Special report
Commodity prices, escalation clauses and L/Cs

by Peter Sproston

Volatility in commodity prices has become an everyday experience. The causes are manifold and need not be expounded upon here; however, at any given time, linkage between currencies (e.g., USD/JPY carry trade) and commodities (e.g., USD/Gold/Crude Oil), as well as the investment criteria of hedge funds, institutions, sovereign wealth funds, private equity and investors et al can lead to a disconnect between fundamental underlying economics and the prevailing prices of commodities. The dynamics of global capital and investment flows are complex; hence, the need arises for commodity market participants to protect themselves as much as possible from unexpected and often inexplicable price fluctuations.

The need for protection against adverse price movements is not new. Hedging, whether for commodities or currencies, has been a standard tool for a long time. An early form of hedging, pre-selling future corn crops, was practised in ancient Egypt. But the increasing price volatility as divorced from market fundamentals is perhaps more recent.

One might think that the main risk is in a market of falling prices. However, this is only really true for sellers, exposed to the potential risk of buyers reneging on contracts and covering themselves at the lower, prevailing prices. Yet there is also a risk in a rising market to the extent that a seller might wish to re-allocate goods to a more profitable spot sale and seek (almost any) means of escaping his delivery obligations.

L/Cs and commodities

Looking at L/C-related transactions, this article concentrates on the former risk, that of falling prices. At this point it is worth noting that reneging upon, or seeking to avoid, L/C payment obligations, is an act limited initially to the banks, sellers and buyers, bound as they are by current UCP rules. Avoiding payment due to the presentation of non-compliant documents under an L/C is the easy option for an unwilling buyer, but does not necessarily (depending upon the nature of the discrepancy(ies) found in the documents)[1] free the buyer from his underlying contractual payment obligations. The seller, however, has to pursue this right in litigation/arbitration.

Therefore, although the primary source of payment (under the L/C) may be endangered, the secondary course of obtaining satisfaction will still be available, the variants being the time and uncertainty concomitant upon obtaining and then enforcing a court judgment in one's favour.

Whilst there are several cases to choose from, one which I remember clearly due to the immediate impact it had in banking circles (when I still belonged to this happy elite) is *Glencore International AG v Bank of China*[2], mentioned in previous issues of *DCInsight*[3], which illustrated the decision to take advantage of discrepant documents when linked to a fall in market prices.

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[1] e.g. late shipment, delivering non-contractual goods (breach of contract), backdating the BL (fraud) etc.
[2] (1996) 1 Lloyd's Rep. 135; (1996) 5 Bank. L.R. 1; C.L.C. 111; (1998) Masons C.L.R. Rep. 78, *The Times*, November 27, 1995, CA
[3] *DCInsight* Vol. 2 No. 1; Vol. 3 No. 3; Vol. 3 No. 4; Vol. 6 No. 2; Vol. 10 No. 2; Vol. 14 No. 3.

The L/C issuing bank, Bank of China, alleged *inter alia* two discrepancies. One related to the goods description (an expanded version was used in the documents, which the court did not consider to be a discrepancy), and that copy, instead of an original, contained certificates stating that one full set of non-negotiable set of documents had been dispatched to the buyer. The market for the underlying goods, aluminium ingots, was falling at the time documents were rejected.

The issuing bank contended that (under the UCP in force at that time) that the documents in question, whilst signed, were not originals as called for. The relevant article[4] read thus: "Unless otherwise stipulated in the Credit, banks will also accept as originals document(s) produced or appearing to have been produced:

i. by reprographic, automated or computerized systems;

ii. as carbon copies;

provided that it is marked as original and, where necessary, appears to be signed."

Whilst the certificates were signed, they were not marked as original. The Court of Appeal considered that the documents appeared to be originals, but they came to the conclusion that they must be construed as authenticated copies (by virtue of the signature appended thereto) and were therefore discrepant. The documents in question were of no commercial value whatsoever, but assumed a disproportionate importance because the issuing bank sought out a technical discrepancy which the applicant declined to accept.

Thus could the buyer avoid payment of goods for the sake of a missing stamp! From this time on, and still today, documents produced in the same manner (i.e., reprographically) are invariably stamped as original, to avoid the same trap. A case like this shows both the strength and weakness of the "strict compliance" concept, for to demand that a bank use its discretion in defining what is compliant or not might appear to be fair in precluding such rejections, but it puts us on the slippery slope of potential abuse of the latitude necessarily granted to banks that this right implies.

How can you protect yourself from such a fate? Of the various mitigants available, one commonly seen in /LC/SBLC structures is a so-called "escalation clause", which we can now look at in a little more detail.

Escalation clauses

What is the purpose of escalation clauses? As the name suggests, they have the effect of increasing the L/C value subject to external pricing mechanisms. The logical counterpart to such clauses is the de-escalation (i.e., reduction) clause, which reduces the value of the L/C (or, more commonly, standby L/C) by the same means. Hence, these two modes are invariably paired to ensure an equitable pricing outcome for both buyer and seller. This will be found *inter alia* in metals and oil products transactions whereby the former will usually fluctuate according to the relevant LME prices prevailing over a certain period (usually linked to the bill of lading date), often as a so-called "wrap around". The period in question can be anything from three days to three weeks around the B/L date, month of shipment, or also to the month prior to, of and after shipment. Regarding oil products, the pricing basis might be a formula using one or more third party pricing publications, e.g., Platts/ICIS/Argus, etc., as a mutually acceptable and independent means of determining

[4] UCP 500, sub-article 20 (b).

the value to be paid, but using mainly the same or similar wrap-around terms indicated above.

An escalation clause is invariably very simple, e.g., "The value of this L/C is increased or decreased in accordance with the price formula evidenced herein without any further amendment hereto being required." One sees such clauses especially in swap L/Cs used as a means of hedging exposures.

Some banks decline to issue these instruments or L/Cs/SBLCs including an escalator, since their payment obligation – being dependent upon the marked-to-market (M2M) pricing movements during the L/Cs validity – cannot be assessed at the time of issuance. Therefore, the maximum liability remains unknown until conclusion of the pricing period. This could result in a customer's credit line being exceeded, with obvious consequences regarding internal controls, demands upon the client for additional collateral security, etc.

Avoiding escalation clauses

However, the issuance of these L/Cs can be avoided or supplemented if the bank's customer does his hedging through a recognized clearing broker/intermediary with whom he has a credit line, and if the account is duly pledged to the financing bank under the terms of a Tripartite Agreement entered into between the bank, broker and customer. In this scenario, margin payments outside of the line (variation margin) will be due to the broker, but settled by the bank as a means of securing the price risk.

Usually the credit facility will include a sub-facility for such payments or, better yet, permit them to be handled outside the credit facility so that the customer can continue his commercial activities without undue constraints upon his cash flows/liquidity.

Such a facility is essential in times of great price fluctuation, since it avoids a line being consumed by margin calls, which, in turn, limit the bank's customers from fully engaging in their market activities. It should be stressed that failure to meet a clearing broker's margin call(s) within the prescribed period – usually one/two banking days – may result in the hedge(s) being unilaterally unwound, which could have dire or even catastrophic consequences for a bank's customer. This is because the physical leg of a deal would no longer have its profit margin locked in, thereby exposing both the bank and client to a potentially loss-making scenario, since market pricing volatility would no longer be mitigated.

Most banks fight shy of issuing instruments incorporating an escalation clause. One reason is simply because the bank cannot *a priori* determine its potential exposure in the event a claim is made. Because the bank has capital allocation rules to meet – based on the face value of its conditional payment obligations – this can be a problem, albeit not an insurmountable one, since there are internationally active trade banks that can issue such instruments. However, one suspects the creditworthiness of the bank's client will play an important role in determining whether they will countenance such issuance.

Another possible reason is pecuniary. Commission is calculated on the maximum face value of the instrument issued. If this can only be determined in the event of a claim, it's possible that the bank has been providing its payment undertaking at a discount to its obligor.

One solution
The most common means of overcoming this conflict of interests is to issue an instrument incorporating an escalation clause, but capping the bank's maximum payment obligation. The market value of the underlying goods at the time of issuance is then taken as a benchmark, but with a cap set at an agreed percentage in excess of the same. The seller may have the right to call for an adjustment in the instrument's value during its validity to compensate for any upward price movements in excess of the original fluctuation band.

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