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Collateral damage

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Despite a stable end to 2021, the commodity finance industry remains wary of being embroiled in another fraud scandal. Though price rises and strong liquidity have led to booming business at the top end of the market, smaller traders continue to struggle for access to finance. Could strengthening collateral checks or warehouse inspections

help mitigate those risks and reopen the market to SMEs? *John Basquill* reports.

Fear of fraud continues to shape the commodity finance industry. Though the stream of fresh cases that emerged during 2020 appears to have largely dried up, the total losses to trade finance lenders has already run well into the billions of dollars.

In two of the most high-profile cases – those of Agritrade International and Hin Leong, two Singapore-based traders that collapsed within weeks of each other in early 2020 – the fallout has included criminal charges against senior executives as well as efforts by creditors to claw back lost funds. Liabilities to banks and other creditors from the two cases totalled as much as US$5bn.

Fraud allegations have also emerged following payment issues at smaller traders during 2020, including at UAE-based Phoenix Commodities and GP Global, and Singapore's ZenRock, Hontop Energy and Sugih Energy. In many cases litigation is ongoing.

Inevitably, the conversation since then has turned to prevention. In some cases, trade and commodity finance lenders have scaled back their exposure to the sector, focusing efforts on a smaller number of larger customers – a trend dubbed a "flight to quality" by traders and banks alike. Other lenders have exited the sector entirely.

However, for lenders that are still keen to support SME commodity traders, there are lessons to be learned from 2020.

In some of the world's leading commodity trading centres, industry participants have joined forces to raise standards around due diligence, risk assessment and information sharing.

In Geneva, a group of 10 commodity finance lenders spent more than a year collaborating on a best practice guide, published in October 2021 by the Swiss Trading & Shipping Association (STSA). Though not mandatory, the recommendations are designed to "reduce the potential for future losses" and ensure commodity finance activities remain sustainable.

And in Singapore, the city-state's banking association has joined forces with Enterprise Singapore, an innovation-focused government agency, to produce a code of conduct aimed at improving transparency in the sector. The code is not mandatory but has the backing of the banking regulator, the Monetary Authority of Singapore.

Some initiatives have focused on documentation, turning to technology to ensure the same documents cannot be used to raise finance from multiple banks.

In Singapore, Standard Chartered and DBS Bank have jointly led a project to construct a blockchain-based registry of trade finance transactions, which would flag up attempts to raise financing more than once against the same cargo, without disclosing sensitive commercial information.

Meanwhile, **GTR** revealed in September that financial messaging network Swift is trialling a trade finance fraud prevention solution that carries out document duplication checks, using fintech company MonetaGo's Secure Financing platform.

But for some industry experts, the key to preventing fraud could be improving oversight of the cargo itself.

Collateral management

Misuse of collateral is at the heart of the allegations around Hin Leong. Its collapse was triggered by founder and chairman Lim Oon Kuin admitting to investors that the company had suffered vast undisclosed losses, and that collateral pledged to support lending by banks had already been sold.

Judicial managers later revealed suspicions of a pattern of fraudulent activity, where trade finance was raised multiple times against the same invoices, or in some cases, where the underlying cargo did not exist.

However, past experiences suggest relying on warehouse receipts or goods certificates may not be enough to eliminate the risk of fraud. The Qingdao metals scandal, exposed in 2014, involved Dezheng Resources raising finance against forged receipts or certificates for aluminium ingots, alumina and refined copper.

Chen Jihong, chairman of the company, was jailed for 23 years in 2018, but legal wrangling has continued. As recently as November 2021, Deutsche Bank and Mercuria settled a US$21mn dispute arising from the scandal, after Mercuria purchased aluminium that was later found to have been sold on already, or never existed in the first place.

Christine Grolimund, head of collateral management at Medlog, the logistics arm of shipping giant MSC, said during October’s GTR Commodities event in Geneva that in many cases, trade-related fraud can be detected by carrying out physical inspections at a warehouse, typically via a third party.

“In terms of our physical stock, the main risk is that there is no stock, or the same stock with several warehouse receipts is pledged to several banks,” she said.

Citing examples from her own experience, Grolimund described finding fraudsters had constructed an inner tube inside a petroleum tank in order to give the appearance it was full. In another case, she described a warehouse with a false back wall, which allowed goods to be hidden from inspectors.

Other red flags include inspectors having access to a warehouse refused or delayed, for instance because senior staff are not available.

“The role of the collateral manager is important, because it prevents that,” she said. “It’s important to have a company that is not the one to whom you would claim… so you can make sure that the stock is in good hands.”

Using a third party to carry out warehouse inspections can prove costly, however. Sander Stuijt, managing director for structured commodity trade finance at Deutsche Bank, points out that banks can be reluctant to pass those costs onto their customers.

"If our clients have to pay for it, that's where you can get into trouble," he said at the same event in Geneva. "Are they willing and able? When you look at fraud cases, the costs are minimal compared to what you can lose, but day-to-day, how do we convince [clients]?"

Rupert Cutler, director and principal of specialist risk and insurance consultancy Holtarka, argues that affordable technology that would enable interested parties to carry out real-time inspections of collateral is already available.

"There are services where you can record video anywhere in the world and produce a downloadable report, which helps reduce fraud," he tells **GTR**. "There are also internet of things devices where you can fix a monitor to a container.

"It's just that people choose not to do it. These things are not particularly expensive, and if you don't have a good tool for this, you're going to get defrauded."

Weighing it up

There may be deeper, more structural reasons why many trade and commodity finance lenders remain reluctant to invest in warehouse checks.

"In the normal world, when you do a deal, you would check the inventory by paying for a third party to be your eyes and your ears, especially if you're far away from your base," says Jean-François Lambert, founder and managing partner of Lambert Commodities.

"But the problem is the relative profitability of these transactions. In absolute terms – in hard dollars – you can make a nice profit, but profit is not only measured in absolute terms; it is relative to the capital requirements set by Basel."

Under Basel III, which has been fully implemented since 2019, Lambert says taking security over goods does not necessarily give banks a significant reduction in the amount of capital they must hold to undertake a trade finance transaction.

"The main thing is the probability of default by the borrower, and no matter what security you have taken, if the probability of default is high, that will need a lot of capital to be put on the table," he tells **GTR**.

"That means the overall return on capital is not great, and you're effectively competing with other parts of the bank that might promise a better return of capital. That's just how these decisions are driven."

If a bank does decide to proceed, the low relative profitability on many trade finance transactions means further expenditure – on warehouse inspections or other goods checks – is seen as more of a burden.

Baldev Bhinder, managing director of Singapore-based specialist law firm Blackstone & Gold, says that typically, reaching a collateral management agreement with a third party is unlikely to be commercially viable for lower-value trade transactions.

"You have to reach a minimum threshold in terms of the value of the cargo before that makes

sense," he tells **GTR**. "There is a cost point – you have to have a certain critical mass in terms of the volume of trade you're doing, and the pricing of those trades."

For Lambert, the relatively low reward compared to higher risk or cost means some banks "end up simply avoiding these trades".

The 'flight to quality'

Relatively few banks have exited trade finance entirely.

ABN Amro announced in August 2020 it would shutter that part of its business after booking impairments of over US$1.8bn. Its exposure to Hin Leong was estimated to stand at US$300mn, second only to HSBC, which was owed approximately US$600mn.

Other notable lenders to have withdrawn or scaled back trade and commodity finance activities include fellow Dutch lenders ING and Rabobank, as well as Paris-headquartered BNP Paribas.

Generally, the availability of trade finance facilities has become more concentrated at the larger end of the market. During 2021, several large traders – including Cargill, Glencore and Trafigura – reported record-breaking net income, in some cases posting greater returns in the first nine months of the year than for the whole of 2020.

Smaller traders, meanwhile, have reported reluctance on the part of their banking partners to extend financing lines – though such firms are often cautious of speaking publicly about difficulties accessing finance, wary that it could further worsen their image in the eyes of lenders.

Part of the issue is straightforward: banks are nervous about being caught up in another fraud scandal. Speaking at GTR Commodities in October 2021, Michiel Teunissen, Rabobank's head of innovation, trade and commodity finance, warned that "if there is a huge case again anytime soon, that would seriously jeopardise commitment" across the banking sector.

But there are other complications for smaller and mid-sized commodity traders. Larger firms are able to take positions in the capital markets, complementing their trade finance activities with other instruments such as currency swaps and hedging, while smaller firms lack the liquidity or access to finance to do the same.

The drastic volatility in commodity prices during 2021 has exacerbated those issues. Access to the financial markets means larger traders can optimise returns on price fluctuations, but as Bhinder points out, for a smaller trader "what was a US$1mn trade now becomes a US$5mn trade, for the same cargo".

Rajesh Johar, co-founder and managing director at Singapore-based commodity trader Avani Resources, says the situation in the city-state is "not really great".

"The high prices of commodities have further squeezed traders' ability to handle a greater number of transactions," he tells **GTR**. "The volatility of the prices only adds to the risk, as well as increasing the discomfort for banks."

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As a result, the discrepancy between larger and smaller traders in terms of access to trade finance still appears to be widening.

"There was a trade finance gap for SMEs already, but with the pricing where it is now, and with the value of the cargo having gone up, it's becoming wider," Bhinder says. "I hear traders complaining on a weekly basis about the lack of financing."

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