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Beijing Backs Derivatives Fights

China Encourages State-Owned Companies to Challenge Foreign Banks

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China's government on Monday offered public encouragement to state-owned companies challenging foreign banks over huge losses from derivative contracts, a move that bankers say has raised the risks of dealing with some of China's largest enterprises.

Some of China's biggest airlines and shippers lost hundreds of millions of dollars last year on derivative trades made with major international banks when the price of oil plunged. They are now seeking to claw back those losses.

In a statement on its Web site, the State-owned Assets Supervision and Administration Commission said it supported moves by unnamed Chinese enterprises to seek recourse for their losses in structured financial derivative contracts tied to the price of oil and reserved the right to file lawsuits itself.

China's Derivatives Losses

View Interactive

"The move is a very normal action for enterprises to use legal tools to protect their deserved rights in commercial activities," said the one-paragraph SASAC statement. The commission is Beijing's umbrella organization responsible for companies owned by the central government, including 150 major state-owned enterprises.

With concern already rising in recent weeks that Beijing might challenge the fuel-derivative losses, bankers have been scurrying to protect themselves. One day last week, trading in certain

contracts all but shut down in China, bankers say. Now, bankers are discussing how to impose stiffer collateral requirements for Chinese airlines and other companies that seek derivative contracts.

"It significantly increases the cost for Chinese airlines," one person familiar with the matter said of the effort to require more collateral.

The statement is the latest reminder of how Beijing is ready to adopt forceful methods to support its resource-hungry companies. Last month, Shanghai police formally arrested four employees of Anglo-Australian miner Rio Tinto Ltd. on suspicion they illegally procured information to use in negotiating a multibillion-dollar deal to supply Chinese steel makers with iron ore.

In early August, China Eastern Airlines Corp., Air China Ltd. and China Ocean Shipping (Group) Co. sent letters to six international investment banks warning that certain transactions "may be void, invalid or unenforceable," said a person familiar with the letters.

Among the banks understood to have received such letters are Deutsche Bank AG, Goldman Sachs Group Inc., J.P. Morgan Chase & Co., Citigroup Inc. and Morgan Stanley, according to three people familiar with the situation.

China Eastern entered into complex deals called "collar structures" designed to keep fuel prices within a range and which included buying and selling a basket of options. When oil prices unexpectedly plunged last year along with other financial markets, the airline faced deep losses, according to disclosures by the company and bankers familiar with the matter.

The Shanghai-based carrier said in January it faced a loss of about $900 million on aviation-fuel-hedging activities. In a reminder of how volatile financial markets can be, it more recently said its position had reversed.

Bankers may seek stiffer collateral requirements on derivatives for Chinese airlines and others. Here, China Eastern workers at a Shanghai airport.

China Eastern Chairman Liu Shaoyong declined to comment on the government statement but said he expects Beijing to issue new rules on the use of derivatives. He noted that hedging is a "normal" business activity. Air China and China Ocean Shipping also declined to comment.

Lawyers said Beijing's statement is startling. The government is "actively encouraging Chinese state-owned companies to cut their losses by taking various actions, including legal actions," said Alan Wang, a partner at Freshfields Bruckhaus Deringer LLP.

By stepping into oil-derivative contract disputes that have been bubbling for months, Beijing is sending a signal that its strategic interests can extend to foreign financial markets.

That is important because as Chinese companies go abroad to procure commodities, global banks are finding big new customers for hedging contracts and other derivatives deals that aim to capture profits, offset losses and offer stability to the purchase deals.

Chinese leaders are concerned that state-owned companies, stepping outside the protective walls of the government-planned economy in search of natural resources overseas to power their rapid expansion, are easy targets for globally savvy resources suppliers and financial institutions.

The SASAC highlighted in its statement that it is investigating the oil contracts in order to "safeguard state assets," while noting the "risks and complexities" in some contracts that make them difficult to understand.

When financial markets have tripped up state companies in the past, Beijing has sometimes sought to distance itself from obligations.

Five years ago, a Chinese trading firm in Singapore lost $550 million on trades in fuel contracts. Shortly afterward, the SASAC and the trading firm's parent company, state-owned China Aviation Oil Holding Co., issued statements saying any losses were the fault of the Singapore subsidiary and called on counterparties to be "realistic" in their expectations of repayment.

About two years ago, the Chinese company settled its claims, paying less than estimates of the initial losses, a lawyer involved in the case said Monday.

Monday's government statement reiterates warnings that Chinese companies are permitted to enter derivative contracts only to hedge, or protect themselves from swings in commodity prices, and not to speculate. The policy is backed up by numerous rules, which bankers said could be tightened further.

Some in the industry believe that foreign banks will face pressure to offer derivatives through domestic Chinese financial institutions, presumably so their activity could be better monitored by Beijing. Already, China has made vigorous efforts to bring more such activity onshore through Chinese commodity markets and over-the-counter trading regulated domestically.

Financial policy makers in China say government leaders often don't grasp how derivative products work and then react angrily when deals backfire.

Mr. Wang at Freshfields said the recent events highlight the need for foreign institutions to ensure that Chinese entities have necessary authorization to enter a deal, since legal challenges are often grounded in an argument that the deals weren't permitted or were too complex. Also, contracts should specify that disputes will be settled via international arbitration, since China won't typically enforce foreign court decisions.

—*Yue Li contributed to this article.*