

Divining risk

Chris Thorpe looks at the challenging nature of risk management

More than three years since the financial crisis approached its zenith, we find the markets again in turmoil. The European sovereign debt crisis has affected European demand, most major currencies and commodities. As a result, global markets continue to gyrate without any regular direction. The persistent volatility has made fuel management strategies even more challenging for the bunker and shipping markets. Fortunately, we are seeing business managers adding more risk management resources and expertise to their senior leadership teams. Their challenges, however, are proving more and more complex.

Known versus unknown risks

Often market participants tend to focus on the known risks, versus the unknown. Will the market go higher or lower? Will China keep consuming and growing at the rate witnessed in the last few years? Are oil supplies really drying up as fast as we fear? These seem to be the most prescient questions for energy and fuel risk managers. After all, the known risks of market direction are the simple part. The more obscure part of the market, one could argue, is the measurement of credit risk or company specific risk. Not surprisingly, there are leagues of professionals that commit their entire career to it. But can they really ever accurately quantify future business risks?

The pitfall of measuring risk almost always lies in basing assumptions on the past and not the potential outcomes in the future. This does not have to imply that 'Black Swan' events, or highly unexpected occurrences, must be accounted for in every business situation. For many markets, preparing for wild price swings does not deserve too much attention. For example, it rarely makes sense to hold large amounts of inventory even when high inflation or price spikes are expected at some point.

During the 2008 financial crisis, we learned that collateral backed mortgage risk was grossly underestimated by the professional analysts. The web of intricate legal structures, layers of liens and underlying market assumptions clouded the judgment of the best among the credit ratings world. Rating agencies including **Standard & Poors, Moody's** and **Fitch** all missed or underestimated key risk factors embedded in the latest financial instruments at the time. They relied on historic norms, averages and trends in the market, largely ignoring the market changes that rendered past experience useless. But there were a few that did the

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research that exposed the future risk. Trading firms such as **Paulson & Co.** took huge bets on that information and enjoyed windfall profits in the billions of dollars. This, of course, would be speculative risk taking, but it still illustrates the use of analysing future risk potential in the market.

Contrasting the challenge of risk management with the risk of speculation is a worthy exercise. Take the case of **MF Global**, which had been one of the largest commodity futures clearing firms in the world judged by the size of client funds. MF Global made bets on European sovereign debt in order to capture potential trading profits. Although not necessarily a poor trading decision, the company was forced to declare bankruptcy after untimely book losses and a downgrade from credit rating agencies earlier in October 2011. In this case, the expected value of MF Global bond trades were overcome by adverse events in European debt markets that changed the risk adjusted value of such trades.

Not long thereafter, the company was forced into liquidation following the discovery that customer segregated funds, which are not allowed to be used other than for customer positions, had mysteriously vanished. What was initially the result of market risk quickly became an issue of company risk and management if not fraud. With a reported 150,000 exchange clearing clients using futures for global commodities, foreign exchange, interest rates and other financial products, MF Global failed to maintain the critical safeguards of client funds. This is significant because exchange cleared futures, swaps and options are meant to be closely overseen by government regulatory bodies in each country where they are hosted. By historic norms, the exchange cleared model was assumed the most secure method of balancing company risk and credit risk.

Most surprisingly, the firm had only one week earlier been audited and was found to be in compliance, implying that any wrongdoing was purposeful and done in an attempt to cover cash requirements of the firm's proprietary arm. In this real



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time example the former US Senator and State Governor John Corzine was in charge of a firm that allegedly circumvented the system designed to safeguard market risk. Upon filing for bankruptcy, every client account was frozen from new trades other than for liquidation purposes. This had an immediate effect on market liquidity in a variety of markets. This kind of risk is something far beyond the control of any business risk manager. So does government oversight necessarily guarantee compliance and professional, ethical behavior? Arguably, nothing can be guaranteed.

History lessons

As we look to history as a guide, we underestimate what has changed and how risk may be different in the future. History can provide some valuable lessons nonetheless. We know from historic measurements that market risk can be reduced through diversification.

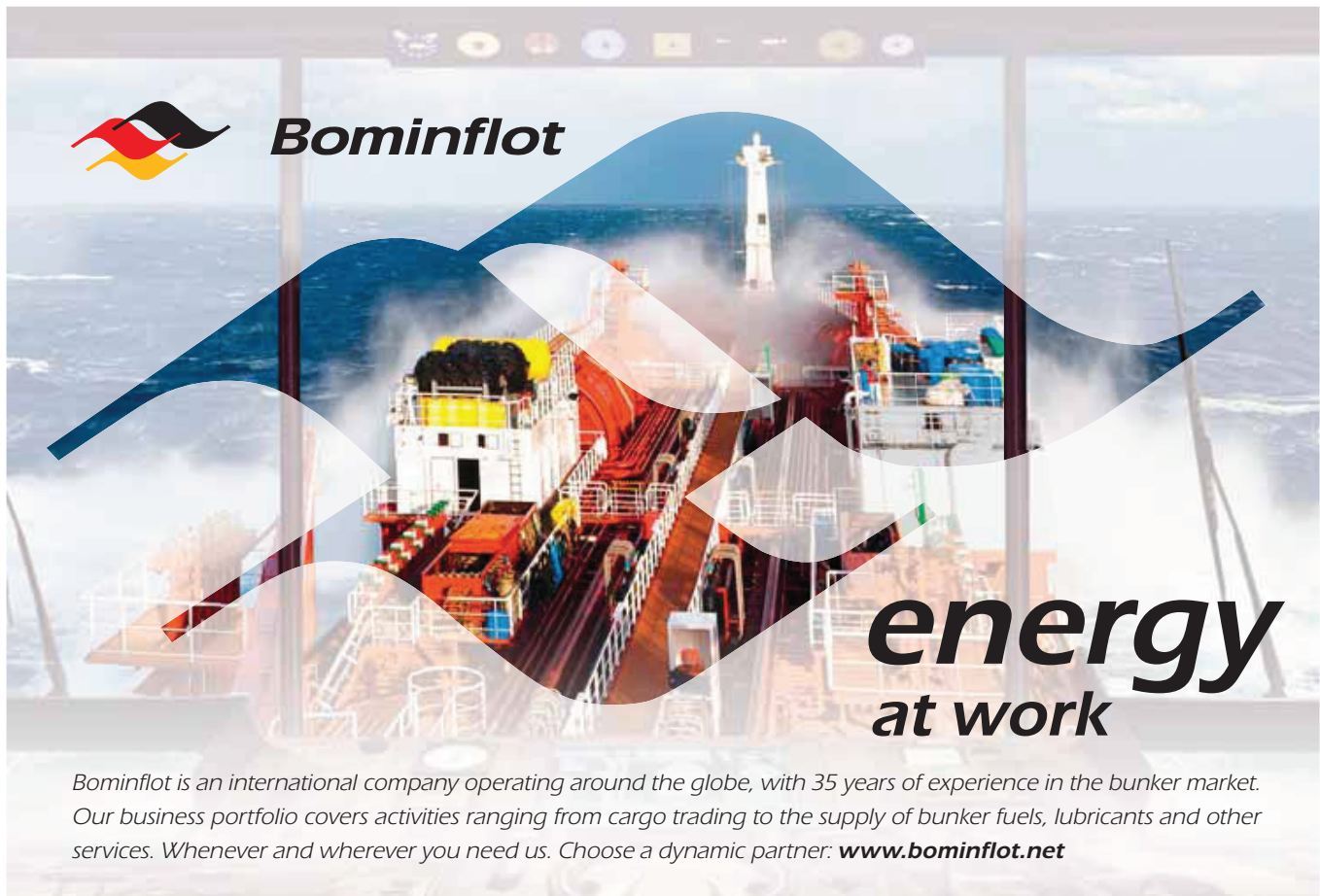
The same can be said for risk to trading and business partners. Concentration to any one entity or market segment can dramatically increase business risk so we seek to diversify clients, identify new growth markets and reduce exposure to contracting markets. Historic evidence provides guidance on how change can affect business risk.

For non-commercial risk, such as fire, flood or accident, we can look to financial tools for insurance in times of distress. However, insurance does not typically cover events that are caused by purposeful human action. The same can be said for attempting to completely isolate your business from fraud, theft or unfair competition. You can simply prepare for the unexpected with the tools available, at a cost that allows your business to run effectively and profitably.

It is expected that MF Global's client funds will all be returned in time, but some commercial hedgers may be required in the

meantime to re-capitalise new accounts to hedge their commodity risk. This in itself may inflict even more business casualties. If the European sovereign debt crisis continues on its current path, the next surprise is not likely going to be something positive. In this case, there is very little history to base any risk management plan.

From the perspective of fuel and shipping markets, market volatility indicates uncertain times ahead. For commodities such as oil that are sourced from unstable countries, we ought to be using history to realise that sudden events can quickly affect prices. However, the prescient questions regarding the global economy and incumbent risk may prove more important. One thing is for sure, the commodity and financial markets don't have any memory. It is the behaviour of the market participants that causes changes in prices, impacts volatility and creates opportunity.



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