INSIGHT-Fixing the world's metals warehousing: why so long?

By Susan Thomas, Veronica Brown and Josephine Mason
1,710 words
15 November 2013
01:00
Reuters News
LBA
English

LONDON/NEW YORK, Nov 15 (Reuters) - In the mid-1990s the London Metal Exchange was embroiled in a criminal investigation after the discovery that a trader - nicknamed Mr 5 Percent for the share of the world's copper he reputedly controlled - had spent years manipulating its systems to hoard copper and boost the price.

The episode, when Japanese trade house Sumitomo Corp's head trader Yasuo Hamanaka racked up $2.6 billion in unauthorised losses trying to corner the copper market, plunged the LME into crisis and led to an investigation by the British government.

No criminal charges were ever brought in the UK, but a 1997 probe by former Treasury official Alan Whiting triggered an overhaul of the rule book of the world's biggest metals market and introduced limits on traders' positions.

While lessons were learned from the incident, a review of the Whiting report and other LME reports spanning 17 years suggests opportunities may have been missed to prevent a more recent controversy.

Lawsuits filed by manufacturers in the United States in recent months assert that, enabled by LME rules, banks and traders hoarded metal in warehouses they owned, raising prices. The firms and the LME say the claims are baseless.

In his report Whiting flagged potential conflicts of interest in the LME's global metal warehouse system - the some 700 warehouses certified by the LME to hold metals that meet its specifications.

Whiting highlighted the relationship between warehouse companies and members of the exchange and identified several threats to a well-functioning market - the practice of long-term storage, incentives offered by warehouses to encourage storage, the charges levied by warehouse companies to extract stocks and delays in delivery.

Fast forward to 2013.

The LME, which was sold last year by its member owners to the operator of the Hong Kong stock exchange, is a defendant in the lawsuits accusing Goldman Sachs, JPMorgan and Glencore-Xstrata of rigging the aluminium market and violating anti-trust laws.

The lawsuits accuse the banks and traders of stockpiling metal in warehouses, delivering it out at the minimum pace and driving up the prices of industrial products from soft-drink cans to aircraft. Plaintiffs argue the LME abetted the scheme by writing rules that made it possible and ignoring calls to change. The LME says its rules were made independently.

The lawsuits coincide with a probe by the U.S. Department of Justice into the metals warehousing industry and the ownership of physical assets by Wall Street banks.

The report by Whiting was not the first.

A review in 1996 by the-then UK financial watchdog the Securities and Investments Board urged the LME to examine warehousing and raised aspects of the relationship between warehouse companies and LME members which it said were potentially open to anti-competitive behaviour.

There were several further external and internal reports, complaints and consultations on LME warehousing.

In 1998, the LME added to its warehousing rule book a stipulation requiring "Chinese walls" between an LME member and a related warehouse company. But the exchange said UK competition law prevented it from banning LME members from owning warehouse companies.

FIRST STEPS TO A CRISIS

A first step in the trading house/warehouse relationship was taken in the late 1980s when one of the LME's biggest shareholders at the time, broker Metallgesellschaft (MG), bought British warehousing firm Henry Bath. The LME did not stop the purchase.

"With the benefit of hindsight, the LME should have dealt with it," said a former LME board member who, like many of the people Reuters spoke to for this story, declined to be named because of the sensitivity of the subject.

"If they had, we would have had a different scenario. Once you set a precedent, you can't stop it being repeated."

In 1999, some of the 400 industry responses to an LME discussion paper entitled "Warehousing: The Way Forward" raised concerns about high warehouse charges and a few worried about the relationship between LME members and warehouse companies.

Just over a year later, in the first half of 2001, the LME board received "30 official letters of complaint about the way in which LME-approved warehouse companies operate", according to a report by then complaints officer **Oonagh McDonald**.

Her report suggested that one key issue for the LME was the long-term storage of metal away from areas where it was likely to be of most benefit to consumers.

"Inducements played a part in this and resulted in high out charges," her February 2002 report noted. "A closer correlation between the location of LME warranted stocks and demand for them could make a significant difference, as could the more efficient movement of metals to lower cost facilities."

At the end of that year, the LME issued a consultation document following a review of slow deliveries out of warehouses, warehousing costs and the location of warranted metal.

In the early 2000s, the LME acted. U.S. warehouse firm Metro was prevented from warranting metal in its Long Beach and New Orleans depots after complaints that it had "failed to demonstrate it can meet acceptable delivery out rates". It was fined 50,000 pounds.

But the complaints about warehousing practices continued, and in 2006 the LME commissioned independent consultancy Europe Economics to undertake a study into the implications of changing all LME metals contracts from delivery "in warehouse" to "free on truck" - so overcoming charges associated with extracting stock from warehouses.

It concluded that changing the LME contracts would not benefit users and in any case, once again, there were questions over the ability of the LME to change its rules because any attempt to regulate prices could contravene competition laws.

But Philip Crowson, who chaired the LME committee examining the issue, wrote in a note with the Europe Economics report that this did not mean the status quo on rents and charges was desirable or that the LME should be complacent. He urged the LME to be vigilant over all warehouse rents and charges.

WARNINGS

The accumulated warnings about warehouse ownership, rent charges and the concentration of metal in specific locations appeared to go unheeded.

In the meantime, MG had sold Henry Bath to Enron, which in turn sold it to RBS Sempra. And in July 2010, the warehousing firm landed up in the hands of JPMorgan when it bought RBS Sempra Commodities' global oil, metals, coal and European power and gas assets.

The same year, Goldman bought Detroit-based warehousing firm Metro, and other LME shareholders and traders soon followed. Glencore bought Pacorini and Trafigura bought NEMS.

The wait times that had prompted complaints in earlier years got even longer as the new warehouse owners concentrated metal into depots at single locations and released it only at the minimum daily rate mandated by the LME.

Warehouses registered by the LME at ports around the world are supposed to allow companies that need metal to take delivery of supplies against the exchange's futures contracts.

The lengthening queues, particularly in Detroit, prompted the LME in 2010 to commission a second report by Europe Economics, this time to assess the rate at which warehousing companies were delivering out metal.

The full version of the report was not published because it contained proprietary information, the LME said in May 2011 when it released a summary of the findings. The LME adopted recommendations doubling minimum delivery out rates to 3,000 tonnes per day for warehouses holding more than 900,000 tonnes of metal per location.

The LME noted at the time that the lengthy queues were specific to aluminium and to one location only. "The LME does not have a systemic issue with its warehouse network," LME Chief Executive Martin Abbott said then.

The problem then spread to other metals, including zinc and copper, in multiple locations from Johor in Malaysia to Vlissingen in the Netherlands and New Orleans in the United States. Warehouses in New Orleans, for instance, now house 60 percent of the total global LME stocks of zinc.

In 2011, British minor metals merchant Anthony Lipmann, invited to address a UK parliamentary committee on strategically important metals, took that opportunity to question LME-members' ownership of warehouses used for storing metal traded on the exchange.

"My argument is that if you go back to first principles and simply say that a warehouse cannot be owned by someone who has an interest in outcome of price, the conflict of interest at the heart and core of the world's leading free market in base metals would not have happened," Lipmann told Reuters.

HONG KONG ERA

Having paid $2.2 billion for the LME for a significant commodities foot-print, Hong Kong Exchanges and Clearing also bought the warehousing conundrum. HKEx Chief Executive Charles Li said warehousing was an issue that could have seen him walk away from the purchase.

But he showed no fear about tackling the issue, promising in October last year to aim "a bazooka" at the problem of long queues once he was able to consider the matter fully.

"If people have to wait for a year that's a very big problem, it is a level-one issue. If somehow the LME system is making clients suffer in that way, that is not acceptable," Li said at the time.

Less than a year later, on Nov. 7, the LME unveiled a plan to slash wait time to a maximum of 50 days, give itself powers to act swiftly to prevent abuses of the system and is reviewing its agreement with warehouse companies. But the LME's new chief executive, Garry Jones, acknowledged last week that the exchange still cannot stop trading companies from owning warehouse firms.

Reaction to the new plan has been mixed, but some of the biggest critics of the LME's policy, including big aluminium users Coca-Cola and brewer and can maker MillerCoors, are already calling for a greater overhaul.

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