NAUTICAL SUPPLY INTERNATIONAL

A New Era of Credit & Counterparty Risk Management

Pareto Principal

The 80/20 rule means for the vast majority of the time the market trades within a range. In the 80% category those with or without price risk management tend to make money with the major risks being choosing the right counterparties.

During the 20% when the market trends up similarly those with or without price risk management tend to do very well. The problem comes when the market trends down:

-Those unhedged on the supply side are left horribly exposed in the short term
-Those who have bought and sold forward fixed price contracts are exposed over a longer period

Why were so many unhedged

The period preceding covid-19 saw all suppliers and traders make super profits as:

-Logistics were in flux with the switch over in product types
-The market was opaque on the price reporting side
-Delivery premiums soared
-The forward curve gave many companies opportunity to understate the backwardation in HSFO and book heavy profit

Naturally these profit levels would have rebalanced February/March but the market disruption caught everyone by surprise. Many players just did not see the shift of the 'trend'. They did not see the 20% risk.

The most striking example is Hin Leong/OBS which went with a strategy of being heavily on the spot market for the end of 2019 and start of 2020. If Covid-19 had not happened would they be in the same situation now? From November through to January it looked from the outside that they had read the market well and took advantage of the massive increase in delivery premiums on the spot market

Small Traders

In the run up to IMO2020 the narrative in the press was that small traders would face a liquidity crunch as prices would rise and large buyers would look for a safe haven. It was expected that there would be greater consolidation.

Currently there is:
-No liquidity squeeze due to lower pricing
-The majority of business on spot market so no long term 'issues'
-They have the ability to scale up or down being light on staff

The potential crunch will come with the changing view of banks when it comes to financing the bunker market. I believe we will see a contraction of available facilities especially for those without the provable checks, balances and policies within which to operate.

Similarly, we are already seeing credit insurance companies reducing coverage for counterparties and this will heavily impact on those whose banking facilities are tied to risk management by credit insurance.

Larger traders

Those with dedicated risk management teams should have managed the risk of a falling market. There is risk though with those which have limited knowledge of risk management and less stringent checks and balances.

The main risk with larger traders are the ones we cannot see. The spectre of unrealised hedging losses looms large.

We know from publicly listed shipping companies that there are numerous forward fixed price contracts in the market, whereby, the owner is paying $200-300 USD per MT over the current spot market. We also know that some of those companies now have the vessels laid up.

In order to offer the FFP the trader will have had to buy swaps to lock the price. In event of default or force majeure by an owner the unrealised hedging loss will become concrete.

The difficult aspect to assess is who is holding these contracts and which owner(s) will potentially default?

Suppliers

We have seen the rapid implementation of hedging programmes by some following heavy losses when the market trended down. Short term losses have happened for sure but for most risk has been managed.

Cargo purchasing remains another hidden risk as some bought cargo off ICE Gasoil only to see local gasoil indexes like FOB Med fall like a stone. They essentially ended up having very expensive cargo in tank

These factors should not though be an existential challenge rather one that wiped out the Q4 2019 and Q1 2020 super profit plus some.

Ship Owners

Some sectors are struggling more than others. The key to managing risk is:

- Open dialogue with the ship owner
- Independent advice from credit reporting companies
- Credit insurance
- A good credit manager

These have been the same for many years and are well known by all market participants

KYC

Banks and insurance companies will be looking more closely at supplier and traders KYC procedures.

Likewise shipping companies operating on tight margins will conduct more oversight in how purchasing has been done.

Tied to this are the other unseen risks:

-Sanctions issues
-Corruption
-Price Manipulation

Bunkering suffers from a lack of a real global regulatory system. There is limited oversight. Past cases although taken seriously have not resulted in existential threats to companies. I believe the climate is changing and we may well see companies disappear due to the above issues.

Lack of Strategy

For too long many companies have focussed on transactional profits rather than clear strategy. This has left them open for large losses when market disruption happens.

Will this change? I am not too sure. In the short term, the business model of grow by taking on more staff may switch to consolidate the staff and maintain market share. It will be interesting to see if normal business is resumed once the effects of COVID-19 are over. It will not manage the right risk long term.

It seems many companies took few lessons from the OW Bunker debacle.

Managing Credit Risk

It will essentially come down to greater transparency between counterparties and enhanced KYC checks.

Like an iceberg the size of the risks are largely unseen. A greater understanding of your counterparties procedures, internal risk management, audit controls, banking facilities, insurance facilities, hedging programmes will limit the exposure to risk.

The real sea change will come with greater regulation and oversight and further transparency in the market.

GET IN TOUCH

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