SwissBanking

SwissBanking|Factuals

Switzerland as a commodity trading centre

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Preface

Commodity trading is an unwieldy concept. Commodity trade finance is yet another category more complicated. But the commodity trade is a key factor for global economic development and enhanced prosperity. Commodities such as oil, ores or grains are shipped from one place in the world where there is a surplus supply to another where they are needed for the production of goods or for consumption. Suppliers and consumers or users are brought together by commodity traders. The act of trading also implies paying and hedging; this is where commodity trade finance comes into play. The present paper explains the important role that Switzerland plays in purchasing and reselling commodities and how the financing mechanisms work.

The activities of commodity traders and the financial aspects of the commodity trade in particular will be considered in detail. This comprises the financing of the physical commodity trade, which is the main area of banks' market involvement in Switzerland. However, this paper cannot cover the entire value chain in the commodity trade, from extraction and production through transportation to further processing. Contrary to a widely-held opinion, derivative financial instruments – which are traded only very marginally in Switzerland – are not the main activity of Swiss banks in this line of business.

In recent years the commodity trade made a significant contribution to Switzerland's economic development and is recognized as an independent sector today. Nevertheless it has recently been easy for prejudices and (mis)information overlaid with emotions to influence public opinion negatively. Our position paper does not intend to anticipate political debates. By creating transparency, it aims to contribute to an objective discussion and to show that the commodity trade and its financing are regulated and useful business areas which it is worth promoting.

Claude-Alain Margelisch
CEO, Swiss Bankers Association

Executive Summary

Clustering by various drivers

A package of favourable general conditions and locational factors has meant that over the last two centuries Switzerland gradually developed into the global commodities hub. The relevant drivers include pull factors such as a stable political environment, legal certainty and an internationally competitive tax system as well as push factors, such as an inadequate rule of law or political instability in the exporting countries. Trading in general and trading commodities in particular lead to increased economic welfare. In the area of physical commodity trading, a significant cluster has formed in Switzerland with 570 trading companies and over 10,000 employees. The commodity trade today is perceived as an independent sector of the economy that earns approximately 3.6% of Switzerland's gross domestic product (GDP). In 2010 as much as half of Switzerland's GDP growth was attributable to the commodity trade. As a commodity trading centre, Switzerland has decades of experience of the relevant expertise in trade finance.

Distinction between commodity traders and derivatives traders

Commodity traders transport commodities from one place to another and/or organize brokerage of commodities. They ensure sufficient and reasonably-priced availability of in-demand commodities of the desired quality. Derivatives traders, on the other hand, use financial instruments to benefit from rising or falling commodity prices. Major derivatives trading centres are located in Chicago, New York and London. Their existence is a prerequisite for trade financing on favourable terms and to hedge market risks. The proportion of derivatives traded in Switzerland is extremely low at 3%.

Financing through banks makes the commodity trade possible in the first place

Commodity trade finance is closely linked to commodity trading itself through the banks (known as commodity trade finance). The role of the banks is mainly to meet the financing requirements faced by the trader as a result of the purchase and further processing of commodities (conversion, tolling, blending of raw materials), and the handling of their transportation. Without this financing, it would not be possible for commodity traders to ensure the purchase, transportation and price hedging. These so-called trade finance facilities are usually short-term, purpose-specific financing operations (known as transactional finance).

Broad regulation already in place

A broad range of rules, regulations and laws provides an appropriate framework for the commodity trade and its financing. Thus, for example, both domestic and international legislation and sanctions have to be observed. In addition, the banks apply various due diligence measures that include customer identification and individual risk assessment and prevent money laundering. In the area of transparency, in addition to the efforts made at the European level and by the USA, there are also voluntary initiatives aimed at disclosing flows of money transparently. Switzerland has been very actively involved in the implementation of voluntary initiatives such as the "Extractive Industries Transparency Initiative" EITI. Switzerland is a pioneer in the area of combating corruption.

Introduction

Commodity trade as an intermediary between demand and supply

The commodity trade is an important business for the economy and one that is growing strongly with globalization. As commodity market specialists, commodity traders act as intermediaries between the producing and the consuming markets. In doing so, the commodity trade ensures that resources are distributed between the regions that have a surplus and those that are experiencing increased demand. The commodity trade plays a central role in creating a balance between supply and demand.

Commodity trade is extremely capital-intensive

The commodities traded are energies such as oil, gas, coal and electricity, metals and ores and agricultural products such as grains, sugar, coffee, vegetable oils and soya. Without this trade, the availability of commodities at the destination locations would not be assured. Financing of the commodity trade (known as commodity trade finance) is closely linked to the commodity trade itself and is usually conducted through banks. Since the commodity trade is very capital-intensive, proximity to a financial centre and the relevant know-how constitutes a competitive advantage.

Increasing criticism from NGOs

The commodity trade is also a topical and controversial issue in numerous initiatives in the Swiss Parliament. The initiatives go beyond food speculation and include areas such as, for example, transparency, money laundering and human rights. Between the two extremes of the great importance of the commodity trade to the economy and the political debate, there is a growing need for facts in view of the multi-faceted nature of the business.

Various initiatives in Parliament go beyond food speculation

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Creating the basis for a factual discussion

This position paper sets out to demonstrate the importance and functions of the commodity trading sector in Switzerland – about which the public knows rather little – and to contribute to a facts-based discussion. The paper will deal in a first stage with the activities of commodity traders in Switzerland and in a second stage will explain the role of the banks.

1 The commodity trade

Distinction between physical trading and derivatives trading

Physical commodity trading and derivatives trading are two business activities that are fundamentally different. The tasks of commodity traders are brokerage of commodities between producing and consuming locations and the related activities such as transportation, further processing, financing and price hedging. Without this trade, the adequate availability of reasonably-priced, in-demand commodities would not be assured in the desired quality.

Derivatives market ensures supply of liquidity on the commodities markets

Derivative traders such as hedge funds, on the other hand, use financial instruments (options, futures and OTC products) to bet on rising or falling commodity prices. This trade is criticized in some quarters because it is assumed that derivative traders push up commodity prices. If prices are to be set at the right level, however, it is necessary to have a high volume on financial markets which ensures an appropriate level of liquidity. During the financial and economic crisis, the derivatives market, by procuring liquidity, helped to keep the trade in commodities going and to absorb losses amounting to billions. Furthermore the derivatives trade is of key importance in hedging transactions. For each hedge against falling commodity prices, a market operator is required who bets on rising prices. Since commodity traders are directly exposed to price volatility, they must hedge themselves against falling or rising commodity prices, for example, by using derivatives.[1]

1.1 How it works

Various players involved in the commodity trade

In addition to buying and selling, the physical commodity trade also includes the transportation and financing of the respective commodities. Accordingly, various players are involved in the commodity trade: commodity traders, forwarding agents, banks, insurance companies or goods inspectors. The commodity trader organizes, inter alia, the purchase and sale of the goods, transportation by ship or other means of transport, storage in warehouses or silos, and quality control. Depending on the commodity, the processing of the good is also organized (e.g. refining of crude oil). Figure 1-1 shows the example of the oil trade, from extraction to the petrol pump.

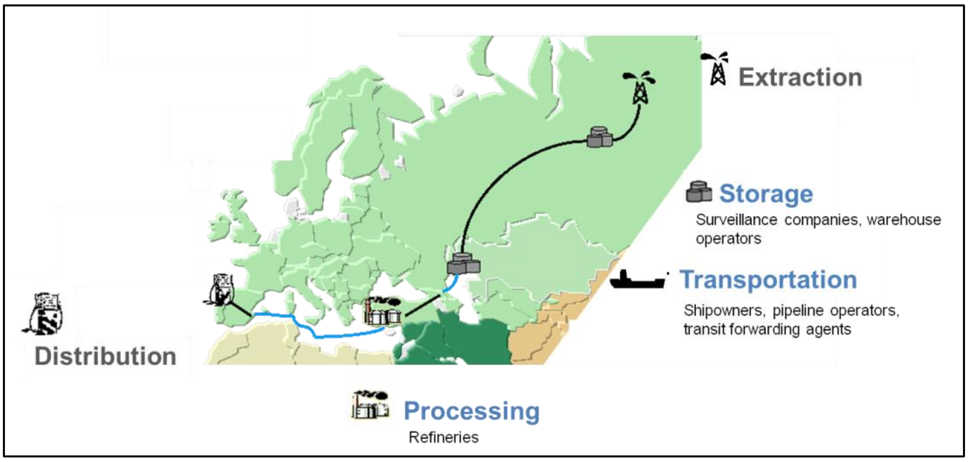
In addition to commodity traders, brokers are also involved in this business as intermediaries. Investors can trade in commodities via these intermediaries - usually in derivatives. But since brokers, unlike commodity traders, do not act for their own account but for that of the investors, they do not take any risk either.

Vertical integration as a result of opportunities or as a strategy

Over the last few decades, companies have developed – both as part of a vertical integration strategy and as a result of detecting opportunities that arose – which also engage in further activities in addition to the commodity trade alone, such as, for example, extraction of commodities.

[1] Commodity traders can also hedge by means of a selling contract, which is dependent on the trend in the price of the commodity and is entered into almost at the same time as the purchase contract. In this way the price risks are set off.

1-1 From production through transportation to distribution



Source: GTSA

Commodity traders generally bid publicly for the goods

In the commodity trade, a company purchases an export delivery for which it has bid in a public tender and sells the delivery to a buyer who is generally also located abroad, without the goods being physically imported into and exported from the country. The procurement markets are mostly located in developing or emerging countries having significant natural resources. The commodity trade is location-independent and accordingly is carried out from the locations with the best general conditions (be it from a legal, regulatory, fiscal and political point of view or due to considerations relating to financing by the banks).

Trading in public international trading centres

The commodities market is very transparent. Thus commodities are traded internationally on exchanges in Chicago (Chicago Mercantile Exchange), New York (InterContinental Exchange) or London (London International Financial Futures and Options Exchange, LIFFE and London Metal Exchange, LME) and on platforms about which volume and price information exists. Commodity traders hedge against price fluctuations on the physical markets. This can be done through derivatives. A hedge is therefore important in order to avoid being exposed to negative surprises caused by price fluctuations. During transportation, commodities are generally insured and high commodity prices are reflected in higher insurance premiums. Price increases may consequently depress physical demand, which is why, a priori, high prices are not in commodity traders' interests.

Distinction between the commodity trade and commodity finance

Commodity trade finance is closely linked to the commodity trade itself through the banks. Thus a distinction must be made as a matter of principle between the commodity trade and commodity financing (known as commodity trade finance).

1.2 Global trading activity

Trade in fuels and mining products has risen more than trade in agricultural products

According to the world trade statistics of the World Trade Organization (WTO), exports of fuels and mining products have decoupled in recent years from agricultural products. The trading volume of fuels and mining products more than quadrupled from 2000 until the financial crisis in 2008. The growth in exports was due mainly to higher prices, as can be seen from the Standard & Poor's Goldman Sachs Commodity Index (S&P GSCI). Whereas prices increased rapidly, the quantitative increase in the physical commodity trade was about 5% per year.

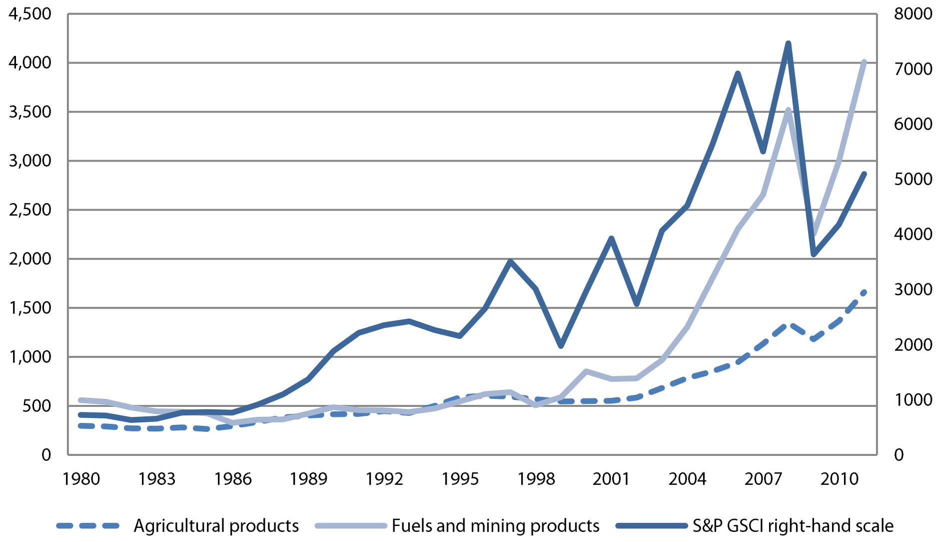
Sharp downturn in global trade due to the econo-mic crisis

Owing to the economic crisis, world trade suffered a sharp downturn (-36%) in 2009 (see figure 1-2). In the following two years 2010/2011, trade in fuels and mining products rose again sharply (+33% and +34% respectively). Exports of these products from the Middle

East, the Community of Independent States countries and Africa increased by 46%, 37% and 15% respectively in 2011. The lower growth in Africa is attributable mainly to the crisis in Libya. This shows that political developments have a strong impact on trade. The share accounted for by fuels and mining products out of Africa's total exports was 64% in 2011.

1-2 Trend in commodity exports from 1980 to 2011

In bn USD

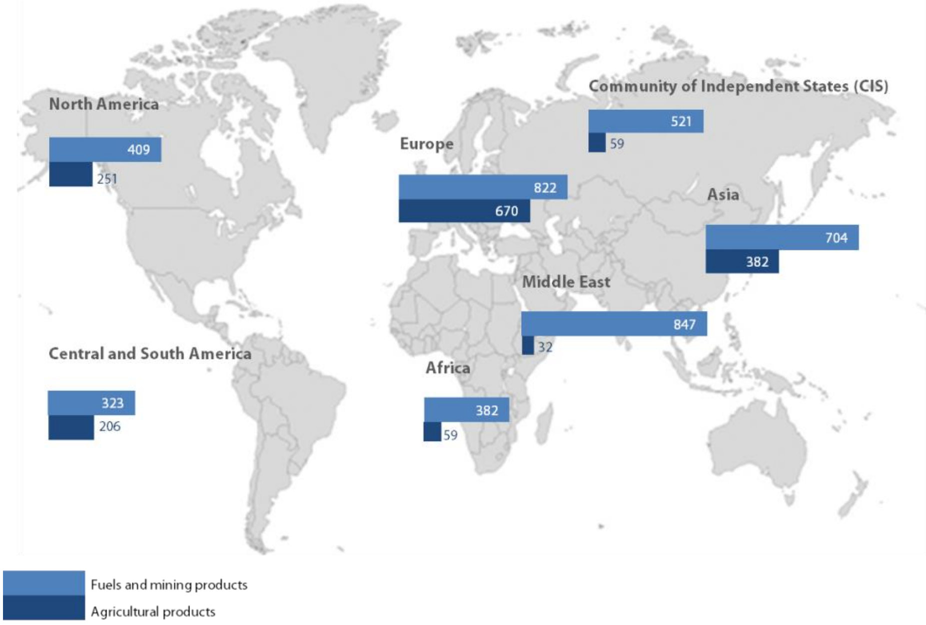


Source: WTO, Thomson Datastream

As can be seen from figure 1-3, in 2011 the Middle East and Europe were the largest exporters of fuels and mining products, measured by prices. Switzerland has an average proportion at 6.8%. At USD 670 billion, Europe is by far the largest exporter of agricultural products in world trade. The share of exports from Switzerland is 4% for agricultural products.

1-3 Commodity exports by region 2011

In bn USD



Source: WTO

1.3 Global Derivatives Trading

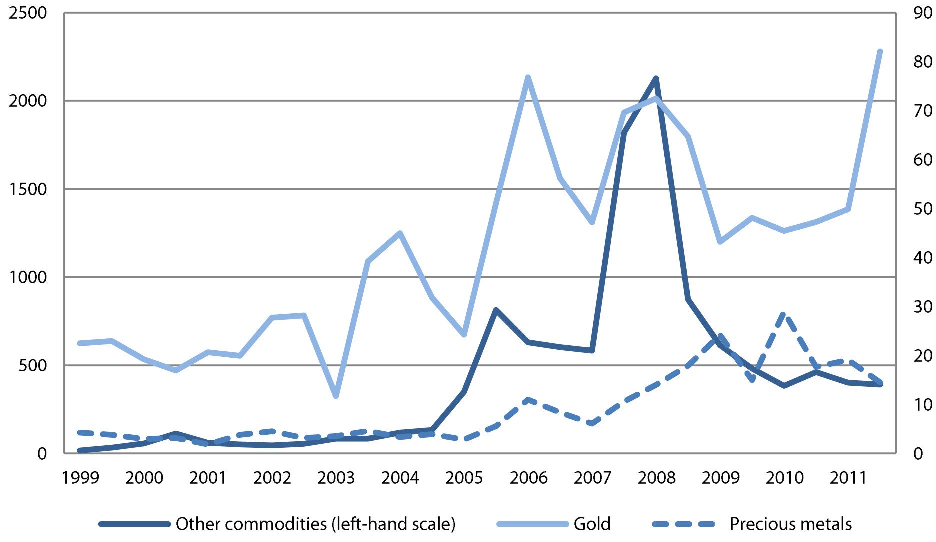
Derivatives as an investment or a hedge

Apart from the physical commodity trade, it is possible to trade in commodities by means of derivatives (called derivatives traders). Derivative traders are primarily investors who bet on rising or falling commodity prices and generate corresponding returns. In addition, there is also the possibility for physical commodity traders or producers to hedge against price fluctuations by using derivatives. The derivatives most widely used are futures, swaps or options. Compared to derivatives traders, commodity traders only have a marginal role in the derivatives market.

OTC trading ("over-the-counter") with derivatives on "other commodities" (excluding gold and precious metals) increased massively until the financial crisis erupted; af-terwards a steep drop was seen to the level of 2005 (see figure 1-4).

1-4 Trend in derivatives trading in commodities from 1999 to 2011

In bn USD



Note: Gross market values of derivatives

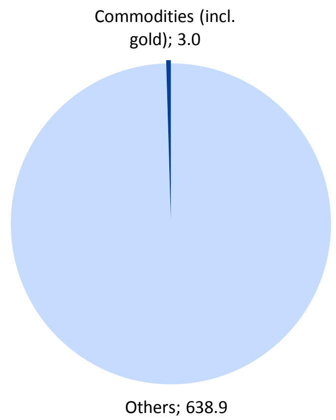
Source: BIZ

Proportion of commodity derivatives extremely small

As can be seen from figure 1-5, the face value of commodity derivatives is less than 0.5 percent of the total OTC volume (USD 639 trillion). By far the largest proportion is accounted for by interest-rate and currency derivatives. The corresponding volume of the gross market values is USD 25.4 trillion and USD 0.4 trillion for commodity derivatives. Their share thus amounts to 1.5%.

1-5 Outstanding derivatives volume as at June 2012

In trillion USD



Source: BIZ

In addition to hedge funds, various banks are also active in derivatives trading. Most of them originate from the USA or the United Kingdom. Banks in Switzerland are not very active in derivatives trading. The daily turnover on the Swiss OTC derivatives market amounted to USD 83 billion in April 2010. The international derivatives market is far greater. According to the Bank for International Settlements (BIS), the proportion of derivatives traded in Switzerland is thus only 3%.[2] Interest-rate and currency derivatives dominate both the international and the Swiss derivatives business (90%). The share of commodity trade derivatives traded in Switzerland is thus even far less than 3%. Most counterparties in the Swiss OTC derivatives business are provided by banks from abroad (93%).[3]

1.4 Economic functions

Efficient allocation of commodities

Due to the different geographical distribution of natural raw materials (known as international factor endowment differences) and the timing disparity between extraction and processing or consumption, the commodity trade is absolutely essential for economic development and the generation of wealth. Thus, for example, only a few countries have petroleum resources. Yet demand for petroleum products is global. Consequently, at the point of production - where there is a large supply - commodities are worth far less than at the destination, where they are in short supply. Crude oil trading leads, for example, to efficient distribution of the commodity to the respective consumer markets.

Temporally determined price differences influence returns

In addition, production, harvesting or extraction do not coincide temporally with consumption, so that it is commodity traders' task to match them with one another. Production peaks during the harvest periods are adjusted by commodity traders to constant consumption. This is the purpose, for example, of storing commodities. During this period, commodities may be subject to large price fluctuations, which impact the commodity traders' returns accordingly.

Risks taken by commodity traders

In the course of their business activity, commodity traders take price and counterparty risks, for which they are remunerated accordingly. In addition, logistical and political risks such as strikes in transport companies, export bans or political instability represent considerable challenges.

Economic added value through trading

The commodity trader generates an economic added value in both the exporting and the importing country by efficiently balancing supply and demand. Settlement of the trade must be cost-efficient and the price obtained, as a scarcity indicator, must reflect the market situation as accurately as possible. The use of price and quality differences, the knowledge of the global market players (buyers and sellers, forwarding agents, banks and goods inspectors) as well as the optimization of costs within the supply chain provide the firms with appropriate sources of income.

Since the last century the increased trading activity and the associated division of labour have led to a strong increase in macro-economic welfare. Adam Smith and David Ricardo had already noted in the past century that states benefit from free trade. [4] This approach based on comparative advantages also leads in the case of the commodity trade to an efficient allocation of the available resources.

[2] BIS (2010)
[3] SNB (2010)
[4] Mankiw (2004)

2 Commodities industry in Switzerland

2.1 Switzerland: the commodity trading centre

Development of the commodity trading hub has a long history

Switzerland was able to develop international expertise in the commodity trade thanks to the impetus provided by the Swiss players André & Cie (1877), Henri Nestle (1839), Salomon Volkart (1851) and H.-L. Rottmann (1859), among others. This laid the foundation for the establishment of leading foreign commodity trading companies in Switzerland. Thus in the 19th century centrally located Switzerland benefited from the trade in cotton and coffee (Nestlé, among others). In the 1920s Switzerland finally established itself as a commodity trading centre with grains, soya oil and nuts. Free movement of capital after the Second World War and the expansion of Société Générale de Surveillance (SGS) further drove this development.

Oil crisis in the 1970s furthered the develop-ment of Switzerland

The establishment of the commodity trade in Switzerland was furthered by political and economic instability in many countries. Thus in the 1950s and 1960s families from Eastern Europe, the Middle East and North Africa established themselves in the Lake Geneva region as active players in the trading business. The attractiveness of Switzerland as a trading centre increasingly grew and the first major trading companies like Alcoa and Cargill established branches in Switzerland. At the time of the oil crisis in the 1970s, relations were established with oil companies in the Middle East which further reinforced the importance of Switzerland as a trading hub, not least because oil had also become a commodity traded on the financial markets. After the collapse of the Iron Curtain in the 1990s, an increasing number of Russian traders also came to Switzerland.

Switzerland as a leading global commodity centre

The stable legal framework, the existing acknowledged expertise in commodity trading and its guaranteed financing led to an increasing number of commodity traders setting up in business in Switzerland. Thus Switzerland has since developed into the world's leading location for commodity trading and vied with London for the leading position. The commodity traders are based mainly in Geneva (see box, "International significance of Geneva as a trading centre"), the Zug area and Lugano.

International significance of Geneva as a trading centre
Geneva has a world market leader position for various commodities. According to the Geneva Trading and Shipping Association (GTSA), they are the following areas:

- Commodity trading:
  - 1/3 of world trade in crude il and crude oil products
  - Number 1 in small coal and oil seeds
  - Number 1 in Europe for sugar
  - Number 1 (together with London) in cotton
- Number 1 in trade finance
- Number 1 in inspection and certification
- 22% of global shipping for raw materials

Source: GTSA

2.2 Locational factors

Conducive general conditions in Switzerland

Switzerland has general conditions that are conducive to the commodity trade. These locational qualities include the stable political and social environment, which ensures the necessary legal certainty. Standards and laws are upheld in Switzerland and if companies do not comply with them, appropriate sanctions are imposed. Trust is an important factor in this line of business and has been built up by a continuous business relationship. The high quality of life and high level of education and training in Switzerland make it easier to recruit qualified employees. The transport infrastructure offers commodity traders convenience, reliability and fast and punctual service within Switzerland and, thanks to the country's central location, international connections to the main markets. In addition, the country has an internationally competitive tax system.

Proximity to a financial centre is necessary owing to capital intensiveness

The commodity trade is very capital-intensive, which is why proximity to a financial centre and the relevant know-how is invaluable. Commodity traders' financing requirements are great because the goods are either paid for prior to sale to the customer or - in most cases - the banks provide corresponding payment commitments (known as letters of credit).

Clustering through a package of locational factors

This package of locational factors has led to the formation of clusters over the years. In the meantime, in addition to the trading houses there is a very high density of other players in a small area who are active in the commodity trade business. The trading activities go hand in hand with the logistical operations for the shipping of commodities and the actual financing of the transported goods. Thus in addition to the trading houses, the supporting companies that ensure a smooth sequence of operations such as logistics companies, law firms, international organizations, banks, insurance and inspection companies are located in a small area.

From Switzerland's perspective, push factors were also relevant drivers in addition to pull factors. Thus an inadequate rule of law or political instability meant that commodity trading companies looked for a safe and economically and politically stable location. With precisely these locational factors, Switzerland was able to score points and attract appropriate businesses and employees.

2.3 Economic importance of the commodity sector

Commodity trade as a driver of Swiss economic performance

The commodity sector is today perceived as an economic sector in its own right and is extremely important for the Swiss economy. According to the KOF Swiss Economic Institute, the value created by the commodity trade in 2010 was approximately CHF 18 billion, corresponding to a 3.6% share of GDP. Half of GDP growth was attributable to the increase in commodity trading, which in a difficult international environment contributed significantly to Switzerland's economic stability. The commodity trade directly and indirectly generates about 10% of GDP in Geneva and 2% in Ticino.

In 2010 about 10,500 people were employed in the entire commodity trade sector in Switzerland.[5] Of them:

- 7,500 worked in trading companies
- 1,700 in banks
- 700 in the cargo business and
- 500 in inspection.

[5] Boston Consulting Group, Swiss Bankers Association (2011).

The Geneva Trading and Shipping Association (GTSA) estimates that in the Lake Geneva region alone, a workforce of approximately 8,000 to 9,000 is employed in the trading companies and in the other sectors that benefit from their activity (direct and indirect employment).6 The commodity trade in Zug employs nearly 2,000 people, which accounts for approximately 2.4% of employment in the canton of Zug.[7] In addition to Geneva and Zug, a third cluster has formed in Lugano, focusing primarily on steel, base metals, coal, and partly also on agricultural commodities and employing 1,000 people.[8]

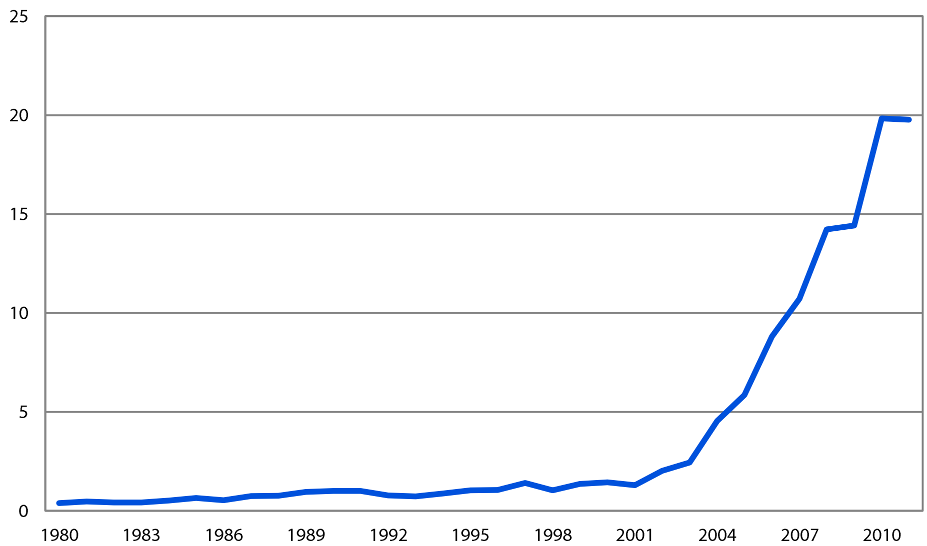
In Switzerland as a whole, the number of trading companies is estimated at 570, most of which are located on Lake Geneva (400) as well as in Zug (100) and Lugano (70).

Income from the commodity trade has overtaken financial services

According to the balance of payments calculated by the Swiss National Bank (SNB), in 2011 the commodity trade (in SNB nomenclature "merchanting") overtook the banks' receipts from financial services and is now the most important component of the current account.[9] Figure 2-1 shows that the revenues (net income) from the commodity trade increased massively from CHF 2 billion in 2002 to around CHF 20 billion in 2011. According to the SNB, energy accounted for nearly two thirds of the goods traded and the category "Non-metallic mineral products and metals" for about one fifth. In the third quarter of 2012, the revenues from commodity transactions fell by 2% compared to the same quarter of the previous year.

2-1 Receipts from the Swiss commodity trade from 1980 to 2011

In bn CHF



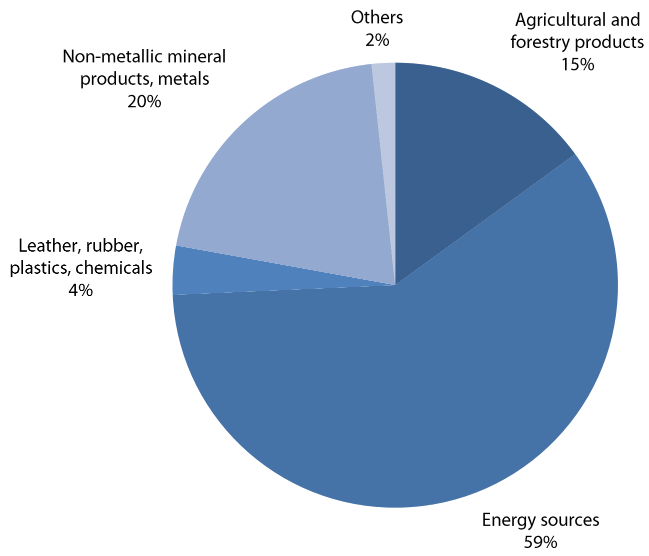
Source: SNB

Most of the revenues from energy

The total sales revenue (= turnover) increased by 14% and amounted to CHF 762.9 billion. Of this amount, energy accounted for 59%, non-metallic mineral products and metals for 20%, and agricultural commodities for 15% (see figure 2-2).

[6] As a result of different survey methods, the number of employees in the individual regions (Lake Geneva, Zug, Lugano) cannot be compared directly with the figures for the whole of Switzerland.
[7] Zug Commodity Association.
[8] Lugano Commodity and Trading Association.
[9] SNB (2012).

2-2 Turnovers in transit trade by product groups



Source: SNB

A positive outlook for the future

Economically, the sector is important for Switzerland not only on account of its size. It has also proved extremely robust during the protracted crisis in the developed countries and was therefore an important factor of stability for the entire Swiss economy. As global prosperity grows, the importance of the commodity trade will increase even more in the future, which is also expected to benefit the whole Swiss economy, along with the banking sector. In 2011 the Boston Consulting Group and the Swiss Bankers Association (SBA) forecast annual income growth rates of 4% for the commodity trade finance business area until 2015.[10] This activity is thus a promising pillar for the future of Swiss banks, which are undergoing a period of transition.

[10] Cf. “Banking in transition - future prospects for banking in Switzerland”, 2011

3 The role of the banks

3.1 Financing activities

Banks meet financing requirements between purchase and settlement

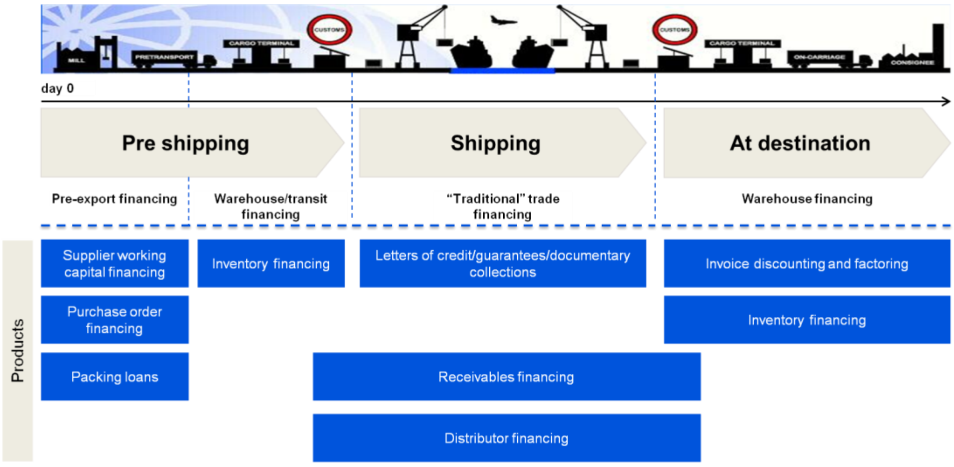
The role of the banks is principally, on the one hand, to meet the financing requirements faced by the trader as a result of the purchase and processing of commodities and of providing transportation and, on the other, to process, hedge, organize, and monitor the related flow of payments and goods by using appropriate instruments. The purchase of commodities, transportation and price hedging could not be guaranteed without the financial services provided by banks.

Trade finance as a Swiss speciality

Trade finance facilities are usually short-term, purpose-specific financing (known as transactional finance) granted to globally operating trading companies and almost without exception are transnational in nature. For this reason, they usually take place in US dollars. What is typical for Switzerland is the financing of a specific business transaction or the construction of a payment commitment in the form of documentary products as a collateral instrument in the trading business.

Traditional trade finance comprises the documentary business and generally finances the transport phase of the commodity trade. However, both upstream and downstream activities of commodity traders also need to be financed. For example, figure 3-1 shows the different financing products along the commodities supply chain.

3-1 Trade finance along the supply chain



Source: International Maritime Bureau (IMB), Credit Suisse

So-called "combined credit limits" allow for the design of documentary products and for any interim financing (receivables financing or supplier financing, see figure 3-1). Whenever possible, international trade finance will be carried out by means of documentary products. Although documentary products are complex in terms of the work they involve, they are used not only for financing but also to provide collateral for performance and payment - two major risks of this business.

Transactional finance as a locational advantage

The basis for the granting of transactional trade credits is the critical assessment of the specific transaction, its various risks, experience and the creditworthiness of the company's balance sheet. This represents a locational advantage compared with the system in the

English-speaking countries, where the creditworthiness assessment is based on the company's balance sheet and trading firms have a short-term operating credit.

Transactional finance has advantages in the area of leverage, the risk of loss to the bank as well as in the implementation of the "know-your-customer" principle. Since the above-mentioned credit limits are available only for physical transactions and the risk in the speculative business model is too high, banks in Switzerland do not finance speculative transactions.

Wide range of active banks

Commodity trade finance in Switzerland which is guaranteed by banks amounted to an estimated volume of around CHF 1,500 billion in 2011.[11] French banks are leaders in this business. Foreign banks service the market, both from abroad and also from Switzerland via branches and subsidiaries. An increasing number of Middle and Far-Eastern banks are also moving into the business; their margins in the syndicated loan market are substantially lower than those in Europe or the USA. Among the Swiss banks, the two major banks and some cantonal banks are active in the area.

Capital intensive business requires a certain size of balance sheet

If a bank wishes to move into the trade finance business, it must have many years' experience and be familiar with the commodity business. In addition, the bank must have experience of lending business, so as to assess the counterparty risk correctly and to be able to perform effective risk management. In addition, this business is capital-intensive, which places corresponding requirements on the size of the balance sheet. Competition with banks abroad is a challenge for Swiss banks. Banks abroad are subject to less stringent capital requirements than in Switzerland, which reduces their refinancing costs (cf. 4 "Regulatory Framework"). It is in particular the general conditions on the financing side that are crucial if Swiss banks are to be able to increase their market share in this attractive business area.

3.2 Asset Management

Not commodity trade in the narrow sense, but still significant

Asset management is not part of commodity trading in the narrow sense; but this business area is of great importance to the efficient functioning of the commodity markets and has a high volume. Investments in commodities – be it via physical depositing or by means of futures contracts – have increased markedly over the last ten years.

Commodities as an asset class

Commodities have established themselves as an independent asset class in asset management. Investments in commodities are driven by the following four factors in particular:

Diversification: The price-determining factors such as geopolitical risks with oil or weather risks with agricultural commodities do not correlate very closely with the price-determining factors (usually macro-economic indicators) of equities and other risky assets. Thus investments in commodities make it possible to diversify the portfolio. However, since 2008 the correlation has increased greatly as commodity-based financial investments have become more attractive.[12]

Protection from inflation: The risk of rising prices is increasing with the increased expansion of the money supply by central banks around the world. Since food accounts for a significant proportion of the basket of goods, its prices are correlated with the consumer price index. Commodity investments therefore offer investors a degree of protection from inflation and serve to maintain purchasing power.

[11] The four largest commodity trading companies alone in Switzerland posted a turnover of USD 680 bn. in 2011.
[12] UNCTAD (2011).

Real values: Commodities constitute real value variables and therefore do not involve any counterparty or default risk. In times of great uncertainty, real assets such as gold or silver are in great demand, which accordingly leads to rising prices.

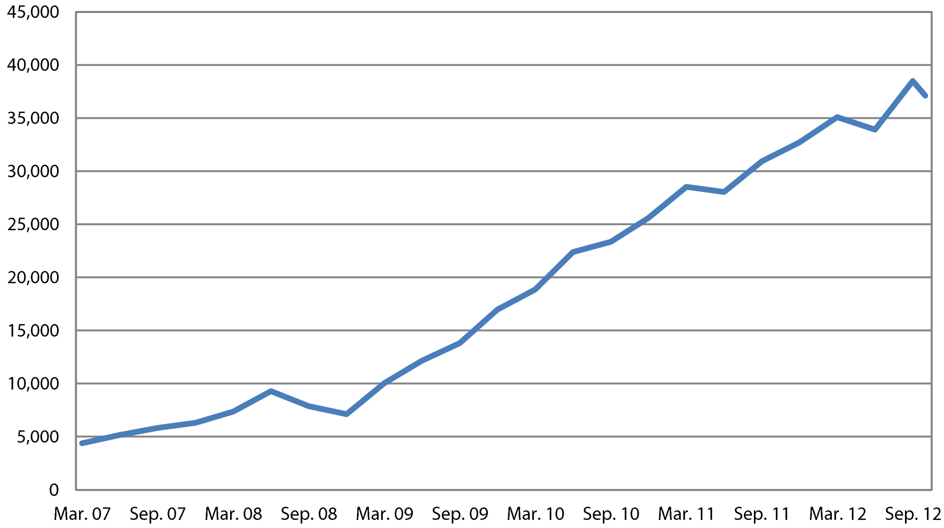
Attractiveness of the asset class: Over the long term, commodity prices are driven by the fundamental factors on the supply and demand side. Owing to limited supply and increasing demand, particularly from emerging countries, high commodity prices are likely to be sustainable.

Sharp increase in commodity investments

These four factors are jointly responsible for the fact that investments in commodities have increased steadily for years. According to Blackrock, as of January 2013 investments in commodities amounted to USD 203 billion and accounted for 9.9% of total exchange-traded products (ETPs)[13]. Over 80% of them are attributable to investments in precious metals.[14] On the SIX Swiss Exchange, a total of 120 exchange-traded funds (ETFs)[15] and 36 exchange-traded products are listed on commodities. Assets invested in commodity products (funds, ETFs, active and passive products) and managed in Switzerland have increased from around CHF 4.3 billion to approx. CHF 37.1 billion since 2007 (see figure 3-2). The majority of these funds are invested in physically deposited gold funds, as investors want to hedge against an escalation of the global debt crisis.

3-2 Assets under management in commodity funds

In millions CHF



Note: Assets in funds that are authorized for distribution in Switzerland and were generated via Swiss distribution channels.

Source: Swiss Fund Data, Lipper/Thomson Reuters

The large number of assets under management shows, on the one hand, the importance of commodities as an investment vehicle for investors and, on the other, their significance for creating value in asset management. With management fees of about 100 basis points, an amount of CHF 371 million is generated each year for the fund industry on the invested assets.[16]

[13] ETP are collateralized, non-interest-bearing debt rights made out to the bearer (debentures).These products do not come under the Collective Investment Scheme Act (KAG) and thus are not regulated by FINMA. (Source: SIX Swiss Exchange).
[14] Blackrock (2013).
[15] ETFs are collective capital investments as defined by the Collective Investment Scheme Act (KAG). ETFs are subject to approval and regulation by FINMA. (Source: SIX Swiss Exchange).
[16] Estimate based on figures as at the end of October 2012

A wide range of commodity investors

In addition to direct investments in commodities (or their derivatives or commodity funds), investments are also made by various investors in companies that extract, produce or process commodities. Many of these companies are listed on an exchange and financed by private, institutional investors (e.g. pension funds and insurance companies) and public investors. The breadth effects of the commodity boom on these investors should not be underestimated.

4 Regulatory framework

Commodity trade is already widely regulated

Criticism of the commodity trade goes beyond the widespread argument of food speculation and includes areas such as, for example, transparency, money laundering and human rights. Contrary to common assumptions, the commodity trade or its financing is by no means unregulated. There is a wide range of rules, regulations and initiatives that impose strict requirements for dutiful performance of the various activities. In addition, there is already a high degree of transparency in the commodity markets with regard to volumes and prices, as most commodities are traded on public exchanges. In the near future, regulation in the commodity trade will be further tightened up.

Risk reduction through "know-your-customer" principle

Commodity traders and banks, like other players, have an incentive to check up on and know their counterparty in order to minimize the risk they take. If laws or internal directives cannot be complied with, commodity traders and banks forego a trade. Allegations that corruption is omnipresent in the commodity trade are therefore not consistent for Switzerland. Rather, the commodities sector does not involve any greater risk than other international sectors of the economy. Like all legal entities and natural persons, commodity traders are also subject to criminal law, and the fight against corruption is widely implemented.

Application of national and international sanctions

Since most transactions are conducted in U.S. dollars, they come under the **sanctions** of the U.S. authorities (Office of Foreign Assets Control, OFAC). Commodity traders operating in Switzerland are also subject, in addition to the U.S. sanctions, to the Swiss Seco sanctions. Through its membership of the United Nations (UNO), Switzerland has also adopted the international or regional sanctions (European Union or other countries). The internationally operating banks observe all global sanctions and the sanctions at all of their locations.

Equity capital requirements make commodity trade finance more costly

Since the beginning of the financial crisis, the equity capital regulations and **liquidity requirements** imposed on banks have been further tightened up. Trade finance is assigned by the "Basel Committee for Banking Supervision" to the so-called "off-balance sheet" positions. Such positions are to be assessed at 100% for the liquidity requirements. Under the old Basel II rules, this factor was still 20% up to a maximum of 80%. Basel III thus massively increases the liquidity requirements, which in turn increases the cost of such financing operations to the bank.

Leverage ratio punishes "good" risks

The proposal to introduce a **leverage ratio** within the framework of Basel III will have an impact on all financing and thus also on commodity trade finance. The leverage ratio is already a regulation that applies to the large Swiss banks. Since "good" risks as opposed to riskier financing operations do not benefit from lower risk weightings, they are punished. Transactional finance in the commodity trade is a business covered by collat-erals. Thus the risk of a default – similar to a mortgage – is much lower than on an unsecured loan and accordingly would need to be backed with less equity capital. The more stringent capital regulations in Switzerland and the fact that in both the European Union and the USA the introduction of Basel III is running behind the original schedule are likely to weaken Switzerland's competitive position.

Money-laundering regulations exceed international standards

The Financial Action Task Force (FATF) certifies that Switzerland has a network of preventive measures against **money-laundering** that works properly. The commodity trade is governed by the Anti-Money Laundering Act if financial intermediaries accept or have custody of foreign assets as part of their business activity. With these regulations, which have been in force since 1998, Switzerland goes further than both the FATF recommendations and E.U. and U.S. law. Own-account trading was deliberately excluded by the legislator because the anti-money laundering legislation provides for suspicious assets that have been entrusted to a financial intermediary to be frozen if a notification is effected. [17] This concept can hardly be applied to own-account traders because they neither maintain customer relationships nor do they have control over foreign assets. What is not excluded, on the other hand, is own-account trading in the Penal Code, where money laundering is generally a punishable offence. In addition, as part of the amendment of the Anti-Money Laundering Act, cash payments of over CHF 100,000 will no longer be possible in future. [18]

Switzerland is a pioneer in combating corruption.

In the area of the **fight against corruption**, commodity traders are already today subject to various regulations. They include the Swiss Federal Law on Unfair Competition (UWG), the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the UN Convention on combating corruption. Switzerland's efforts are rated very good by Transparency International in each case.

New demands for transparency in the EU and USA

However, further challenges are in the pipeline for the commodities industry and the banking sector. Thus, for example, as part of extended **transparency requirements** (known as the Transparency Directive), the European Parliament is calling for an extension of country reports to the banking sector, whereas the European Commission imposed these requirements only for extraction. The aim of this directive is to prevent any possible corruption. It is still unclear as to how exactly the directive is to be implemented. In the USA, the Dodd-Frank Act contains rules of the U.S. Securities & Exchange Commission (SEC) which are aimed primarily at extraction companies that are listed on U.S. stock exchanges and operate in the areas of oil, gas and minerals. It is still unclear whether the SEC will extend this regulation to physical commodity traders as well. It should be mentioned, however, that there are countries (e.g. China) which explicitly prohibit such a disclosure.

Efforts to regulate over-the-counter derivatives

The G-20 established at the 2009 Pittsburgh summit that by the end of 2012 all standardized **OTC derivatives** should be traded on exchanges or electronic plat-forms and, if appropriate, should be cleared through central counterparties. Subsequently the Financial Stability Board (FSB) was instructed to regularly review implementation. In February 2012, the International Organization of Securities Commissions (IOSCO) published its report[19] on the directives for mandatory clearing of OTC derivatives. This paper is aimed at the national regulatory authorities and contains proposals for a clearing system for standardized derivatives. The aim is to increase transparency and reduce systemic risks.

In the EU, the “European Market Infrastructure Regulation" (EMIR) will regulate over-the-counter trading of financial derivatives. In the USA, a similar regulation is coming into force under the Dodd-Frank Act. Depending on their specific form, both regulations would probably have an effect on commodity trading business in Switzerland - especially if a corresponding Swiss regulation is applied.

[17] See chapter 5 for internal precautions taken by banks
[18] An amended anti-money laundering act is currently in the parliamentary consultation stage (time-limit: June 15, 2013). In future, any trade above CHF 100,000 will have to go through a financial intermediary. This will also close the last loopholes in the commodity sector, because a financial intermediary is obliged to take preventive clarification measures with regard to the transaction to be processed.
[19] IOSCO “Requirements for Mandatory Clearing” February 2012

Voluntary regulation initiatives

At the international level as well there is already a wide range of voluntary initiatives – partly in cooperation with NGOs – on transparency, corruption and human rights. Switzerland and Swiss companies are working to ensure compliance with the recommendations. Increased transparency (e.g. payment flows in the area of extraction) attained in an internationally regulated framework is to be welcomed. The following is a summary of the most important initiatives.

The United Nations Global Compact is a strategic initiative that seeks to ensure that companies bring their business operations into line with ten principles in the areas of human rights, labour standards, environmental protection and the fight against corruption.

The International Council on Mining and Metals (ICMM) was established in 2001 to promote sustainable development in the mining and metals industry. A total of 22 mining and metals companies as well as 34 national and regional mining associations and global commodity associations are following this approach.

The so-called "Extractive Industries Transparency Initiative" (EITI) aims to combat corruption in developing countries and to strengthen good governance by making transparent payment flows that go from extraction companies (oil and mining products) to the State in the form of taxes, and the use that is made of such funds. By doing so, the aim is to prevent the embezzlement or misappropriation of these funds. The EITI publishes on its website a list of all the countries that already disclose their payment flows, are preparing to disclose them or have announced that they will do so. Switzerland is officially represented on the EITI Board through the Seco and in this way actively contributes to increasing transparency.

As early as 2000 the Organization for Economic Cooperation and Development (OECD) issued far-reaching recommendations for multinational companies with its "Guidelines for multinational enterprises". Despite their non-binding nature, they are supported by the OECD countries, where most of the multinational enterprises originate. The recommendations contain guidelines and standards for responsible business conduct in the areas of employment relationships, labour relations, human rights, environment, competition, information disclosure, taxation, combating corruption and consumer protection. The governments of the USA, United Kingdom, the Netherlands and Norway, international enterprises in the energy and extraction sectors and NGOs have joined forces in a dialogue (The Voluntary Principles on Security and Human Rights). This association seeks to find solutions in the areas of corporate social responsibility and human rights.

The "International Business Leaders Forum" (IBLF) is an independent, global organization of over 150 leading multinational companies. IBLF works across sectors and focuses on critical sustainability, growth and leadership issues. It works directly with the board level to drive changes in the companies concerned.

5 Responsible business activity by banks

Detailed and recurrent due diligence audits

As already mentioned, banks have an inherent interest in avoiding improper pay-ments. For this reason, they engage in detailed and ongoing due diligence audits. This includes, first, identification of the customer (Know-your-customer, KYC) and, second, also the risk-based audit of the customer's direct counterparties (referred to as Know-your-customer's-customer, KYCC) and the respective market (referred to as Know-your-market, KYM). It is in the own interests of the banks to respect regulations and recognized rules to avoid damages to their reputation. Strict monitoring is not only in the bank's own interest, it is also mandatory under the regulations. The Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence (CDB), which was enacted by the Swiss Bankers Association as a self-regulation instrument and compliance with which is verified by FINMA, lays down the banks' obligations in terms of customer identification and determining the beneficial owner.

Standardized procedure for customer identification

The starting point in any process is what is known as "client due diligence" (CDD). Prior to the initiation of a business relationship, various standardized procedures (identification, verification of the customer's identity, etc.) are applied. CDD takes a risk-based approach, particularly with regard to potential trading activities (origin and nature of commodities, geographical markets, products and services, parties involved, countries or regions with which customer or supplier relationships exist, etc.). The audit of applicable laws and rules and regulations is conducted permanently during the business relationship, and not only when it is initiated.

Extended due diligence if necessary

So-called "enhanced due diligence" (EDD) is carried out in a further step. This pro-cess takes place when a customer moves into a higher risk category or when an in-depth audit proves necessary during the standardized due diligence process. The EDD helps one to understand the trading cycle and enables compliance with the regulations of the customs authorities and licensing rules, physical verification of the goods traded and the legitimacy of the payment flows made.

Risk-Based approach

Owing to the nature of the business (the bank's guarantee is before execution), it may be that a business activity is only classified as risky when it is actually carried out. In this case, an additional in-depth due diligence audit is carried out. The ongoing monitoring and risk-based examination of the CDD supports a sustained business relationship with the customers. If the risks are assessed as higher, an additional audit is carried out more often (usually in conjunction with a credit risk review, information received from the customer, an examination of media coverage, etc.).

Ad hoc due diligence audit in the case of credit facilities

A special focus is given to the individual case when it concerns non-transactional finance (e.g. if the bank approves funds on the basis of a credit facility and the customer does not yet have control over the goods to be traded). This leads to an ad hoc due diligence audit.

International standards as a benchmark

The banks' procedure – which is based on the Anti-Money Laundering Act – is aligned with international directives. They include the following:

- In the area of sanctions, the rules of the International Chamber of Commerce (ICC) are followed.[20] The Banking Commission of the ICC,[21] as a leading global standard-setting body for the banking sector, issues generally accepted rules and guidelines for documentary letters of credit, documentary collection, "bank-to-bank" settlements and bank guarantees. The voluntary, market-based approach of the International Chamber of Commerce has often been praised as a step towards a level playing field.
- The Wolfsberg Group published the "Wolfsberg Trade Finance Principles" in cooperation with eleven global banks in 2011. These guidelines address the risks of money laundering and terrorism financing through commodity trade finance and compliance with national and international sanctions, including the United Nations' non-proliferation of weapons of mass destruction.

Strict voluntary restrictions by banks

Banks in Switzerland subject themselves to strict, voluntary restrictions. Thus no payments are made to private individuals or non-transparent offshore vehicles (unless it can be shown that the corresponding payment is legitimate). In addition, payments are only made that correspond to usual market prices so as to adhere to the corresponding transfer pricing provisions or to avoid illegitimate payments. As with any transaction, the counterparties and persons involved are filtered and checked. Banks also take such precautions with a view to renouncing the financing of critical transactions (including diamonds, tropical timber and palm oil from uncertified sources, or certain forms of extraction). All ships are checked to determine whether they are on a black list. There are also some banks in Switzerland which as a matter of principle do not finance any energy transactions owing to the possibility of accidents occurring during transportation.

[20] Cf. ICC (2010) "Guidance Paper on the Use of Sanction Clauses for Trade Related Products (e.g. Letters of Credit, Documentary Collections and Guarantees) subject to ICC Rules".
[21] The ICC Banking Commission has over 500 members from 70 countries.

Conclusions

Commodity trade as an independent economic player

The commodity trade has brought the Swiss economy significant growth and it would be difficult to imagine the latter without it. A package of optimal general conditions has contributed to the successful development of Switzerland as a hub in international commodity trade.

Ensuring liquidity by derivative traders

A distinction should be made between commodity traders that act as brokers between the producing and the consuming markets, and derivative traders. Unlike commodity traders, derivative traders bet on rising or falling commodity prices. But the high volume invested by derivative traders is not bad per se, as it ensures the necessary liquidity on the markets. Only in this way can prices be set at the right level and hedging be provided for commodity traders and producers.

No interest in high prices

Since price increases in the physical market can lead to unwanted situations for commodity traders and push up hedging costs, commodity traders are not interested per se in high or rising commodity prices.

Increasing regulation leads to new challenges

The banks have become an important part of the commodities industry and finance a large part of the commodity trade. Domestic and international pressure and regulatory efforts – led by the USA and the European Union – are confronting the industry with new challenges. They include higher transparency requirements and regulation of OTC derivatives. As with any intervention in the market, attention must be paid to corresponding competitive disadvantages, which may have great repercussions in this highly international business.

Numerous laws and rules regulate the commodity trade

But contrary to common assumptions, the commodity sector is not unregulated. Moreover, there are many laws, rules and internal and external directives. As with any transaction, it is in banks' interest to know and check up on the counterparty. Illegitimate or illegal behaviour is not supported or financed by the banks. Systematic precautions are taken in this respect.

A facts-based discussion despite its complexity

A look behind the scenes of this complex business makes it possible to have an objective and facts-based discussion. Our aim in writing this position paper was therefore to create transparency and to explain how the business of the commodity trade and its financing work.

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