robust mechanisms' which should allow them 'knowledge and monitoring' of the transaction, quite apart from offering recognition of both 'collateral' and 'structure' subject to various operational conditions, are all aimed at the traditional risks, but are all well within the grasp of most STCF lending banks in the market (which may also explain why these teams have weathered the transition to Basel III and CRD IV rather better than the commodity trading teams within banks).

If one now looks further to address prudential conduct in STCF, in fact it is quite a short step to take. It is relatively straightforward to embed a dedicated purpose and application of funds in loan documentation, to be very clear where the commodities come from/go to, and how the revenues which repay loans are generated. It has also long been considered good practice in STCF circles to include in the due diligence not just desk-top analysis of printed sources, but also to participate in the 'boots on the ground' site visit, which is no longer dismissed by senior management as 'industrial tourism' by the specialists, but is rather now part and parcel of the whole KYC process – of course a bank should know its clients, and see what they do, if one is to judge whether the transaction is 'appropriate and suitable' (in the latest regulatory language) for its needs.

Excluding, for this purpose, unsecured RCFs under the STCF banner, the 'full fat' STCF products have the potential, if required, to be very specific about the whole asset conversion cycle being financed, providing a fully evidenced audit trail from front to back, from the way in which the money gets used, through to how it comes back for repayment. There may soon come a time when this will be the only basis upon which loans are made.

John MacNamara is managing director of Structured Trade and Commodity Finance at Deutsche Bank

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This is an extract from an article first written for "20 Years in the Loan Market" (2016) by the Loan Market Association (LMA), a book produced to mark the Association's 20th anniversary. Written by senior loan market practitioners, it outlines the evolving nature of the loan product and provides an overview of the current state of the market, along with challenges and opportunities ahead. www.lma.eu.com