

Are metals markets ready for change?

Gavin Lavelle, ceo of commodity software solutions company Brady, explains how electronic access to exchanges is changing trading

LONDON

Today, century-old methods of doing business in the metals markets are changing at lightning speed on significantly expanded volumes in electronic trading and increased regulation and compliance requirements as a result of the credit crunch.

Volatility in the metals markets has been phenomenal over the past year and would have tested risk management systems to the limit, while long-term negotiated iron ore contracts look like moving to a more flexible over-the-counter (OTC) forward market.

This results in an unprecedented period of opportunity and change for the commodities markets, which have rebounded after a sharp sell-off last year.

Both the base and precious metals markets are growing and the specialist metals traders and brokers are being joined in them by the big banks and other financial institutions.

Competitive edge

Owing to long-term under-investment in commodities, bankers, brokers and traders are all looking to take advantage of electronic access to exchanges, which enables them to use trading and risk management technology to provide a competitive edge and contain costs.

Use of electronic order entry systems has resulted in the metals markets starting to catch up with other asset classes in terms of technical sophistication. This is being driven partially by increased speed and efficiency, as well as the

reduced costs offered by electronic systems compared with manual entry.

All companies are facing greater pressures to cut their trading costs and it is clear that the unautomated trading of metals is becoming ever more expensive due to the level of manual intervention required to fix failed trades and track and correct errors.

Despite recent criticism, banks do have highly skilled and well resourced risk management practices, largely as a result of Basle II, but it is clear that risk groups have been ignored while banks have been pursuing higher returns and market share.

Corporates have less defined and resourced risk groups and have neither the investment in policy, personnel or technology to deal with the increasing volatility and demands of today's market.

Given the movement in markets, corporates need up-to-the-minute market, credit, operational and liquidity reporting. It is clear that corporates are potentially exposing themselves to significant losses if they potentially are not able to quantify risk exposure given massively changing input data.

A significant hurdle new participants are facing is that their generic corporate trading and risk systems are unable to recognise and process the unique complexities of the metals markets.

But starting afresh can be an advantage compared with trying to build upon predominantly manual solutions, homegrown, expensive or disparate un-integrated legacy risk systems.

Lavelle: period of innovation is approaching

The specialist technology is becoming more sophisticated and easier to implement, giving corporates an additional incentive to evaluate and implement them.

In benign, upward trending markets, everybody looks good, but the fallout from the credit crunch will be increased regulation.

US treasury secretary Tim Geithner is already talking about forcing OTC contracts to be cleared through exchanges, which will have a massive impact on the markets.

Underlying risk

FAS 133 and IAS 39 require companies to demonstrate that derivatives are used to hedge underlying risk and that the hedges are suitable.

Share prices in major companies have been falling due to the prospect of having to have additional capital to off-set potential margin calls for centrally cleared hedges.

Furthermore, London is a principal market for gold spot and forward trading, supported by settlement and clearing of London Good Delivery.

The prospect of increasing capital requirements for OTC forwards has led the market to consider exchange-cleared forwards. In response to this, Comex has launched a cleared-forward contract and there could be a shift in volume away from London to Chicago.

There is also the possibility of further oversight of the gold market by US regulators.

London, organised through the London Bullion Market Assn, the not-for-profit trade association, has yet to respond in terms of the governance, capital structure and necessary investment in systems and personnel to the possibility of



centralised clearing.

London and New York have traditionally been the places to trade metals, and the rest of the world looks to them for best practices and innovation, especially the London Metal Exchange and London Good Delivery which are the hubs of global metals trading.

But, other players are appearing: for example Shanghai is starting to trade physical metals.

Ultimately, the cost and ease of doing business will be significant drivers of where liquidity goes.

Liffe's transition from open-outcry to electronic trading, triggered by almost losing its entire business to the DTB exchange's superior and cheaper electronic trading platform, is a good example of this.

In conclusion, the combination of increased electronic trading, more flexible trading arrangements and increased regulatory and compliance requirements, are the drivers of change in the metals and commodities markets.

The investment required to make these changes will initially add cost to businesses already under pressure in today's challenging markets.

But, once up and running, fully automated trading organisations that only require manual intervention for exception processing are highly scalable and ultimately provide excellent return on investment.

Regulation and compliance, applied sensibly, should be seen as good practice rather than a tax on business.