Derivatives gain pace

Tanker derivatives have been mysterious to all but the most financially savvy shipowners. The collapse of Enron did not help, and during the intervening year, the marketplace has addressed some of the real and perceptual problems, making it worth a fresh look. By Barry Parker

As the fourth quarter of 2002 approaches, the air in trading rooms is filling with excitement again. As rumours of war have rumbled through the markets, oil prices have climbed and the physical tanker market has spiked (as high as WS 60 on VLCC's ex AG) after a rather languid stretch. Each brush with volatility attracts industry interest in the financial contracts that can be used to either mitigate or amplify volatility, depending on the appetite for risk.

Over the past few years, the marketplace for tanker 'derivatives' (financial instruments, i.e. without physical delivery, whose ultimate value is derived from independent movements of an index or rate quotation) has been growing, now with over-the-counter tanker FFA annual turnover estimated to be on the order of $300-400m, contrasted with a physical market sized at an estimated $25-35 billion (depending which consultant you talk to). One leading broker, Philippe Van Den Abeele, from Clarksons Securities, suggested that the approximately 250 tanker transactions done through late summer of 2002 have generally consisted of less than full vessel sizes, with a maximum size of 50,000 tons.

Tanker owners and charterers have used devices such as freight swaps to fine-tune their market exposure as part of a portfolio approach. Increasingly, tanker brokers now have a swaps and options trader alongside the spot desk, and project brokers have noted that swaps can look a lot like time charters. In a marketplace that readily accepted Knightsbridge Tankers (five VLCCs on to Shell) and Nordic American Shipping (three Suezmaxes on to British Petroleum), maritime financiers are more comfortable with structures where monetary outcomes can be tied to indices and broker panel quotes on discrete routes - generally originating from the Baltic Exchange in London. The Baltic's Baltic International Tanker Routes (BITR) has gained increasing acceptance over the past few years. Economists and crystal ball-gazers smile when they see the 'forward pricing curve' showing the marketplace's best view of rates at future points in time.

Trading derivatives

So, once the ability to physically perform voyages is stripped away, the marketplace is really driven by credit considerations - what is the likelihood that the other party in a transaction will be able to pay? Not unlike other financial markets, the boundaries between risk management and outright speculation are sometimes blurred. A 'short' position on a swap receives cash inflows as a result of a softer WS rate or lower TC hire, as measured by a Baltic route quote. A short derivatives position representing a fraction of vessel deliverability over some time period, and (even better) put in place in a strong market, represents prudent and well timed risk management - not uncommon around industrial shipping businesses. However, if the owner keeps selling and the swap position represents more MT than available for cargo, the boundary separating hedging from punting has now been crossed.

Freight derivatives are mainly traded the old fashioned way, over the counter by boisterous brokers (albeit now sitting at new trading desks) glued to headsets, but the telephone markets have been supplemented by internet messaging, electronic order entry and even online virtual trading venues for futures - a sub species of derivatives.

As activity has accelerated this year, staff have been trading places at some of the leading London brokers such as Clarksons and SSY. The market growth has not

been without pain; the paper market, like the physical marketplace, has seen its share of worrisome credit defaults, most notably Enron. Recently, Williams Companies, another energy trader (with some ex-Enron staff), was sniffing around the FFA markets while wrestling with its own set of business issues.

The impact of Enron

While the Enron affair took a big toll on dry freight, paper markets in tanker freight were not impacted in a major way. The spectacular flame-out of Enron (which had been a disproportionately major player in a small market) saw its obligations on freight derivatives being subordinate in standing to its many other credits. Yes, Enron cast a pall on the overall market, but has led to the introduction of a stronger legal framework, drafted by the FFABA (Forward Freight Agreement Brokers Association), a group of brokers who are members of the Baltic Exchange and therefore permitted to use its route quotes for settling swap and option contracts. Brian Perrott, a partner with City lawyers Hill Taylor Dickinson, helped draft the new contract. He described it as "an attempt to learn from some aspects of Enron". His experience of Enron-related problems provided him with a unique insight into what can go wrong. He went on to explain that the innocent paper party will now, in the event of a counterparty's deteriorating financial condition or outright default, find its position strengthened, relative to the old form.

The document retains its user-friendly characteristics and is significantly scaled down from the massively complicated financial swaps contracts offered by the International Swaps Dealers Association (ISDA). For example, ISDA refers to "fixed rate payers, floating rate payers, etc", while the FFABA form sees the world through the same eyes as shipping people, talking about "buyers" and "sellers".

Another way to deal with the knotty problem of counterparty risk is to borrow a page from the regulated futures markets and insert an actual credit guarantor, in the form of a clearing house, in between buyers and sellers. Such an approach has been adopted by the Oslo-based International Maritime Exchange (IMAREX), where members trade futures contracts on tanker routes electronically through a website. Settlements are tied to quotes from the BITR, made available by license. In both the pure paper markets and in the electronic world, trading activity mirrors volatility on particular routes. Over the summer months, the VLCCs from AG/ Japan and the MR-size tankers Singapore/Japan have seen increased activity. The CEO of IMAREX, Tom Mortensen, described increased trading early this year, in the Suezmax leg, West Africa to Philadelphia, but suggested that interest in this route and hence the number of transactions, waned during the summer.

The instruments traded on IMAREX differ from over-the-counter FFAs because of the credit intermediation of the Norwegian Futures and Options Clearing House - which must approve the creditworthiness of members, who can then trade anonymously. Contracts range from weekly instruments (for 1,000 MT value) on routes which are quoted by the Baltic Panel, out further through monthly contracts (4,000 to 5,000 MT value), quarterly units (13,000 to 14,000 MT value), and yearly instruments (52,000 MT equivalent). Through adroitly staggering maturities and continuously rolling positions as new contracts are launched onto the screen, it is possible to construct freight coverage going 18 months out. At the present time, the forward curve suggests expectations of a rising market; indeed, Mortensen suggests that owners seeking time charter cover for 2003 are finding more buyers in the paper markets willing to pay levels above those in the physical market, where counterparties are less willing to commit.

IMAREX, which charges 0.4 per cent commission on tanker trades (a portion of which is shared with the Clearing House), requires margins of approximately 10 to 20 per cent of the value of trades, with the Clearing House changing margins in response to volatility and liquidity.

Brokers have suggested that market participants include I.M Skaugen, Frontline, Torm, Heidmar and Blystad from the owning side, as well as Morgan Stanley, Vitol, Goldman Sachs and Glencore from the traders.

Progress at IMAREX

Its early successes have enabled it to attract BP Shipping, known to be an active player across a broad spectrum of routes. The Commercial Director of BP Shipping, Andy March indicated that, in BP's eyes, IMAREX's sweet spot centers around enabling members to lay off risk in a paper marketplace, but without the counterparty financial risks. In addition to traded futures contracts, IMAREX enables offers its clearing capabilities to members who can then enter into customised (non-standard) swaps, which are effectively credit-enhanced due to the clearing mechanism. Shipping and derivatives have had an uneasy relationship since the first traded futures contracts were launched, and failed, on the Biffex market in 1986. The tanker industry's encounters since then with outside financial markets, and increased disclosure, have led to a more sober view of risk management, with the paper markets finding an important and growing niche in the bigger picture.