

# Bluecrest Capital Management: strategy, risk transfer, credit crunch

First interview with Bluecrest Mercantile

JAMES PARSONS, PORTFOLIO MANAGER, IS INTERVIEWED BY TRADE MONEY

The overriding feature of the commodity trade finance market over the past few years has been the meteoric rise in the price of most basic commodities. Oil prices, for example, have risen fourfold over the past six years, while copper has risen more than five times in price over the same period. Commodity financiers have consequently had to deal with much larger transaction sizes. A million barrel tanker of oil is still the same shipment, but now costs \$80m or more compared to \$20m in 2001.

This potent combination of booming commodity prices, together with changes in banking regulation underlie the rapid growth in demand for structured transactions in trade and commodity finance. In this first exclusive interview, James Parsons, portfolio manager, explains how the BlueCrest Mercantile Fund is helping meet the needs of a changing market.

Reflecting on the commodity price boom of recent years, Mr Parsons comments that, "Not unreasonably, bank credit-risk lines have not increased at the same rate as prices, and as a result there has been more demand for structured transactions to modify risk - in order to close the gap between commodity financing requirements and bank risk appetite".

As an investment manager for a fund that takes excess risk from banks, Mr Parsons has seen the effect of market change very directly, with significant demand from banks for risk transfer in relation to facilities, for example, for oil and metals producers.

The BlueCrest Mercantile Fund, which launched in November 2006, is a long/short market neutral trade finance fund that supports global trade finance providers. One way these finance providers gain a competitive edge is by transferring risks to the fund where they can exploit the differences in the structure and cost of capital between a fund and a bank. Typically, banks that work with the BlueCrest Mercantile Fund do so to

transfer risks where internal risk limits are at capacity. Equally they use it to reduce risk-weighted assets in relation to individual transactions or portfolios of assets, or to reduce the capital that is required to support these. In most cases, title to the assets remains with the bank and the fund is a silent risk partner.

The fund has assumed substantial volumes of this type of risk from its bank partners, enabling them to increase the size of the facilities they can offer their customers. At the beginning of December, BlueCrest Mercantile had approximately \$1 billion of risk asset exposure. The scope of risk includes credit risks in relation to documentary credits, trade loans, pre-export financing, structured commodities and inventory financing, asset-backed lending, trade receivables securitisation and invoice discounting.

As a long/short fund, the trade finance risks that BlueCrest Mercantile takes are actively managed through selective short positions in offsetting risks. There is no perfect hedge for most trade finance risks, so the moving basis between the long and short positions is continuously and dynamically managed, through which the fund seeks to capture returns for its investors. For BlueCrest Mercantile's bank partners this means the fund is not working to the same economic model as bank portfolios, so it is able to offer original value to banks in terms of pricing. The approach also increases the amount of risk capacity the fund can offer.

Apart from the strategic risk transfer, Mr Parsons highlights three other advantages for banks in conducting business with funds: "The first is that the fund is a silent partner in transactions and specifically does not wish to be disclosed to the bank's customers. The second is that once risk transfer documentation is in place, the fund is able to respond extremely quickly to new proposals from banks. The third is the large transaction sizes that Mercantile is able to accommodate." BlueCrest Mercantile has typically taken single risk transfers in the

\$5m to \$50m range, with its largest individual transaction to date a portfolio risk transfer in relation to hundreds of millions of dollars of trade finance exposure.

This appetite for risk among hedge funds is an attractive feature for banks that will be facing increased balance sheet constraints under the new Basel II regulatory regime.

Historically, capital was not a major business issue for trade finance since the Basel I regime attributed relatively low regulatory capital risk weights to typical trade finance exposures (such as the 20 per cent risk weight for claims on banks of less than one year maturity, regardless of the rating of the obligor).

The imminent implementation of Basel II has brought capital considerations to the forefront however, with risk weights that are much higher for sub-investment grade risks, which is where the majority of trade finance exposure typically lies. As a result, banks are increasingly focusing on return on risk-adjusted capital (RAROC), as well as credit risk appetite, when evaluating new transactions. The new higher risk weights make many transactions much less attractive to hold on the balance sheet, however there is still a requirement for banks to service the customer or else risk losing the relationship.

Additionally, under Basel II structured commodity finance transactions have to meet tough structuring criteria for commodity collateral to be eligible to reduce risk weights in the regulatory capital calculation. In the “real world” customers typically resist the restrictions that these requirements would put on their business operations and for many transactions it is simply impractical to meet the criteria. However, this situation imposes high risk weights and as a result high capital requirements on the transaction.

Consequently, banks are increasingly looking for outlets for the risk they assume when servicing their customers. Traditional bank-to-bank risk participations will work less well under Basel II than they have in the past because all regulated banks will suffer from the same risk weights problem. Hedge funds, however, are a source of unregulated capital (in the sense that the Basel II rules do not apply to hedge funds as they are not deposit taking and payments handling institutions)

“Apart from the existing bank partners that BlueCrest Mercantile already works with, we are experiencing increasing interest and more unsolicited approaches from other global banks looking to hedge funds to lay off their trade finance risks”, says Mr Parsons. “Banks are especially attracted by the fact that the fund specialises in trade finance risk while it is a silent partner and interested only in risk assumption and not in the bank’s customers”.



“We see a lag between the credit crunch and its impact on trade finance, but the pressures building up elsewhere are now starting to push trade finance spreads wider.”

— James Parsons

To date these new approaches have tended to be from the larger banks that are sufficiently sophisticated to understand how the different risk transfer mechanisms can most efficiently be used when dealing with hedge funds. “With the increased pressure from Basel II we expect the demand for risk transfer to further escalate next year, and that some of the smaller and less sophisticated banks will also want to learn how to use relationships with hedge funds as a tool to manage and increase their business.”

In addition to a growing number of participants, there has been an increase in the range of derivatives products

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used in trade finance. Credit default swaps, for example, are growing in popularity as a way to transfer risk.

BlueCrest Mercantile has entered into risk transfer agreements on trade finance exposures using credit derivatives totalling more than \$300m to date. This includes risk cover on leasing transactions, trade-related loans, documentary credits, and portfolio risk transfers.

“Credit default swaps, together with their variant total return swaps, are fast growing in popularity in trade finance because of their flexibility and because they open the door to a much more efficient and comprehensive silent transfer of risks, both between banks and from banks to funds,” explains Mr Parsons. “We are aware of a number of other institutions that are also increasing the use of credit default swaps for risk transfer in trade finance, and we expect this to be a fast-growing area over the next months for both individual asset and portfolio risk transfers.”

This summer’s crisis in credit derivatives markets will, of course, have an impact on trade finance markets. But, while there are pressures for spreads to widen, demand remains healthy.

“We see a lag between the credit crunch that started in the summer and its subsequent impact on trade finance, but the pressures building up elsewhere are now starting to push trade finance spreads wider.”

Bank balance sheets have become much “heavier” with the backlog of underwritten leveraged loans that remain unsyndicated. Meanwhile, bank back-stop funding lines are being utilised by conduits that can no longer fund in the commercial paper market, and there have been unexpected increases in commercial and industrial loan volumes as corporations find the commercial paper market less attractive or closed to them.

Central banks’ attempts to address the credit crunch have had limited success to date. Despite many central banks providing more liquidity to markets through special funding operations and the US Federal Reserve’s 75 basis point reduction in the Fed Funds rate with more cuts expected, LIBOR premiums over official rates remain high in the US, European Union, and elsewhere. The knock-on effects have been felt in a number of key emerging markets for trade finance as well, with local market liquidity conditions in Russia and Kazakhstan, for example, persistently tight.

But it appears that the introduction of trade finance hedge funds has created new opportunities for banks to manage their trade finance exposures. BlueCrest Mercantile is currently planning capital allocations for risk transfer from a number of banks looking to manage their balance sheet for the year end.

“There is more demand for risk transfer from banks

looking to slow down the growth of their balance sheet or to reduce balance sheet size, while borrowers’ requirements for trade finance from banks has increased as the availability of alternative funding sources (such as the capital markets) has diminished. We don’t expect this trend to abate prior to year-end, in fact we see signs of acceleration now that year-end is approaching.” □

*BlueCrest Capital Management LP is an alternative asset manager based in London, managing over US\$ 11bn across its funds. BlueCrest Capital Management have asked us to state that nothing in the above article that concerns either BlueCrest Capital Management or its funds is intended as and is not to be taken as an offer or solicitation with respect to the purchase or sale of any security or interest.*



## BIOGRAPHY: JAMES PARSONS

As portfolio manager at BlueCrest Capital Management, James manages the BlueCrest Mercantile Fund, a structured credit fund that invests in trade finance, commodities finance and commercial finance risks.

Before joining BlueCrest, James was managing director and co-founder of LTP Trade, the trade finance consultancy firm and technology provider. Prior to that, he was a managing director at Deutsche Bank where he worked in the emerging markets divisions in New York, London and Hong Kong. James began his career in derivatives at Morgan Grenfell.

A leading authority on the impact of Basel II on bank lending activities, he is a regular speaker at conferences and has written many articles on the subject. James is a member of the Professional Risk Managers’ International Association.