HD After port fraud, China's vast warehouse sector under scrutiny

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SYDNEY/SHANGHAI (Reuters) – Shaken by a fraud investigation into metal financing in the world's seventh-busiest port, banks and trading houses have been made painfully aware of the risks they face storing commodities in China's sprawling warehouse sector.

The probe at Qingdao port centers around a private metals trading firm suspected of duplicating warehouse certificates in order to use a metal cargo multiple times to raise financing.

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Some banks have asked clients to shift metal, used as collateral for loans, to more regulated London Metal Exchange (LME) warehouses outside China or those owned and operated by a single warehouse firm to limit their exposure.

"The banks still haven't looked under the hood," said an executive at a bank involved in commodity financing in China, referring to China's warehousing sector.

At the heart of the issue is China's roaring commodity financing business, which has helped drive up stockpiles of commodities at ports to record levels, stored in warehouses not always regulated to the same extent as elsewhere.

Though many global firms are involved in the warehouse industry in China, there has been outsourcing to local firms to cut overheads and avoid dealing with complex local regulations.

Using commodities as collateral in financing in China is common practice and not illegal, but issuing receipts to repeatedly mortgage an asset is fraud and could leave more than one creditor holding claims to the same collateral.

Illustrating how difficult it may be to unravel competing claims, China's CITIC Resources Holding Ltd. said that a court had been unable to secure more than 100,000 tons of aluminum stored at Qingdao port.

Traders said there was a risk the metal could have been already claimed before part of Qingdao Port was sealed off, adding that at least two trading houses had moved metal out as soon as news of the scandal broke.

CITIC Resources said it would conduct its own investigation and was considering further legal action.

Trading Blame

In Qingdao, sources with knowledge of the probe said authorities were looking at whether the firm under focus, Decheng Mining, had secured multiple warehouse receipts because an affiliate managed logistics at the port's Dagang bonded zone.

Phone calls to Decheng Mining and its parent firm, Dezheng Resources, seeking comment were not answered. Officials at Qingdao port could also not be reached.

"Warehouse receipts are not title documents, they are documents of entitlement. But they are being used as title documents for sales and purchase and transfer of ownership," said a person at a warehouse company with operations in Qingdao. "Everywhere else outside of China, a warehouse receipt is cut for one party."

A source at a Western bank with direct knowledge of Qingdao said warehouse firms should bear the brunt of responsibility, while a senior official at a warehouse firm at the port said responsibility "remains very much up in the air."

A lawyer, who has previously been involved in litigation over fraudulent warehouse receipts, said banks' primary recourse would be against whoever had forged receipts.

"But if the fraudster is gone, the bank may decide that it wants to go against the warehouse," said the lawyer, who did not want to be named because of the sensitivity of the issue.

A warehouse operator and a banker said agreements with clients meant there could be limited liability for a cargo, capping a payment at around $100,000, depending on specific terms and conditions. For example, a shipment of 10,000 tons of copper would be worth about $68 million at current prices.

Even if banks or their customers have insurance for the metal, some warehouse sources said they might struggle to get paid if fraud is uncovered or their agents are implicated.

Global Firms

Singapore-based GKE Corp., a part-owned unit of Louis Dreyfus Corp., CWT Ltd. and the metals warehousing arm of Glencore, Pacorini Metals, are among global firms involved in the warehousing business in Qingdao.

GKE said on June 16 to the best of its knowledge management or employees were not implicated in the port investigation.

Spokesmen for Glencore and CWT declined to comment.

A firm that appears to have steered clear of the current problems at Qingdao is C. Steinweg Handelsveem B.V., the world's largest independent metals warehousing and logistics firm.

The Dutch firm, which does not operate in the Dagang area of the port where the fraud probe is centered, does not contract out logistics operations to third parties and usually owns its warehouses, according to traders, bankers and warehouse sources.

Steinweg declined to comment.

Benefit LME?

As well as potentially benefiting firms owning and operating warehouses, the Qingdao probe has prompted some movement of metal to LME-approved warehouses in locations such as South Korea.

The LME, which is owned by Hong Kong Exchanges and Clearing Ltd., has approved more than 700 warehouses and storage facilities in about 40 locations globally.

The exchange is keen to break into the Chinese market, where it is not currently permitted to license warehouses.

The LME sets down specific requirements for warehouse firms it licenses, such as evidence of adequate capital and insurance, as well as regulating metal movement and conducting audits.

"The extension of the LME's warehouse network into mainland China is an important issue for the LME and its users and we alongside HKEx put a high priority on this initiative," said a LME spokeswoman.

A person at a warehousing company in Singapore said that countries where the LME operates the "the confidence level is much higher" with a regulatory system in place.

But the reverberations from the Qingdao probe may not be clear cut, since global warehousing firms potentially exposed to the scandal are licensed by the LME to operate in other ports. The LME declined to comment further.

One thing looks certain, however, banks involved in commodity financing in China are set to charge higher fees.

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"The cost is certainly going to go up, whether it's going to be from local banks or international," said analyst Colin Hamilton of Macquarie in London.

By Melanie Burton and Fayen Wong, with additional reporting by Rujun Shen and Susan Thomas

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