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# Investors now eye freight derivative netting scheme

**Bankers have felt the shockwaves from the huge meltdown across all the sectors of the shipping markets. With plunging rates in shipping, netting may take the pressure off over-the-counter freight derivatives. Barry Parker reports**

A lesser known corner of the markets, the 'paper' or forward freight agreement (FFA) sector, has created further difficulties for financiers in the drybulk arena.

At issue are payments among counterparties to over-the-counter (OTC) FFA transactions, which are cash-settled financial swaps tied to daily broker assessments of vessel hires on shipping trades.

The drybulk segment of the swaps market had burgeoned to an estimated USD125 billion in 2008.

By some estimates, this paper sector, where there is no physical delivery of a vessel, was rivalling the highly opaque physical marketplace - in which charter deals are done bilaterally between parties and, hence, reckonings of market size are little more than educated guesses.

As the drybulk market soared in 2007 and 2008, the percentage of transactions settled through the intermediation of financial "clearing", in contrast to direct settlement between parties, rose.

Under clearing arrangements, a financial clearing house guarantees the performance of counterparties that must settle their trades after expiry, picking up a small fee for bearing the risk.

In the freight markets, the London-based LCH Clearnet (clearing a broad range of asset classes including: securities, exchange traded derivatives, energy, inter-bank interest rate swaps and euro- and sterling-denominated bonds and repos, besides freight), and the smaller specialist NOS

Clearing - part of the Oslo-based Imarex - have been clearing financial freight swaps.

The intermediation is handled either directly, when actual market participants have accounts with the clearing house, or, alternatively through the auspices of large clearing brokers

that have accounts with the clearing house and hold money on behalf of market players.

Clearing has been around in freight markets since the advent of futures trading in the mid-1980s. Harris Antoniou, chief executive officer of energy, commodities and transportation, at Fortis Bank (Nederland), tells Jane's: "Clearing has been an option back in the days of Biffex, with the International Commodities

Clearing House (ICCH) guaranteeing the trades. However, it was after the Enron collapse that market participants demonstrated an increased interest in clearing.

"Today, financial houses affiliated with the market places - Imarex Nos, New York Mercantile Exchange (Nymex), SGX and LCH - provide clearing services, with trades given up to the clearing houses representing 50 per cent of total trades reportedly in July 2008."

During July 2007, when data first became available, an estimated 20 per cent to 30 per cent of new drybulk FFA trades were handled through the clearers; the estimated proportion ratcheted upwards to between 50 per cent and 60 per cent as freight levels rose to unprecedented highs in October 2007.

Antoniou adds: "We can expect this July balance (50 per cent) to have been adjusted in today's economic environment to explicitly favour the cleared trades over the OTC which involve counterparty risk."

Antoniou's prediction was spot on: after the Lehman Brothers bankruptcy in September, the cleared percentage climbed to between 85 per cent and 90 per cent of freshly initiated drybulk FFA transactions - a barometer of judiciousness and caution

by counterparties. Many FFA traders now required that their trades be cleared, rather than settled directly with the counterparty.

Interestingly, one listed company actually bucked this trend earlier in the year, citing the working capital benefits of OTC trades, which, unlike their cleared analogs, do not require margin payments.

In a May announcement, Nasdaq-listed shipowner Ultrapetrol revealed that it had converted a group of cleared 'sell' transactions, which were designed to protect the earnings of four vessels, into OTC deals.

One part of the Ultrapetrol announcement, said: "The Company entered into a series of FFAs to buy back 274 days in cleared FFAs, mainly offsetting the positions previously sold for the third quarter and fourth quarter 2008. We simultaneously sold 274 days in OTC FFAs for these same periods, with both the economic and accounting effects of these two transactions being almost neutral. With these transactions we reduced significantly our future working capital requirements."

The Ultrapetrol announcement clearly identified the trade-offs implicit in such a strategy: "These trades have been conducted 'over the counter' and consequently have no margin account requirements but do bear a higher counterparty risk than a cleared FFA. Our counterparties under these trades are subsidiaries of major international grain houses."

In mid-May, when the announcement was made, the rising market would have required Ultrapetrol and other sellers to post margin payments - calculated based on volatility - which themselves do not impact income but do eat into available cash or short-term capital. Prior to a late November increase in margins on cleared trades, NOS Clearing was requiring margin deposits varying between 20 per cent and 35 per cent of the value of cleared FFA positions, depending on vessel type and the contract tenor.

The importance of having "freight cover" is well known; bankers will frequently require timecharter employment when providing finance. Synthetic cover, through the medium of freight swaps, is also a possibility.

Antoniou tells Jane's: "We would accept owners to use FFAs instead of timecharters, as part of a security package tied to financing the purchase of vessels in the present market. Unless we have a very clear view on the counterparty risk though, we would be looking at cleared trades."

In the context of companies with rated debt, forward coverage is considered in ratings determinations. Standard & Poor's (S&P's), in discussing its recent rating action on Navios Maritime Holdings, a long-time player in the drybulk space, stressed: "The outlook revision reflects a dramatic weakening of the drybulk shipping markets in the past two months, which is expected to lead to lower than previously expected profitability for Navios in the years ahead."

However, in revising Navios' corporate rating from BB-, Positive" to BB-, Stable, an S&P analyst points out: "These risks are balanced by Navios' high level of medium-term contract coverage."

Navios has USD300 million of 9.25 per cent high-yield notes (due in December 2014) outstanding; the issue is rated B+ by S&P.

Ultrapetrol's careful choice of known and trusted trading partners underscores the perceived security of dealing with end-users rather than "freight operators"- a group known to be among the more active FFA traders. Throughout 2007 and 2008, market activity was fuelled by these speculative operators, taking ships for periods of two to three years, and then re-chartering them (usually for short-term trip timecharters), at substantially higher day rates. The nature of the drybulk market has lent itself to speculation, with the result being long daisy chains of charters and recharters.

The activities of the speculators were fuelled by the downward sloping term structure of shipping rates. Until the market collapse in August/September, spot trip charter rates, quoted in US dollars per day, were substantially higher than rates for chartering ships over multiyear periods, a price relationship mirrored by the "backwardation" in the forward curves for FFA prices in the paper markets. With this relationship, an operator might, for example, charter a vessel in at USD75,000 per day from an actual owner - a rate for panamaxes on two-year deals earlier this year - and then collect trip charter revenue at USD150,000 per day from end-users.

Difficulties with the drybulk freight operators were underscored in early October for one listed owner, Nasdaq-listed Star Bulk Carriers.

After a bankruptcy filing by one customer - a Ukraine-domiciled timecharter operator facing a clutch of high priced in-charters that were underwater in a reduced spot out charter market) Star Bulk Carriers revealed that a capesize vessel on charter at USD106,500 per day had been handed back.

Some shipowners had resisted the siren song of charters to operators. Simeon Palios, chairman of New York Stock Exchange- (NYSE-) listed Diana Shipping, in describing charter contracts with terms of one or two years says: "It is important to charter ships to end-users because they have the urgency to move their own cargoes. We believe by sticking with them we have a better chartering position."

The Greek company executive adds, in a separate announcement: "We have accepted slightly lower rates in order to do business with creditworthy charterers." News from early December brought confirmation that even large corporate end-users may not honour their period timecharter commitments, placed at levels substantially above the current rates.

Australian iron ore producer Fortescue Metals Group (FMG) - Australia's third largest miner behind BHP Billiton and Rio Tinto, and exporting around 18 million tonnes in 2008 - claimed "unforeseen circumstances" in announcing that the company would suspend all of its long-term shipping contracts, letting customers charter-in vessels at much cheaper prevailing spot rates.

Many of the company's vessel contracts are private. However, database searches did reveal a five-year capesize deal concluded on a Danish-flagged vessel in at USD75,000 per day in November 2007 with tonnage and another booked in June 2008 on Greek tonnage at USD85,000 per day.

FMG's customers, including Chinese steel mills, would be able to take similar vessels at timecharter trip rates that have now plunged to between USD5,000 and USD10,000 per day. Diana Shipping does not have vessels contracted with Fortescue.

The well-publicised physical market incident at Star Bulk Carriers - out in the open through requisite regulatory disclosures of material events - was viewed as the potential tip of an iceberg involving several hundred owners and freight operators, mainly private enterprises.

In mid-October, amid seized-up credit markets, a leading intermediary and one of the two clearing houses organised a netting session for the settlement of uncleared OTC FFAs that were expiring at the end of October. These contracts were due for financial settlement during the first week of November.

In co-operation with swap broker Freight Investment Services (FIS), NOS Clearing was able to organise a multilateral netting facility in early November.

According to a presentation by NOS Clearing, which handled payments for the 38 entities that joined the facility, the netting session included 318 trades on transactions worth a notional USD300 million.

Although details of the session remain confidential, the net payments ¡ funnelled through the intermediation of NOS - were USD40.5 million, with all receivers of funds paid out by 7 November.

Calculations provided by NOS showed that participants ranged from one entity settling out one transaction, with a value of USD242,000, to another netting out 100 trades, worth

USD4 million. One entity with 27 trades outstanding was on the receiving end for USD9.4 million.

Another drybulk netting session, which attracted additional participants, was continuing during the first week of December where payment is outstanding on OTC trades to be settled according to November prices. Preliminary reports from NOS Clearing had 571 trades, with a notional value of USD623 million successfully matched and settled.

After the netting eliminations, only USD96 million in payments was actually transferred among the various parties.

The participants in the two sessions have reportedly included well-known listed companies BHP Billiton, Bunge Corporation, Clarksons and Navios, plus a host of private firms.

There were no defaults in either session although NOS Clearing was at the ready with contingency plans if a participant's inability to pay had thrown a spanner in the works. FIS, the broker, estimated that the early November session handled between 15 per cent and 20 per cent of the outstanding OTC contracts expiring at the end of October.

Inspiration for the freight-netting facility came, perhaps, from successful sessions for netting out financial derivatives organised by the International Swap Dealers Association (ISDA), in the wake of the Lehman Brothers bankruptcy.

Going forward in the markets for OTC financial derivatives - which dwarf freight by an order of magnitude - the regulatory tide is flowing in the direction of more oversight.

The Wholesale Market Brokers Association (WMBA), representing the group of inter-dealer brokers actively putting together buyers and sellers in the swaps markets for interest rates, currencies, equities and credit, has recently announced its support for the concept of central counterparty clearing in the OTC markets.

The Federal Reserve Bank of New York's objective of establishing a clearing house for credit default swaps (CDSs) has been met by competition to create a central clearing facility for what had been an OTC marketplace.

Although the attention of regulators and groups, such as the WMBA, has turned to larger and more notorious financial markets - such as CDS, with a size estimated at USD47 trillion - freight may prove to be more than an afterthought. One of three hopefuls, intending to be operational by the end of 2008, is a consortium that includes the Intercontinental Exchange (ICE) where swaps are actively traded on oil and coal - two leading maritime cargoes. Another group, the Chicago Mercantile Exchange (CME), which acquired Nymex earlier this year and is currently in the process of integrating systems, provides a venue for trading oil and other physical commodities.

Nymex acquired a minority stake in Imarex, parent of NOS Clearing, in late 2007.

A third entrant, NYSE/Euronext, was once the largest shareholder in LCH Clearnet.

Nor are the leading swaps dealers, who handle trades between the large dealers, strangers to freight. A group of WMBA members (GFI Group, Traditional Financial, Icap and Tullet

Prebon) did transition into FFA

brokerage during the boom of 2003 to early 2008. Their activities took the form of either outright acquisition of shipbroker teams or partnership with ship/cargo intermediaries.

Following on the successes of its temporary freight netting, NOS Clearing has set its sights on

creating what it describes as a "semi-clearing" marketplace, which would provide open membership with multilateral netting. Like the traditional futures exchanges, positions would be marked to market, with limited margining. NOS is also sketching out plans for a multilateral netting scheme where both FFAs and physical freight contracts would be netted - an idea that is not without precedent.

Michael Gaylard, strategic director at FIS, points out that one large user in the physical and paper markets, Australian mining company BHP Billiton, had crafted a clause in its physical freight documentation that provided, in the event of a default, for a bilateral settlement.

Gaylard also points to a mechanism used in the mid-1990s in which shipowner obligations on certain grain voyages could be converted into positions in the still inchoate FFA market in the event of non-performance by the shipowners. Commodity bankers will recognise this as the opposite of the widely used Exchange of Futures for Physical (EFP), where buyers and sellers in futures markets settle transactions through actual physical delivery, with agreed-on parameters.

Going forward, that 20 per cent slice of freight swaps that is currently settled between the parties may go the way of paddle-wheeled steamers. Antoniou tells Jane's: "If the market is going to get broader, clearing will be a requirement."   n

**Beyond the forward freight agreement market**

The Jane's interview with Harris Antoniou touched on topics beyond the forward freight agreement (FFA) market.

Antoniou was keen to discuss the role of ship finance within Fortis Bank (Nederland), which is distinct from the Belgian entity that was sold to the Belgian government and BNP Paribas.

Antoniou explains: "In Fortis Bank (Nederland) we house all traditional asset financing activities - legacy of Mees Pierson days - with significant exposure in energy, commodities and transportation (ECT) as well as principal financing and equity investment activities for those sectors.

"These are businesses that I am responsible for, although temporarily with a smaller presence abroad than before. We are aiming at re-establishing our international presence in line with the character of the business and the requirements of our clients who have been extremely supportive during these challenging times.

"Recently the minister of finance of the Netherlands announced the choice made by the Dutch state to have Fortis Bank (Nederland) integrate with ABN Amro. The integration will create a strong, healthy Dutch financial institution with an international image and a broad customer base.

"The merged group will grow to become an international merchant banking business. Since we are still active in 24

countries, we believe we have a strong starting position to do so. Our profitable businesses have a strong client base served by people with a long track record who are important assets for the new bank.

"Until the integration is completed, we will continue to operate as an independent, autonomous bank. The number of deals we have done over the last few months shows that clients have trust in what we are and appreciate the knowledge of our people."

Following a disappointing second half of 2008, Antoniou

expressed the following opinion on when lending levels will normalise.

"Pressure on banks' balance sheets worldwide will continue to exist as the effects of the economic recession will eventually translate to corporate defaults, reducing further appetite to lend. Hence a bleak picture.

"However, governments around the world are using unprecedented innovative measures to support the global financial system and this will sooner or later translate into lending being restarted," he says.

As for whether sell-offs in the shipping industry were overdone in 2008 and the direction shipping markets will take in 2009, Antoniou offers: "The shipping business has been particularly hit by the global economic recession as trade virtually stopped and producers are de-stocking, faced with a deflationary environment in commodities. As companies work through their inventories and the effects of government spending their way out of the recession are felt, we will seee a revival in trade and, hence, a pickup in drybulk rates. Unfortunately, the spate of deliveries over the next couple of years will dampen expectations for growth.

"Similar dampening effects on rates will be experienced as deliveries of newbuilding containerships come in a market of reduced consumption. Here, the only positive factor is that cheaper consumer goods are manufactured and transported from overseas, hence increasing utilisation rates.

"The advent of mega-containerships will create a fight for market share so that the economies of scale these vessels can deliver are captured. Smaller liner companies, therefore, may be forced to consolidate.

"Tankers are influenced by different geopolitical factors and are holped by th oil price reduction countering the effects of recession. Undoubtedly, though, there will be pressures here as well."

Assuming that credit does open after the new year, the bank plans to move forward.

"As markets and values correct, we are moving again into interesting territories for investment lending.

"We have a fairly diversified portfolio which we will try to expand along the lines we always did, paying attention to counterparty strength and the security of the cashflow," Antoniou adds.

"We have clustered together the ECT business as we believe opportunities exist in the crossover between the sectors and that is where we are going to play an important role. We believe in offshore and oil services in particular, in areas backed by long-term demand for construction and maintenance in deepwater drilling."

As for financing structures and types of deals to be sought, assuming the market reopens next year, Antoniou states: "We will continue playing a role in all risk classes, from senior lending to mezzanine and equity.

"We have a strong track record built over the last 10 years, having been involved in setting up and helping companies grow and go public - or simply profiting from asset appreciation. We intend to continue with this strategy, and the next few years will be interesting from that perspective.

"Also, we have a great principal finance [leasing] practice that is a leader in inter-modal and aviation structures. Again, our intention is to build on our strengths.

"Our focus will be on servicing our clients' financing needs, on ensuring high credit quality for our portfolio, good execution, and profitable expansion," Antoniou concludes.

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