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Days of Futures Past | Episode 8
Andy Home, Senior Metals Columnist, Thomson Reuters

We continue our *Days of Futures Past* series this week with Andy Home, Senior Metals Columnist at Thomson Reuters. SmarterMarkets™ host David Greely sits down with Andy to explore the history, the crises, and the scandals of the metals markets and the London Metal Exchange (LME). Together, they discuss what lessons we can learn from these histories in order to build better and smarter metals markets for the energy transition.

Andy Home (00s):
All these metals have huge demand prospects because of the green energy transition. We should expect them to become more volatile and probably higher priced as they struggle to meet that demand. This is not a world going forward when we can have that same "oh, you know, look, the market's gonna get it right and we don't have to intervene" approach anymore. No, no, this is a world where metal markets are gonna need safety cushions and barriers. I think one of the wholesale shifts is a change of attitude about how markets should be regulated, but that also reflects maybe a broader change of attitude amongst the London authorities as well.

Announcer (36s):
Welcome to SmarterMarkets. A weekly podcast featuring the icons and entrepreneurs of technology, commodities and finance ranting on the inadequacies of our systems and riffing on ideas for how to solve them. Together, we examine the questions: are we facing a crisis of information or a crisis of trust, and will building Smarter Markets be the antidote?
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David Greely (01m 17s):
Welcome back to Days of Futures Past on SmarterMarkets. I'm Dave Greely, Chief Economist at Abaxx Technologies. Our guest today is Andy Home, Senior Metals Columnist at Thomson Reuters. We'll be discussing the history, the crises and the scandals of the metals markets and the London Metals Exchange and what we can learn from them to build the better, smarter metals markets that we need for the energy transition. Hello, Andy. Welcome back to SmarterMarkets.

Andy Home (01m 44s):
Hello, Dave. Thank you for having me back. It's a pleasure to be here again.

David Greely (01m 48s):
Absolutely and I really appreciate you making the time to be with us again. I know you've been busy as usual, writing the first draft of history, and there's a lot of history happening in the metals markets. I should note for our listeners that as you and I are recording this, we're awaiting the ruling in London's Royal Courts of Justice on the lawsuits surrounding LME's cancellation of nickel trades in March of last year and that ruling will certainly have big implications for the metals markets going forward. But while we await that coverage and your coverage of that ruling, Andy, I thought we could take the opportunity to like look to history a little bit and perhaps you could help us put what's happening today into context by looking back at some of the other crises and scandals that the metals markets have experienced over the years.

David Greely (02m 38s):
As I was thinking about that, it seems like there's kind of one big one every decade or so. So maybe we were due, I don't know, but you know, those who don't learn from history or doomed to repeat it. So maybe you can help us learn a few lessons now so that we can make metals markets that are up to the challenge that's coming. You know, as we talk about the energy transition, energy is becoming more and more dependent on metal, and these markets are gonna be more and more critical to us going forward. So I appreciate you making the time. And, you know, maybe we could start off, I think going back probably the biggest crisis that the, the LME faced prior to now, and I don't know where you'd put today in, in context of that, was in 1985, so maybe we go back four decades or so, and that was the tin crisis.

David Greely (03m 27s):
And at the time, it was the worst crisis in LME history began with the collapse of an international tin cartel and quickly escalated into the potential financial crisis of its day threatening to bankrupt several LME brokers and creating calls for a British government rescue. I don't know if we had coined the term bailouts at that point in time or not, and I was thinking about this in the context of the conversation we had with Michael Marks of the NYMEX a few weeks back and around that same period of time in the energy markets, the collapse of price controlling cartels really set the stage for flourishing energy futures markets in the metals markets. The collapse of a price controlling cartel nearly destroyed the metals exchange. So I was hoping you could take us back to that moment in history and, you know, why was it so threatening to the LME at the time?

Andy Home (04m 17s):
Yeah, I mean, you are absolutely right, Dave. I mean, the LME is a history of crisis and this was the first one I experienced. I actually started writing about these markets in 1987, which was just two years after the, the thing blew up. But there was still plenty of litigation still going on around this tin crisis, right? So what actually happened? Why did it become an existential crisis, we're going back into a time, I guess, when governments generally particularly you know, the United Nations believe that it was right to try and control prices to sort of try and put a floor price there for producing countries and a sort of like a ceiling price there for like mean, consuming countries. I mean, there were similar agreements operating in coffee, cocoa as well as tin right Now, what went wrong with Tin is that you have a buffer stock manager who was supposed to be really sort of like, I mean, pursuing this sort of guiding price policy.

Andy Home (05m 10s):
He was buying at the lowest selling at the highest, trying stabilize the price. Long story short, somewhere around the mid 80s, the Tin market started moving really heavily against him, right, guys weren't sticking to their producer quotas. The other guys were starting up new mines. In short, the world started becoming a wash with Tin and he had no choice but to just soak up the surplus and by the time he sort of went bust, literally ran out of money in 1985, I mean, he'd accumulated something like 121,000 tons of tin. That was about three quarters of the world's annual consumption at that stage, right? It's a lot of tin. And it was also left a black hole of 900 million sterling, 1.4 billion at around exchange rates at that time. Yeah, a lot of money now. A lot of money then. So Tin was suspended, I think in October and a day later, actually it was October the 24th, they suspended Tin a day later, the International Tin Association, the group of 22 countries that laid behind this agreement said they weren't paying.

Andy Home (06m 17s):
They defaulted in essence, right. This is a big problem for the market. At that stage. There was no clearinghouse. Each broker trader acted as principle to everyone else in the market, right. When you are looking at losses of up to 900 million sterling, quite clearly, you could see a domino effect of defaults, you know, broker a who maybe have on a small position but is undercapitalized can't handle the losses. He himself defaults, passes onto brokers B&C and so on and so on, right. No safety in net. I mean that generational metal traders, I remember them very well, really sort of were facing a life or death moment for the hundred 10 year old market as it was then. Yeah. How did they get out of it. Well, two things, two ways. First off, they decided correctly that they were gonna sue the 22 governments behind the ITA.

Andy Home (07m 08s):
It said, come on guys, you got to pay up. Well, that took about four years of tortuous negotiations, and the settlement was finally reached. But critically, in terms of preventing the LME collapsing in on itself, they came out with a pretty innovative solution, if you like. They decided to have what they called a ring out. So bear in mind, I mean the, the market's been suspended for months. The real market price, the gray market price has just carried on, sinking under the weight of our surplus metal, which we now got exposed of the buffer stock manager's metal as well. So they decided to set it at, I think it was £6,250 halfway between the last traded price and what they thought the gray market was and here's the deal. Everyone shares the pain of that settlement, right? Everyone, no one has got a position.

Andy Home (07m 57s):
Everyone shares the pain and most of the, the, the brokerages at that stage were owned by industrial players, and most of them stood by the brokerages. It, it prevented the default, if you like. But having said which tortuous negotiations to try and clog some money back tin was only sort of actually re re-listed for four years later in 1989, right. So it was kind of a pivotal moment for the London Metal Exchange. The LME had probably been under the radar even amongst the London authorities for most of its existence, right? It had operated very much as an old boys club and all that was kind of you know, it had created too much of a stink, if you like, or found itself at the center of too much of a scandal for that to continue to be the case, right, so there was an overhauling governance structure.

Andy Home (08m 44s):
They had to accept external market regulation in the form of what then was the AFBD Association of Futures Brokers and Dealers. And critically, they decided that it was time to have a clearing function because no longer could they trust each other to actually audit debts under an extreme situation, right, But sort of two caveats to this resolution, if you like, I think, which kind of set us up for the next scandal a little bit. The first was in terms of market mentality at the time, right, we're going back to the 1980s and, and this was quite the rise of what we would now call neoliberals views about how markets should operate or how economies should operate, right and here's seemed to be this fantastic example of even government attempts to control a free market price must be doomed, therefore, the market logically should be left to its home devices as much as possible.

Andy Home (09m 39s):
You know, I was looking at some old quotes and old notes from these times, and a board director at the time told me, he said, it's impossible for us to control the free market, and the enemy has thrived only because of its free market principles, right. So it reinforced the sense that the best market is one without any government intervention at all. No attempts to exert price control or whatever and here was the great example, apparently. Yeah. Now the second issue was the old boys club had been broken open, that is for sure and the introduction of a clearing house changed, I think, an underlying way of doing business or set of assumptions in the old market and again, sort of, I was looking at notes from another board director at that time, speaking after the event, and he said, you know, in the old days we could keep out non desirables from our market. It was a closed shop. We all knew each other. We all had a, you know my, my word is my bond was a reality for these guys. And he said, with hindsight, maybe the introduction of clearing generated more risk-taking behavior when it wasn't anymore just the, the company's books that that were in question. And as he put it, maybe it allowed more undesirable elements to join the market.

David Greely (10m 54s):
That's fascinating. It's, you know, we talked a couple weeks back on the podcast with Joe Ray and Dan Mcelduff talking about using the clearinghouse for o TC with the setting up of Clear Port and how important the clearinghouse function is to exchanges. It's fascinating that the LME existed for as long as it did without a clearinghouse where brokers had to face their credit risk and settlement risk of each other. As opposed to, you know, what we all tend to think of as the clearinghouse being the buyer for every seller and seller for every buyer.

Andy Home (11m 27s):
And that's why this particular crisis, I mean, translated it very fast into, there was about 30 ring dealing members of the year, they looking around the ring saying, we're all bustier, technically we're all bust if we, if some of us start defaulting, we don't know how that domino effect is gonna like pass, you know, out across the entire marketplace.

Andy Home (11m 47s):
Right and I guess for a while, they had enough, they all had enough skin in the game where they could keep tabs on each other and, you know, of course, hopefully one of the benefits of the, the old boys club, but a lot of, you know, problems with that as well, obviously. So you, you said this kind of is what set the stage for the next scandal, which I think started brewing around the time the same time, because it went on for about a decade before, you know, as we moved into the nineties, you had the Sumitomo copper scandal, in which the Chief Copper Trader, aka engaged in unauthorized trading, kind of seemed like one of the, the early rogue trader kind of episodes in a way. Yeah, but it ended up, you know, I think it involved in attempt to corner the copper market at times and ended up costing the Japanese trading house Sumitomo Corporation over 2 billion in losses. So can you walk us through that scandal and how did some of what happened in the eighties set the seeds for what happened in the 90s?

Andy Home (12m 43s):
Yeah, you know, it's ironic. I mean, this all blew up in 1996 when Sumitomo dropped its bombshell that it had experienced unauthorized copper training. Yeah, I was gonna take a huge loss but this starts in 1987, right, initially during the Tin crisis or the, the back Tell, why do I say that because a gentleman called Yasu Aka in that year, it was promoted to manage of the Summit copper department, right and how does one become a rogue trader. Well, the simplest way to become a rogue trader is when you replace your boss and he hands over his black book and says, by the way, something you should know, Dave, is that I've been running a black book and is in loss and the two guys seemed to have taken a really fateful decision that they weren't gonna tell anyone.

Andy Home (13m 31):
And Mr. Hamanaka decided that he was gonna be good enough, he'd make those losses back. So right from the start, he's trading the Sumitomo copper book, right. Which is, as you can imagine, a very powerful book, right? I mean, Sumitomo is a big, big player in the copper market for mining through processing smelting physical sales, and has its own, you know, I mean that electronic. So it is a huge book and simultaneously this guy is running I think it ended up being in the court case is Book B, which he could then sort of like me be messing around with, you know, in terms of also building up positions. So the longer, the short of it is using these two books, if you like, it became the dominant Copper Trader as early as 1991, right 1991, he squeezed the copper market and then me put a backwardation limit bit on, as it often did in those days, and also expressly asked him to reduce his limit his positions right behind the scenes.

Andy Home (14m 27s):
So even by that stage, he was running this market. When I used to make my market calls as a junior reporter, in those days, he was referred to simply as the man, you know, the man has bought more copper, right. Everyone in the market was really structuring their trading around the matter, because his positions were always on the one side. They were always long, right. So it became almost hardwired into the market plumbing this huge position that this guy was running. Yeah. But now you also learned the hard way. Well, the Tin Buffer stock manager learned sort of like, I mean, the decade before, if you're gonna manipulate a market, it's only really gonna work for any extended period of time. If you go with the grain of that market. In the early nineties, squeezing copper was quite easy because copper was actually running a, probably a deficit market, but about 92, 93 copper's moved into surplus.

Andy Home (15m 22s):
And guess what, he is back in the same situation as his Tin predecessor. Yeah. What does he do. He has to keep on mopping up that surplus. Yeah, the position getting bigger and bigger and bigger, you know, but about 93, 94, he's regularly running positions of over 1 million tons of exchange copper. Yeah. That's a big position. Now, Dave, back then it was, it was extraordinary position. Right and of course, the bigger the position, the more he's struggling still like to hide losses of parts on the B book, he's trying to arrange financing to keep the credit lines going. I mean, it becomes ever more frenetic or juggling act If you, if you think about it, put it this way, but I think by the time we get into 1996, I think after, yeah, in the report done afterwards, his positions were like all the LME stocks and 90% of the cop stocks he owned the copper market as far as, you know, as exchange stocks go, he'd call it.

Andy Home (16m 14s):
It just, you know outright what really did him, I mean the, the pressures were building obviously, I mean, you know, you, if you kind of look back on the events leading up to the final day no more, it was a frenetic juggling act of getting evermore bigger credit lines from evermore players to try and just keep on like, I mean, juggling these positions around. Right, but what really did them was the CFTC, I think regulators knew something was up. This had been going on for quite a long time, right. The CFTC in December, 1995 subpoenas, Sumitomo accusing them of manipulating the CX copper market, right, Q six months of increased regulatory scrutiny, internal Sumitomo scrutiny and by I think it was June, he has been promoted away from the Copper book and the full horror comes out. Yeah, leaving them with a nursing.

Andy Home (17m 03s):
A tremendous loss and which copper price is also collapsing exactly as when the Tin Buffer stock manager ran outta money. What did the price do. It absolutely sank because now we know we've got all this metal hanging over the market. Ditto copper in 1996, right? We know that sum retirement's got about a million tons. It has to sell into the market. I think it's kind of important to say on this particular scandal, and it's a crisis, if you like, for the LME, this was a criminal enterprise. You know, Hamanaka went to jail, he did jail time for this in the end, right And Sumitomo's the lack of internal controls for really a decade. I mean, they were also a key contributor to this whole incident. Right, but, you know, we've also got to go back to the LME, right, so first off, we go, go with this thing, right?

Andy Home (17m 51s):
The market will always win laissez fair, let's try and not get involved as much as we can. We believe that the market will out and no one can dominate it artificially for long. Right, well, 10 years later it's quite a long time to wait for that outcome. Yeah. now to be fair to the enemy, it didn't have any real visibility on what was going on, even in its own marketplace. There wasn't really compliance department in those days. None. One was counting positions at the end of the day. So the Chief Executive Officer, David King, he was at the time, really didn't have any good insight into exactly what was going on and the second point is, even if he had had better insight on market, AKA's account was really structured off market. And you know, as early as 90 91, he moved out of the market.

Andy Home (18m 39s):

He started channeling his business through introducing brokers as we call them. First one was in the us, second one was in the UK. He made extensive use of o TC structures, particularly in the options market to influence price. He even by the end of it, was getting into physical off take contracts because he had to work out how to move increasing amounts of metal just around the world and still keep the plates are spinning. Right, but I think there was a sense that it was an LME crisis as well, even though it'll go down in the history books. It's the sum retirement crisis. I mean, essentially what happened is I would compare it to sort of like, I mean a sort of a school which had been suffering from bad discipline for three or four years, and they get a new headmaster in from the top educational board.

Andy Home (19m 25s):
In this case, it was a gentleman called Eleanor Whiting who came in from the UK treasury department. He was a senior over overseer of financial regulation and he was brought in into, he was parachuted into the enemy as Chief compliance officer as we call it now. Right, he gave it the full regulatory overhaul. There was a sense you have been badly behaved and we're gonna tidy up the shop. So he kind of, he really wrote the LME rule book on what he called market aberrations. I mean, the rule book that we're gonna come back to later part of this conversation. I mean, that was his work. He created really what we found as the compliance department, right? Increased transparency over stocks reporting prior to sort of 1996 LME stocks were only reported twice a week. He made them daily things like that.

Andy Home (20m 09s):
But again, I would say there were two big caveats. So the second over all of the LME, right, the first was waiting, did genuinely reflect the UK treasury's view at that time, which was still that wholesale markets in London should be laissez fair from a regulatory point of view. Indeed, London's relatively relaxed oversight of its market, put it in a competitive position next to the likes of the CME or whatever, right, so this was very much government thinking and that laissez-faire attitude was written into this new rule book. The greatest example was they had a possibility of saying, here's a rule. You can't have a position over a certain size. They chose not to do that. The result was, you know, they said you can have as big a position as you want, Dave, but all we're gonna do is if you accumulate that position, we'll not allow you to squeeze the pips out of the market.

Andy Home (21m 03s):
You can squeeze the market, but not the pits daily backwardation limits will be put on your position depending on its size, right, but in principle, this idea of it's a wholesale market, you can play as big as stakes as you want. That was not changed. And why to himself, he was a very, very smart man. I mean, sadly passed. Now I think he also understood that he had two big undealt with problems on the enemy. One was this TC side of it. He knew Sumit Tamel was very expert operator of t z positioning to exert pressure on the futures price. Right and the second thing he knew he had a problem with was warehousing, which I think he's gonna lead us into our, our next crisis.

David Greely (21m 43s):
I was wondering how you were gonna connect those dots to the next decade but before we go there, I wanted to ask you a question first in that I find this so fascinating because there's such the sense that history rhymes if not repeating, and there's echoes, right. Like, it seems like one red flag we should all keep in mind is that if a trader becomes known as the man or big shot or the whale, like that should probably throw some flags for everyone involved. And the other is, there's this, this aspect of transparency into positioning of traders can have positions on exchange. They can have them in the OTC markets through the banks. And it seems like every time there's a crisis kind of, there's, there's a bit of a pullback and oh, well, we didn't know, you know, the positions were, were hidden.

David Greely (22m 28s):
And I think to some extent that's true and then the rule books are improved and the transparency's improved but it also seems those two ideas that on the one hand, people are calling him the man. So there's a sense in the market that this person has outsized positions and influence and on the other hand, after it blows up, everyone's like, well, we couldn't see. So is there, is there a sense that we're always gonna need some sort of informal policing in these markets that, you know, in exchange or the banks or whoever is involved, is gonna need to, even if they can't prove it, if there's a sense, is there some need for a little bit of detective work in making sure that traders don't find the cracks in the system?

Andy Home (23m 13s):
I mean, we've got to start off, I think we're talking about commodity markets. I mean, what are they there for, they're there to hedge the risk of what is essentially an OTC trading system and look, if I'm sending metal to your yard, we may reference the CME price, right, but I mean, that's our business. You know, what's going on between you and me, you book your purchase, I book my cell. I mean, think

about all that metal moving around the world. I mean, it's all moving on OTC contracts, physical market contracts and all that, right, so there was a natural tension in any commodity market between the futures component and the OTC component. I mean, what my takeaway from Sumitomo was that the market had evolved a lot from the ITC days. I mean the tin days.

Andy Home (23m 59s):
I mean, if the buffer stock manager had had the tools available to him, he could probably have perfect in his position quite a lot further. So the market had evolved and particularly the OTC options market had evolved for metals trading and so, you know, there was some big plays put on there and you get to the stage though, there's kind of a malice of forethought, right. I mean, I can have my OTC positions and you know, you asked me as an exchange what they are because I'm not gonna tell you. Well, I can structure my OTC positions specifically to manipulate price and you come to me and say, I want see those positions. I go there, they're hedges, they're hedges. Yeah, but there's many ways, or sort like skinning that cat or making a notional hedge something which can be used to exert maximum pricing pressure on a specific day, particularly on options for declaration day.

Andy Home (24m 49s):
Right, so this is the tension. Yes OTC business is always gonna be a key part of any commodity market, but the exchange has to be aware how dangerous, what it can't see is what you see, my friend, is only the starting point of your compliance function. Yeah. It's there to start giving you clues as to what else you should maybe be interested in here right and I think that was the first time I had seen such powerful high volumes, or like OTC position plays used in any LME market really, to really seem designed only for the purpose of supporting outright price. However, beautifully structured they were to look slightly different to IT regulators.

David Greely (25m 33s):
That's a great insight. What you don't know that'll get you and so what you see is the first indicator of what you need to be looking for beyond what you can see, which wanted to talk next about the 2000s and I'd love to see the connection here because of course in the 2000s I guess the next scandal crisis, what have you surrounded the warehouses for the delivery of aluminum against the LME futures contracts. Can you walk us through that scandal and what problems did it reveal in the delivery mechanism for the LME futures contracts?

Andy Home (26m 07s):
I remember this is when everyone in the market suddenly had to become an expert and how to run a warehouse and mean none of us had actually thought very much about it book but that is kind of symptomatic of warehousing, right. I learned more in in about two years about warehousing. I had in previously in 20 years of covering the LME. So did the LME and so did most traders. Well, does that tell you about that warehousing function. It was part of the plumbing. No one really cared that much about it, right. It was a really neglected part of the, the market ecosystem. I mean, I'll just tell you little anecdote, right. I mean, I found myself a social gathering many years after the event with a guy who had been the chairman of the LME warehousing committee. And I said, well, you know, how did you get that?

Andy Home (26m 51s):
And he goes, it was dead easy, Andy. When I got promoted to the board of directors, I was summoned to meet the other chairman of the board, Raj Bagri. Now Lord Bagri gave him welcome on board and all that, so I'm very pleased to have you. He said, no, no, no, you'll have to, you'll have to be a, you'll have to chair a committee, you know and he said, what about warehousing and my friend said, well, I know nothing about warehousing doesn't matter, nothing very much happens there. The time was probably true, but here's the problem all right. So this is a part of the market. I do think it's part of the market, but was really left with minimal supervision for many, many years, right and warehousing companies did what they wanna do, whether they're not particularly supervised, they started year in, year out lifting their storage and their load out charges and a curiosity of the LMB system, right.

Andy Home (27m 42s):
They're required to set a maximum for each. So it is the maximum that's going up every day. They don't have to charge the maximum. In fact, they're gonna give you a discount. The problem is your discount is been given against a constantly moving up upward price and over a period of time, you created an absolute yawning pattern between the cost of LME warehousing and the real cost of warehousing, right. So what really changed then, this was an accident waiting, it happened and what changed with the global financial crisis and the aluminum markets. So two things happened in aluminum demand evaporated, particularly in the automotive sector, which was having its own meltdown, you'll recall at that time, smelt as a notoriously difficult to power down and switch off and very expensive to do so.

So everyone just kept producing. The net result is LME stocks rise from about, I think 950,000 tons at the start of 2008, to 4.5 million tons by 2009.

Andy Home (28m 36s):
That's the surplus washing into the market of last resort, right. This neglected part of the enemy ecosystem is now big business, right because these guys are destroying huge amounts around aluminum. Goldman Sachs was the first to make its move. It bought Metro in 2010. Now, Metro is the dominant operator in Detroit, which is where much of the aluminum was. It's the epicenter of demand weakness in North America and it's also just over the border from the Canadian smelters, right you know, two years later, Glencore bought another warehouse company called Pini by the middle of the decade, virtually every trading company had bought its own warehouse company. What then really changed, and we can put this down to I think it was September the 10th I wrote down 2010, something extraordinary happened. Someone canceled 100,000 tons of value million in preparation for physically loading it out.

Andy Home (29m 29s):
No one had ever seen so much metal canceled in one day, ever, right. You got to think a hundred thousand tons. I mean, even the biggest merchants do not normally make that sort of call on the market of last resort. What we know now is there wasn't any of them. This was Deutsche Bank and Deutsche Bank was basically taking that method for cash and carry financing trade. You got to go back in time a little bit to those early 90s, right. Two things are happening because there's so much aluminum. It's generating what we call a super contango along the curve, right with huge differential of forward prices over the cash price. At the same time, interest rates are zero. So the cost of, you know, you can use aluminum as almost an interest rate bearing metallic bonds to pay you out 5% or something. The money to do is gonna cost you nothing.

Andy Home (30m 18s):
And by the way, you can't even sort or get any money by leaving it in the bank for the same reason. So suddenly this becomes a very, very attractive financial solution to a interest rate environment, right. The delta in your profitability is the cost of warehousing. That's it. The cheaper the warehousing, the storage, the more money you can make from the trade. Hence Deutsche Bank, thank you for your hundred thousand. Now we're gonna go to a cheaper warehouse, right? Because it's gonna make it much more profitable for us. But the LME system wasn't designed for someone wanting to move a hundred thousand tons. The LME had a minimum load out rate of 1,500 tons per day on all of its operators being warehouse operators. They of course, take the minimum and use it as the maximum. I, we're not gonna do any more than that.

Andy Home (31m 00s):
You can work it out a hundred thousand tons, 1,500. Suddenly you've got a huge load out queue at Detroit, right within a few weeks. That's others follow where, I mean Deutsche's gone. You've got 120 days to get your aluminum out of Detroit. That's the enemy load out from the warehouse, right and the clever thing is because Detroit metal is what we call the free flight metal of the enemy system. Everyone has to pick up this location to get their metal join the queue, my friends, right and that's interesting because the way enemy warehousing works is that if I'm storing metal there, your warehouser Dave you'll give me a nice discount for, for my, for my custom, right? As soon as I cancel that metal, I'll tell you I'm gonna like move it out. No, no we revert to that super maximum rate, which is otherwise never charged, right?

Andy Home (31m 49s):
This creates the Q revenue with the Q revenue. Guess what I can go and bid for more units in the physical market. I become a physical market player, right. Think about it, right? If the queue's giving me a hundred dollars per ton anti aluminum, I can then go and use that a hundred dollars, bid it in the physical market. You know, there's merchants out there going, Hey, you know, we put our usual bids in for the physical tenders. There's a warehouse company is now outbidding us and sucking up all the metal, right? So what happens is this interaction between warehouse and physical market, it starts distorting the aluminum price, which breaks into two LME basis price and the huge physical premium, which is now sort of like anyone has to pay to get a metal in the physical market, which has been driven by the Q model that the warehouse companies are operating.

Andy Home (32m 35s):
It's a horrible, messy sort of like business, right you've got Coca-Cola, the bots, they're complaining to Congress, Congress holds a, you know, an inquiry into it. The C FTC is mega unhappy with the LME quietly drags its feet on giving the L enemy or renewing the LME, your license to operate in the US People try to sue the warehouse operators unsuccessfully in the end, right. I mean, the enemy once again is accused of distorting the market in this case aluminum, right. So that, that was really the essence of it and yet again, certain sort of

things come up. Now, one of the problems of being a neglected part of the L enemy system, I not really, it, it it's an ancillary function. Let them do what they do as long as they don't behave too egregiously. The enemy warehousing rule book wasn't that good at the time.

Andy Home (33m 22s):
So what if I told you Dave, that Wing Deutsche took those a hundred thousand tons out of metro, where do you think it moved? It, it moved it down the road to another metro shed owned by the same company, just a metro shed that wasn't listed with the LME, right? Where it could get super cheap storage and what have I told you that all of its freight costs were covered by Metro. If at the end of the financing deal, it returned all the metal and put it back onto warrant at the original metro shed. Right a congressman famously called this the merry-go-round scheme. Goldman, which owned the metro called it an off warrant transaction. Here we are again, an off warrant transaction, right and here's the thing, the enemy looked into this in quite detail and found, believe it or not, the fact there was nothing illegal against the enemy rule book in doing this sort of me go-round trade.

Andy Home (34m 13s):
They came with the conclusion it was against the spirit, but not the letter of the enemy rule book right leg say fair. Yeah, enemy was slow to react to this. It was a building for several years, as you can imagine. They were, they were consumers shouting blue murder left, right, and center. They took the view, again, this is a market phenomenon. We shouldn't really have to change it. It was only when the, the CFC got really serious and said, you know, guys, you might lose your license to operate in the US if you don't reform the system. That they then embarked on a, you know, a really torturous reform process, basically trying to eliminate what they call structural cues. I would suggest to you it was only partially successful until very recently someone was still running the same Q model for our aluminum in port clang and Malaysia.

Andy Home (34m 59s):
So you know, I think the enemy decided that, I mean it, after six years of reform, it couldn't absolutely eliminate the problem. He tried to say, well, let's perhaps increase transparency around stocks data a little bit more, but I'm not sure that worked either. So that was it really but again, I mean forgetting that the physical infrastructure market delivery is as important as trade flows to price discovery being kind of caught out, that their warehousing problems which they left de fester for quite, you know, several years before doing anything, had had managed to split the Binion price into an enemy basis and a, and a physical market premium and really only under sort like extensive regulatory pressure, do they then embark on the reform process.

David Greely (35m 44s):
Yeah, that episode's such a great example of, you know, how, as you said, nobody cares about the plumbing until it's leaking and no one really cares about the intricacies of delivery mechanisms and the market infrastructure until it breaks. But I think, you know, you got to think about it ahead of time because when a, a stressful event comes, like the big surplus and aluminum, you know, a bad mechanism will break. I think I remember one piece that might have been the insult to injury aspect of that was of course when you, you know, if you were holding a, a futures contract in LME and aluminum and took it to delivery, you didn't get the aluminum itself. You got the warehouse receipt, which you could then turn in to get the aluminum. But of course you are responsible for paying those storage fees until it was loaded out for you. So you could be paying that high storage fee for the a hundred days or 150 days or whatever it turned out.

Andy Home (36m 36s):
The Q model. I mean, you know, it, it is interesting, isn't it? So I mean, the LME and many terminal markets have claimed to be the market of last resort. I would say only one way round. It is, it is for a producer looking to sell surplus metal, it is actually not for a metals user precisely because the warrant that you receive, you know, the warehouse receipt is at the seller's choice. So chances are if I'm an Italian consumer, what I really want of course is the only me to deliver me a warrant in Italy. Chances of me getting that virtually zero, I'm gonna get it somewhere else and then have to go on a secondary trade if you like, to see if I can swap the warrant when no one wants it with the one that I want was, so he doesn't really function as a marketable loss resort practically for metals user in the same way it does for, so I think there's a, there's a risk imbalance there. I mean, it, it, it's, you know, it doesn't work well both ways as the marketer last resort.

David Greely (37m 30s):
That's a great point and I guess that brings us back in the timeline to the current nickel crisis. I was struck by the similarity of the underlying problem to that of the main potato crisis that nearly destroyed the NYMEX in the 1970s. You know, and that is the, the type

of commodity traded in the physical market migrates away from the type that's being traded in the futures market. So that producer hedges or shorts are no longer deliverable against the futures contract leading to a producer deciding to renege on their futures positions. It seemed like that was a lot of what was at the basis of the short squeeze on, on the LME nickel a year ago in March in that the producer was producing a, a speck of nickel more associated with making batteries, not the stainless steel grades that would go to the, the futures. And so they couldn't deliver the physical metal and decided not to, you know, make good on the contracts. And I'm curious because with all these crises, there's, you know, there's the issue, you know, the problem in the plumbing that helped kick it off. And then there's the issue of how you deal with it once the problem's on the surface. And I'm curious how you're thinking about the two pieces of that story in relation to what happened at l e last year and what lesson would you take away from it?

Andy Home (38m 49s):
Well, we should make one really important point at this stage, right. This is not the first time that the LME suspended this nickel contract. It did. So in 1988, 1 year after the nickel contract had been launched, right. It was then really an open out crisis system. But the key official ring session where the, the benchmark days crisis set was suspended because they were, it hit a liquidity vacuum, right. Old ways of doing it, emergency board meeting probably half of them were conflicted, sort of like making the decision. But they, they, they did manage to sort of like find a way of resolving it with by the time of the afternoon ring session. But it provoked a big discussion specifically around the deliverability option cause even then the grade A, if you like, class one refined nickel contract even then did not reflect a large part of the market.

Andy Home (39m 40s):
And back then, just as now more recently, there were shorts who could not deliver their physical product against that contract. So this was a really well known problem. There were many years of quite intense industry conversation about it in the 1990s. But he, in the end, it was just put under a too difficult to resolve file. I mean, no one could work out, you know, a physical benchmark which would act to sort of like bring together sort of this huge spectrum of, of nickel like I mean products and forms and shapes and all that and that still remains the problem of the day. So there's another case of learning from history because what happened over the last six or seven years, you've had a massive build out of production capacity in Indonesia, particularly for stainless steel grades and now more reason for battery grades.

Andy Home (40m 23s):
None of it is deliverable against the LME contract. So what was already a problem in 1988 has become a, an increasing magnitude problem. You know, where the LME contract might have represented, say, 60% of world's production, it's now about 40, 30% and falling all the time. So, you know, for me there's kind of a, it kind of goes back to the warehousing thing. If you are gonna have physical deliverability, make sure it works, right yeah. Understand if there are pressures where it can't work. I mean, I think the enemy seems to have the gut in that lesson a little bit. You know, again, we're back in the o TC buildup sort of a, a position buildup problem of lacking visibility. You know, I mean there were a lot of things that could have been done differently with hindsight. But here's the thing. I mean, here's another dimension to this, right.

Andy Home (41m 12s):
I mean, they were still ended up facing us all like a multiple member default. We go back to the tin crisis, they even with their, with the clearing house there now, right? That tells you how big the positions and how big the potential losses were in it, right? It's going to certainly, look, I think what we've discussed, Dave, is we see the evolution of a market via crisis, right. The only time the LME gets an overhaul is because something has gone very badly wrong with the LME. It is gonna get a another overhaul. By the way, I think the times have changed that laissez fair attitude of the city of London to its markets. It doesn't, it just doesn't anymore. There's been, we had repeated scandals. You can think of the, the gold and silver fixes. You can think of the LIOR interest rate.

Andy Home (41m 58s):
And you can think of the LME embodying this kind of light touch approach or regulation. And I think its days have just passed now. So you look at what the LME has already done in the last year, right. So now we have the hard backwardation limits across you know, the time spreads. We have, I mean price bands, we have volatility bands, right. These were things that were, were, were, you know, these were kind of heresy to the LME community for much of the time that I've been writing about it. But, you know, those days are, are gone now and you, right. So, you know, all these metals have huge demand prospects because of the, the green energy transition. We should expect them to become more volatile and probably higher price because as they struggle to meet that demand, this is not a world going forward when we can have that same, oh, you know, look, the market's gonna get it right and we don't have to intervene approach anymore. No, no this is a world where metal marks are gonna need safety cushions and barriers. Many, many of the enemies

contracts have had real extreme times of tightness over the last two years. I mean, and you know, it could be a taste of things to come. So anyway, I think one of the wholesale shifts is a change of attitude about how markets should be regulated. But that also reflects maybe a broader change of attitude amongst the London authorities as well, right.

David Greely (43m 15s):
Yeah. And I'd love to take a step back and, and ask you about the attitude, because you've alluded to it several times, you know, with the, the laissez-faire attitude, the potential boys club in the old days and you know, in this series we've talked a lot about the importance of people in places, you know, with the character of the people and the cultures of Chicago and New York being reflected in their markets and the exchanges that they built, metals markets of traditionally been centered in London. And I was curious, you know, from your vantage point, how has the character of the city and its people influenced the development of the metals markets there?

Andy Home (43m 49s):
Actually, that's a great question. So if you go into the LME website, right and just go and look at the LME membership, you are gonna see companies from all over the world there, from a US investment banks to Chinese metal companies, to South American producers. It's exactly what you would expect to some extent of a market that has busted you know, generates global pricing but go to the very inner heart of the LME, which still to this day is the open outcry, ring trading part of it, right. These guys in their suits shouting at each other in a ring of sort of like, I mean, leather up hosted chairs, right. This is still the core of the market. Look into that core and I would suggest to you that most of that core lives within 12 miles of itself based around a town called Chelmsford. And if you don't know it, don't worry about it. It's a small town just sitting in Essex, just to the east side of London. All right. Something then that fits back into the history of London. You know, despite what the films will tell you, there are no real Cockneys left in London, right. They left in the 70s, they left in the 80s. In some ways it was down to slum clearance where new towns were built out. I mean outside of London, it was also a reaction, I think, of a largely white population reacting to ways of non-white immigration. Anyway, a large part of those ES went to live guess where? Just east of London in Essex. So in some ways the LME is kind of a historical distillation of the old Cockney London, and it has that brashness about it. You know, there, there's a whole cultural ecosystem that, that we have about which county in the UK has which characteristics.

Andy Home (45m 50s):
So if I had to sum up Essex, it's brash, it's flashy, it's self-confident, it's money oriented. It's definitely sort, I can mean what I call Thatcher, right? It's definitely conservative politics. It's definitely free markets, sort of principles if you like. The Old East end of London just has migrated a bit, but that is where most of the ring traders come from. Some of them are related by family. Many of them are related by friendships just in the way it would've been in the old boys club 30 years ago. All that's changed is the center of gravity. London's center of gravity for that population has moved up a little bit eastwards, and they are probably a slightly less diverse bunch than they were back in the old boys club or the seventies when they really did come from all sorts of walks of life. In fact, in many ways it's where all the misfits ended up. Whereas I think that's less the case now. It's more homogenous, if you like, as a cultural entity, right. As I said, I mean, it, it personifies what would've been known as the old cockney attitudes of London, but which now we in London would call the Essex attitudes.

David Greely (47m 00s):
That's great and no, just as we wrap up, you know, as we look to the future, we know that the energy transitions were requiring tremendous quantities of metals. Some currently trade like copper. Others require new markets to be built or modifications to existing markets like nickel to keep pace with that changing physical market. I'm curious, first, do you think London will remain the center of gravity for the metals trade and, you know, within the Essex group, will that maintain the, the center of gravity within the LME and then what do you see as, you know, the big picture lessons we need to take away if we're gonna build better, smarter metals markets up for the challenge of the energy transition?

Andy Home (47m 36s):
Yeah, so it's a really interesting question. I mean, answer your first question. I don't think the LME will maintain this dominant position not specifically because of the most recent of, of all these scandals, but more because I think the global metal supply chain is de-globalization and that's just part of a broader macroeconomic trend if you like. You know, the pace of urgency is maybe heightened in sun metals because of strategic considerations, maybe by the US military, for example. I mean, this is very explicit in the arena of critical rule materials, the rare earth and all that. But it is happening, I think, I mean, you know, I expect a more regional structure of market pricing to emerge. Maybe there will be global links, of course, how not. But maybe, you know, CME will become a much more powerful price set for the Americas.

Andy Home (48m 30s):
Maybe the Chinese will become a more powerful price set for the Asian area. And, you know, the LME will continue. We'll almost kind of go back to where it started as being a price set for Europeans and some South American producers and, and anyone else who wants, right. I don't think that's specifically about the nickel crisis. I mean, it hasn't helped the enemy's reputation, right, obviously, but I think that's just part of a broader trend and I don't think a, any exchange will resist that. I just see that happening in all sorts of little ways right now. How do we build a better market? Well, so one of the takeaways, two takeaways immediately, right. If you are gonna have physical delivery as an option, the mechanics of physical delivery, what's going on in physical delivery in your warehousing system or your terminal sort like, I mean network, it's as important to price as any order flying across your floor right.

Andy Home (49m 47s):
If you are gonna be physically deliver, well, you've got to take it seriously. Your contracts have to be matched as closely as possible, the physical market, and you have to make sure you have a warehousing system, which is equitable and fair. And I think the, the, the lesson of the aluminum warehousing crisis, it was neither, it was neither equitable nor fair system and it had been allowed to organically grow distorted, if you like, for many years. There's a more profound question though, Dave. I mean, and nickel's a really good example. Have we reached the end of physical deliverability, right? The answer say to, to nickel, I don't think it's another physical deliverable contract. Well, back in the same thing, how do you find a physical benchmark which gives you sort of firm mean sort like, I mean a way of pricing a whole spectrum of different products?

Andy Home (50m 13s):
Is it even possible. I'm not sure it is. The answer may be the bond solution, basically, which you have a series of index prices, you have standardized futures contracts, and you leave the market say, guys, we've given you six or seven options here, which one you work out yourself, which one it is but physical deliverability may simply not be a possible answer to nickel. It may be increasingly difficult answer to other metals as they kind of, their usage transforms, right and even more fundamental question, if you like, again, flowing out of nickel, can the enemy actually take, can its ecosystem handle big positions, particularly speculative positions. I'm talking about its date structure, which tends to fracture liquidity, but also it's capitalization structure. Look, here we are again, even with the clearinghouse last year, we're looking at another domino meltdown of membership through defaults, right.

Andy Home (51m 07s):
Is there a point where this market simply cannot take a dominant position. It's the running theme of, I mean, you know, you look at from the tin stock manager to Sumitomo to the huge positions to be of the financiers for aluminum to now the huge short positions. The structure does not seem to be robust enough to handle it and one answer might be to say that you're combining the wrong things in the wrong market. What if you took out spot price discovery and the futures curve. What have you actually separated those two things out. The spot price is still gonna be physically discoverable, but it's got nothing to do with the futures curve. Now that sounds farfetched. I would draw your attention to an outfit called Global Coal, which is proposing exactly this solution for a new nickel contract. It's not been launched yet, but it's planning we, we wait more news imminently as it were.

Andy Home (52m 18s):
So its idea, it's based on the way it prices coal is, you do have a delivery mechanism there, right. You've basically got a group of people who are gonna trade cargoes of arrivals and there is no speculation. If you don't want to, if you don't want to pick up a cargo of nickel, don't bid for it because you are gonna get a cargo of nickel. So yeah, but that is just used to create a spot index. Yeah and then I sell that spot index, or I do deal with it to, well, you name it a c e or what, whatever, say you go and futurize it, you go know the speculators play as much as they want out there, but they can't get involved in my spot index because it has to be by people who are literally prepared to buy and sell cargoes and this kind of opens up a whole new set of ideas about markets for the modern age. The problem is just as with the two judges in the London high courts of justice judgment is out, we have to wait for them to to launch their sort of like a new nickel contract and, and see whether it works for them. But I find it a fascinating concept of saying maybe the problem here is this market based on physical delivery simply cannot handle a futures OTC or whatever position without sort of coming close to cracking every time. Maybe you separate the two things out, jury out quite literally.

David Greely (53m 22s):
It remains to be seen. Thanks again to Andy Home, Senior Metals Columnist at Thomson Reuters. We hope you enjoyed the episode. Join us next week as we continue to explore the Days of Futures Past on SmarterMarkets. We hope you'll join us.

Announcer (53m 36s):
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Announcer (54m 26s):
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