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Risks and Implications: The Crucial Role of Commodity Trade Finance

The pool of banks financing commodities is dwindling as the risks for those that remain grow.

Banks decide to exit or reduce involvement in commodity trade finance due to regulatory changes, reputational risks, and financial performance. They may exit specific market segments while adapting strategies in response to evolving market dynamics. Credit tightening threatens the coffee trade in the current market, adversely affecting producers as the initial link in the global value chain. There are signals that Dutch lender Rabobank, which closed its commodity trade finance desks in London, Shanghai, and Sydney in 2021 to focus on agriculture commodities, including coffee, may exit the sector soon.

Coffee's journey from coffee farms to a coffee drinker's cup involves an intricate network of transactions, risks, and financing. Commodity trade finance is the lifeblood of the coffee industry, enabling its complex supply chain to function efficiently. Without sufficient financing, the industry would face numerous risks, from supply chain disruptions to financial losses. Banks and trade firms must collaborate, adapt to changing market conditions, and prioritize responsible and sustainable coffee production to ensure the long-term viability of the coffee industry and its financing ecosystem.

The coffee supply chain encompasses multiple stages, each involving various stakeholders. The first link is the coffee producer, which grows and harvests coffee cherries with the beans within. Before reaching consumers' cups, the coffee bean must pass through a series of intermediaries, including coffee mills, exporters, importers, roasters, distributors, and retailers.

Each step in the supply chain requires financing to cover operational costs, manage risk, and ensure timely delivery. The need for financial backing is critical at all levels. Associated risks can occur through the value chain, but especially during periods of increased volatility, which is the current challenge the coffee trade faces.

Commodity trade finance is the lifeblood of the coffee industry.

Unprecedented threats

The years following the pandemic have been unprecedented. The temporary shutdown or delay in parts of the supply chain has had a ripple effect on the coffee trade. The extended closure of China created an even greater dislocation of shipping containers, delaying freight, and increasing costs.

The Russian aggression against Ukraine sent commodity prices soaring with increased costs for fuel and fertilizer. There was a temporary blockage in the Suez Canal. The Panama Canal passage has become sluggish due to reduced water levels from drought and engineering capacity constraints on water flow to support the safe passage of larger container ships.

Interest rates soared to help tame inflation. This is in addition to climatic challenges due to La Niña and El Niño, curbing world production. Now, the Red Sea is facing a barrage of targeted attacks on shipping containers that have any links to Israel. The market structure (pricing from one delivery month to the next) has also inverted due to related concerns about tighter nearby availability than in the future.

All these factors added many risks to coffee traders and the banks that finance them, making it an extremely difficult business environment to operate in.

Broadly speaking, supply chain finance focuses on optimizing the cash flow within the commodity supply chain. It can benefit both buyers and suppliers by improving working capital management. Types of supply chain finance include:

1) Supplier Financing: Financing options help suppliers fulfill orders.

2) Buyer Financing: Allowing buyers to extend payment terms while ensuring suppliers are paid promptly.

Evolving finance

Structured commodity trade finance has evolved to adapt to changing economic, technological, and regulatory landscapes. It has become more complex, global, and focused on sustainability, risk management, and compliance. These changes reflect the broader shifts in the financial and business environments over the past several decades. It has also impacted lending to the coffee industry with sometimes more complex transactions that add risk to both trade firms and banks.

The complexity of structured commodity trade finance transactions has grown as businesses seek more sophisticated financing solutions to meet their needs. These transactions involve multiple parties, complex financial instruments, and risk mitigation strategies.

With the globalization of trade, structured commodity trade finance has become more international in scope. Transactions often involve multiple countries and currencies, requiring financial institutions to have a global presence and expertise.

Companies engaged in commodity trade are exploring alternative financing sources, including supply chain finance, peer-to-peer lending, and non-traditional financial institutions, which have diversified funding sources.

Innovation

The use of technology has transformed the coffee industry. Electronic trading platforms, blockchain, and data analytics have enhanced efficiency, transparency, and risk management in commodity trade finance, including coffee.

Delays in coffee shipping make commodity financing riskier.

Fintech startups have entered the commodity trade finance space, offering innovative solutions for financing, risk assessment, and supply chain management. This has introduced competition and new technological capabilities.

Regulation

Regulatory frameworks have evolved to address the complexities of commodity trade finance. New regulations, such as Basel III, Dodd-Frank, and the Volcker Rule, have imposed stricter capital and risk management requirements on financial institutions engaged in commodity financing.

There is a growing emphasis on environmental and social responsibility in commodity trade finance. Lenders and traders are increasingly considering the environmental and social impact of their transactions, leading to the development of sustainable finance and ESG (Environmental, Social, and Governance) criteria in commodity trade. Financing structures that support environmentally friendly and socially responsible initiatives are becoming more prevalent.

Compliance requirements related to anti-money laundering (AML) and knowing your customer (KYC) have become more stringent, necessitating thorough due diligence on clients and transactions.

Coffee Commodity Trade Finance

Companies involved in coffee, be it trade firms or roasters, need a significant amount of money to purchase coffee, and structured commodity trade finance provides them with the funds they need to make these purchases.

Managing risk/hedging: Trade finance helps companies manage risks by providing strategies and tools such as futures and options contracts to protect against adverse price fluctuations, to ensure price stability for both buyers and sellers.

Logistics and storage: To maintain quality, coffee beans require proper storage and warehousing facilities. Moving and storing large quantities of coffee can be challenging. Structured commodity trade finance can help with logistics and warehousing to ensure the goods are stored and transported efficiently.

Selling coffee: Once coffee is purchased and stored, companies need to sell it. This finance can also help find buyers and ensure that the commodities are sold at the right time and for the best price. Frequently, the coffee is sold and purchased on a forward basis for coffee that has not even been harvested yet or is beginning to develop on the tree. This increases the risk in case the coffee is not delivered promptly, or the seller of the coffee to the buyer defaults on their contract.

Pre-Export Finance: These are financing solutions provided to coffee producers or exporters before the actual shipment or delivery of the goods. Pre-export finance helps businesses cover production and operational costs. Types of pre-export finance include:

- **Advance Payment:** The buyer pays the seller in advance for the coffee.
- **Revolving Credit Facility:** A revolving line of credit that exporters can draw upon as needed.
- **Export Credit Insurance:** Insurance that protects against non-payment by foreign buyers.

Inventory Finance: Inventory finance, also known as commodity inventory financing, involves using coffee as collateral for loans. This would also include:

1) **Collateral Management Agreement (CMA):** A financial arrangement where the lender monitors and manages the collateralized physical coffee.

2) **Receivables Financing:** This type of financing involves using accounts receivable from coffee sales as collateral for loans or credit facilities. Traders, producers, or distributors can use it to access working capital.

3) **Factoring:** Selling accounts receivable to a third party at a discount in exchange for immediate cash.

Working Capital and Economic Development: Coffee production is a lengthy process, with growers investing in their farms well before harvesting. Commodity finance provides working capital to farmers, allowing them to cover expenses such as labor, equipment, and maintenance until the coffee is ready for sale. Access to finance supports economic growth in coffee-producing regions by financing infrastructure development, job creation, and technology adoption.

Export and Import Financing: Exporters and importers of coffee often rely on trade finance to facilitate cross-border transactions. Financing can cover the cost of shipping, insurance, customs duties, and other expenses associated with international trade.

Supply Chain Optimization: Trade finance solutions help streamline the movement of coffee from farms to consumers by optimizing cash flows and reducing working capital requirements. This benefits coffee growers, traders, and buyers alike. Increased access to capital should increase price stability, benefiting producers and consumers.

Environmental and social responsibility are growing concerns in commodity trading.

Banks Reduce Exposure

Over the years, several major banks have scaled back or exited the commodity trade finance business due to various factors, including regulatory changes, risk management concerns, and shifts in their strategic priorities. Some notable examples include:

- **Barclays-** scaled down its presence in commodities as part of broader restructuring efforts.
- **Deutsche Bank-** due to regulatory scrutiny in the past, DB has shifted its focus away from commodities as part of its strategy to reduce risk and improve profitability.
- **Morgan Stanley-** reduced its exposure to physical commodities trading and sold its physical oil business to focus more on financial derivatives and risk management services.
- **JPMorgan Chase-** sold its physical commodities division to Mercuria Energy Group in 2014.
- **BNP Paribas-** faced legal and regulatory challenges related to its commodities trading activities in the past. While it continues to offer commodity trade finance and derivatives services, it has made some adjustments to its operations.
- **Credit Suisse-** reduced its involvement in commodities trading as part of its efforts to refocus its business on wealth management and investment banking.
- **Rabobank-** Scaled back its commodities business and faced regulatory penalties related to allegations of manipulation in the commodities markets. Rabobank has most recently been cited as reducing their exposure even more and creating a further credit squeeze on coffee trade firms with Mercon, a medium-sized firm of excellent reputation and integrity, declaring bankruptcy.

Twice in December 2023, the coffee market saw double-digit declines reportedly linked to one or more banks tightening credit and liquidating positions.

Other firms are also thought to be negatively impacted by the current market environment and tightening access to credit.

Reducing Risk

Commodity trade finance is indispensable in supporting this complex supply chain, ensuring the smooth flow of coffee from growers to consumers. The coffee industry heavily depends on commodity trade finance, and any reduction or disruption in financing can have severe consequences.

Banks extending credit to coffee industry participants face credit risk. If borrowers default on their loans, banks can incur losses. Reducing financing may increase banks' credit risk, particularly in times of economic uncertainty or price volatility.

Without adequate risk management through financing tools like hedging, coffee industry stakeholders may face significant losses due to price volatility. This could affect trade firms' profitability and ability to repay loans.

Insufficient financing can disrupt the coffee supply chain. Growers may struggle to fund their operations, leading to lower coffee production and potential shortages in the market. Reduced financing could impact the competitiveness of coffee trade firms in the global market. Access to financing allows firms to expand, invest in technology, and explore new markets.

The decisions of banks to exit or reduce their involvement in the commodity trade finance business can be influenced by a range of factors, including changes in regulatory requirements, reputational risks, and the financial performance of their commodity-related operations. Banks may also exit certain market segments while offering other commodity finance services.

The commodity finance landscape evolves, with new players or existing banks adjusting their strategies in response to changing market dynamics and regulations. It is not surprising, then, that there has been some belt-tightening in the credit arena in the current market environment that can harm the coffee trade and ultimately hurt coffee producers as the first link in the global value chain.

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