# Whale watching

**A commodities financing scandal in China has shed some light on the murky underbelly of its collateral trade, which some fear is fuelling bubbles in China's economy. *Finbarr Bermingham* reports.**

Earlier this year, a committee of the Chinese Political Advisory Board devoted a full morning to tackling one of the great issues of our time: why haven't China's soap operas captivated its citizens in the same way as online streams of their South Korean counterparts? This unusual bout of naval-gazing was inspired by the wildfire spread of the Korean drama 'My Love From The Star', a classic tale of a 400-year-old alien who falls in love with a modern day film star which by February, had been streamed 2.5 billion times online by people in China.

If the committee had cast their officious eyes 700-odd kilometres down the coast, they may have caught a glimpse of the blockbuster unfolding in Qingdao: a real life drama which makes the top-rated Korean shows look like episodes of 'Barney and Friends'. Crime, conspiracy, corruption and death – not to mention inanimate objects vanishing from the face of the earth – the story that's been drip, dripping from the world's eighth-largest container port over the past few months has had it all.

The plot all began to unravel in May, when Chinese authorities announced that they were investigating a private metals trading company for using fake warehouse receipts in order to secure multiple loans using single cargoes of copper and aluminium as collateral, stored at Qingdao Port. The company was nicknamed 'the Qingdao Whale', a play on the London Whale at the centre of a 2013 scandal in which a JP Morgan trader managed to cover up more than £1bn in credit default swap losses.

For those looking at the case from the outside, the comparison was clear: the waters of China's commodities sector are murky. For all anyone knew, there could have been tens of billions at stake. The whale was soon identified as Decheng Mining, a subsidiary of Dezheng Resource Holding Co, owned by the Singaporean Chen Jihong, who has since been detained by authorities. But as any film buff will tell you, a protagonist is only ever as good as its supporting cast. Over the weeks that followed, the glitterati of the trading world entered stage left to provide the strongest chorus line imaginable.

"This case is particularly significant," says Mike Jakeman, the commodities editor at the Economist Intelligence Unit. "Not because it exposes potential fraud on the edges of the Chinese financial system, but because it has dragged in members of the global banking industry, which is intolerant of such practices."

Standard Bank, Standard Chartered, HSBC, Citi, Glencore, Mercuria and Trafigura all made noises in the aftermath suggesting that they had been exposed to the irregularities in some way or other. Combined, it's estimated that international institutions are likely to incur combined losses of more than US$1bn. Media reports in China suggest that Decheng owes Chinese banks upward of US$2.5bn.

The ongoing legal merry-go-round is enough to make your head spin. Take a deep breath: ABN Amro

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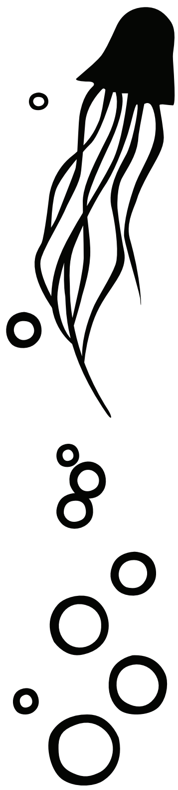
is pursuing Citic Resources, a commodity trading company for making an erroneous claim on a metal cargo at Qingdao Port; the Dutch bank also won a court order forcing Decheng's Chen Jihong to pay it US$22mn owed under a loan agreement; Citic is suing Qingdao Port for losses of US$108mn; HSBC issued wind-up proceedings against the overseas arm of Decheng for defaulting on US$4.3mn of payments; Standard Chartered is pursuing the overseas arm of Decheng for US$36mn in loans; and Shanxi Coal International is suing Decheng for US$177mn in missed payments (figures all courtesy of *Reuters*).



In the grand scheme of things the losses may not be all that great (with the exception of those now facing Decheng Mining, which will surely never trade again) – from what we currently know, Decheng is more beluga than blue whale. But the whole episode has shed some light on a practice which has been allowed to fester for a long time. It's piqued people's curiosity around the legal, but relatively unknown territory that is China's collateral trade, which some analysts fear "seems now to be in danger of imploding, creating major risk for the world's commodity and financial markets, as well as for China's property market".

## Trading places

The owner of those ominous words is Daniel de Blocq van Scheltinga, the founder of Polarwide, a Hong Kong-based financial advisory, which has conducted extensive research into the collateral trade.

"There is nothing wrong with using commodities as collateral to achieve financing if this is done correctly. This is as old as banking and is used globally," he says. "Obviously this means that until the loan has been repaid the commodity in question can't be used in any way. It offers short-term financing solutions, enabling companies to grow or purchase more commodities. If done correctly, it doesn't pose any real dangers."

The collateral trade in China snowballed after the People's Bank of China (PBOC, the Chinese central bank), made lending conditions tougher for private sector companies. Such firms were faced with two choices: visit the shadow banking circuit, or take out a loan secured on the back of a stock of commodity.

"Collateralised lending, which both foreign and Chinese banks provide, is seen as far less risky. In case of default, at least the bank has ownership of the commodity, which they can sell," van Scheltinga explains.

To reiterate: what Decheng Mining did isn't legal: as China moves from an investment-led to a consumption-led economy, finance has been in even shorter supply,

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>
> **Caroline Bain**, Capital Economics

with greater percentages of commodity collateral required to obtain loans, leading in turn to companies using the same collateral to obtain multiple loans.

"Unlike with a mortgage, there are no public registers stating that such and such a commodity has been used as collateral against a certain loan. Even if this were to exist, how can one really differentiate between different bars of steel, piles of copper or bags of grain?" he says.

But on the legal side, there is also plenty of legroom for those companies that wish to manipulate the market. Many companies have been purchasing stocks of steel, copper, zinc, nickel, gold, and even soft commodities such as soybeans and palm oil, solely in order to borrow against.

This has spawned serious distortion of market prices, as well as massive stockpiles of commodities languishing in unregistered warehouses, away from the real industrial market. Some estimate that China has bought two-thirds of the world's iron ore on this model and 40% of its copper. Polarwide notes that enough iron ore to build 1,200 Empire State Buildings is currently lying unused in warehouses.

"It makes it difficult to estimate what's happening with Chinese consumption. You look at imports and it looks like they're growing strongly, but you don't know how much of that will be used physically or put into store. It seems very likely that there are unreported stockpiles around," says Caroline Bain, a commodities expert at Capital Economics.

## The plot thickens

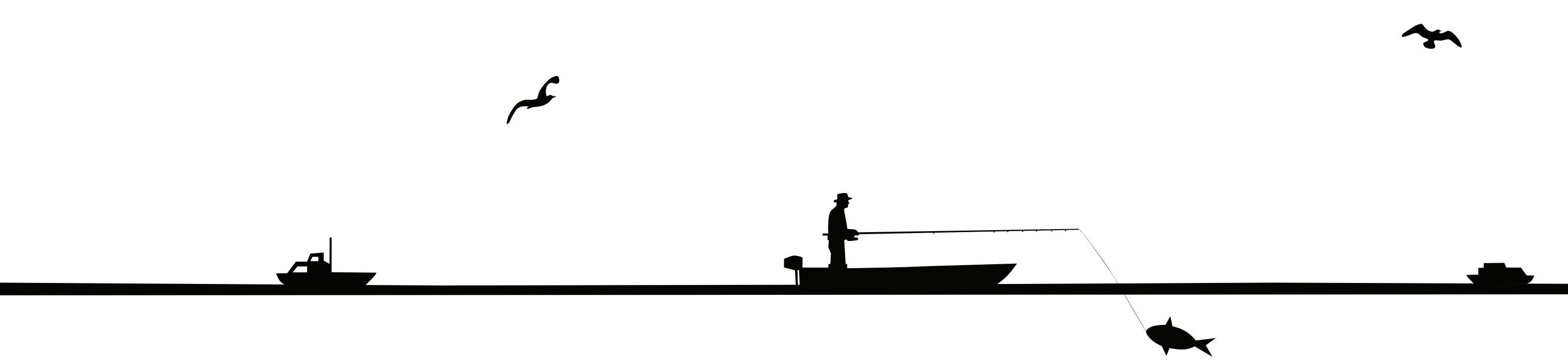
One of the real fears over China's collateral trade centres on its role in the country's property market and shadow banking system. There is evidence to show that Chinese companies have been using trade finance instruments, collateralised with commodities, in order to invest in high-return shadow banking products, which in turn enable the shadow banks that are issuing them to lend to the real estate sector.

The model is complex, but explained in a blog post by International E-Chemicals, a consultancy, and paraphrased below:

A company opens a letter of credit (LC) with a bank to import copper, using the LC to pay the producer. Given that the LC will have, ordinarily, a 180-day tenor, using just a 20% deposit, the company sells the metal to an associated Hong Kong-based company. The Hong Kong company has access to offshore funding and pays with offshore money, which the Chinese company invests in high-yield products commonly associated with the property sector. In the meantime, a second LC is obtained to rebuy the copper, which then returns to China. Using offshore funds again, the copper is repurchased again by the Hong Kong company, which allows the first LC to be repaid, with the second LC being repaid by the returns of the high-yield investments.

In essence, the copper stock passes back and forth between two entities of the same company, paid for by bank debt, with the funds generated invested in high-yield securities. It's doubtful that the copper will ever serve a physical purpose at all.

Companies using the model can also capitalise on lucrative exchange rate and interest rate arbitrage. To June 2013, Goldman Sachs estimated this trade in the copper business alone to be worth up to US$40bn. Across all commodities, the bank estimates that up to



US$160bn has flown in and out of the trade since 2010.

The dangers of this are clear: artificial wealth bubbles are created. Liquidity is being conjured out of nowhere to be invested in an ever-expanding property bubble. Stocks of industrial metals are lying dormant and, until China's latest tranche of fiscal stimulus kicks in, may continue to do so (in some instances, the stocks are perishable).

At the same time, because the demand for commodities to be used in the trade is insatiable, the market prices are artificially high. Nobody really knows what the true picture of China's commodities sector should look like. It shares its impenetrable opacity with the shadow banking sector with which it goes hand-in-hand. Warnings over the financial equivalent have been common in recent years. Alarm bells over the shadow commodity trade should be ringing too.

## The final curtain?

As Chinese summer turned to autumn, the dust began to settle on the Qingdao probe (at least for now). Yet, the headlines still rained in. Bian Peiquan, the deputy commissioner of customs at Qingdao Port died of "unnatural causes" in August, bringing a full police investigation. Players in the commodities game grew ever more litigious, with Glencore bringing legal proceedings against Qingdao Port and Trafigura's warehouse business Impala suing Citi and Mercuria.

One immediate result was the exodus of commodities from Qingdao Port, headed for Shanghai, Busan and ports in Malaysia. "We saw a small temporary reallocation of stocks away from China in late-June and early-July, but a broader reallocation has not emerged, as the scandal didn't spread to the larger store of stocks in Shanghai. Much of the stock in Qingdao is under investigation and not leaving," says Matthew Wonnacott, a copper consultant at advisory firm CRU Group.

Copper and aluminium prices plunged, but then recovered. It was a weird indicator of yet more opacity in the market. With the summertime lull in Chinese construction, industrial metals prices could be expected to remain relatively low. Yet, come mid-August they were buoyant, floating on invisible demand existing between the visible sectors, like some sort of market-making dark matter.

"I scratched my head. It's so strange," Helen Lau, head of metals and mining at Hong Kong-based trading and investment company UOB Kay Hian, tells **GTR**. "Copper prices have kept their level, but where is the copper going? To some unregistered warehouses?"

But the long-term effects of the probe may continue to rumble. It was just one recent event which shook investor confidence in China's commodities sectors. Another investigation is underway in Tianjin Port, near Beijing, into suspected fraudulent trading in mixed aromatics, a refinery product often used for blending petrol.

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In late-June, China's National Audit Office discovered US$15.2bn in fraudulent loans backed by non-existent gold stocks, further exasperating those attempting to get to the bottom of China's missing metals mystery. And in July, it was announced that China was to scrap its corn stockpiling policy which has seen it holding more than half the world's corn stocks in reserve, since storage facilities are overflowing. It never rains, but it pours.

Banks, for their part, are likely to become more diligent in response to the wave (after wave, after wave) of scandals. "Very few banks have said they will completely exit the market. It's a very lucrative market. But they'll be far more diligent in checking that everything is legal and is what it seems," says Caroline Bain.

Already, bank lending levels to the sector are thought to be down (although it's understandably tough to quantify). The PBOC is looking to ways to stop the collateral trade from further inflating the country's property sector. But until there is more transparency around commodity trading in China, it's difficult to know what the efficacy of any course of action will be (will they simply force companies further into the shadow banking sector?).

Some fear the simultaneous series of events that exploded around the Qingdao probe may be remembered as China's Minsky moment: the exact point in time when asset values collapse, after sustained periods of prosperity lead to speculation on borrowed money. Others view it as a mere blip, with the recently announced stimulus package from Beijing well-placed to pick up the lag in price, should dormant metals stocks be forced to re-enter the "real" market. What is for sure though, is that there's a long way to go before the credits role on this one. GTR