www.bunkerspot.com Volume 11 Number 6 December 2014/January 2015

BUNKERSPOT

THE END GAME

THE RISE AND FALL OF OW BUNKER

Risky business

The collapse of OW Bunker has been attributed to its hedging or fuel trading strategies, however human error at the highest levels could also be to blame, says Chris Thorpe

It is almost absurd to think that a public company with audited financial statements and corporate controls can allow for a hedging error that could lead to bankruptcy. OW Bunker's recent bankruptcy filing proves yet again that what we may perceive to be a solid company is only as strong as its managers and control systems. Whilst it is easy to imply that hedging or oil trading were the cause of OW Bunker's demise, there are numerous historical examples that illustrate how leadership and senior management are truly to blame.

Singapore seems to be the nexus for hedging disasters. The examples of Barings Bank and China Aviation Oil (CAO) stand out as cases that had the highest impact on their respective markets of financial index and energy futures. Some may say that traders or remote subsidiary management are too far removed from senior management sitting in another country. On the other hand, Singapore is a rule oriented country with accounting and reporting rules that are comparable to any other highly developed country. So what makes Singapore the place to hide bad trades?

CAO was one of very few Chinese companies allowed to trade in futures markets outside of China. Its main purpose was to source fuel for Chinese demand and, therefore, it was typically buying fuel and thus exposed to volatile market prices. CAO was permitted to hedge against rising prices and inventory but had a natural exposure to rising prices since it was always buying to fulfil its country's demand. In this case, the chief executive officer (CEO) Chen Jiulin was based in Singapore despite reporting directly to senior management in mainland China (hedging was not allowed by law in mainland China at the time). Despite a policy rule that ordered the closure of hedging positions if losses were greater than $5 million, Chen layered on several strategies that were not readily detectable. Banks providing the hedges encouraged the strategies despite Chen's then extremely bearish view on oil prices which, if anything, would signal a time for Chen not to hedge at all. In this case, senior management at CAO's holding company had funded Chen's hedging positions and were aware the $5 million loss limit had been breached. In November 2004, CAO announced it had lost $550 million trading in crude oil swaps, futures and options. In a reactive face-saving move, the Chinese government banned hedging in oil for any Chinese company for several years thereafter.

> 'OW Bunker's recent bankruptcy filing proves yet again that what we may perceive to be a solid company is only as strong as its managers and control systems'

Intelligent and well-meaning people can make bad choices. It happens again and again. When former US senator, New Jersey governor and Goldman Sachs chairman, John Corzine, took the job of CEO at MF Global he undoubtedly was qualified, albeit overqualified. For the most part, MF Global was in the business of providing futures clearing services and over-the-counter hedging products for commodities customers across the energy, metals and foreign exchange markets. Corzine might have been bored or just missed his trading days at Goldman Sachs. Whatever the reason, he strayed from the company's main business to take a bet using a hedging strategy on European bonds that was not appropriate for the business it was in. The trade was not only unsuccessful, it caused cash demands on the company which were satisfied by means of 'borrowing' funds from customer accounts that were technically segregated from the firm's own money. Bizarrely, Corzine testified that he had no idea what happened to approximately $1.2 billion in missing customer funds. He additionally admitted he wasn't 'an expert on the complicated rules and regulations governing the various operating businesses'. With a board of directors comprised of highly experienced finance industry professionals, the thought of their CEO uttering these words seems preposterous.

The senior management of a public company is held accountable for oversight of the business, its people and all stakeholders. They are typically very well paid to do this. It is therefore curious that anyone would blame a junior manager for single handedly bankrupting their firm. OW Bunker's management claimed that their loss may be reduced 'in the case of an average Brent oil

> 'The entire bunkering industry has been shaken to the core and, as a result, hedging activities will likely be under increasing scrutiny'

price of $92 per barrel in Q4 2014'. This is equivalent to stating that you might make money taking a long position in the market but you might also lose money. The statement is obvious but it shows that management was aware of their position despite eventually claiming that junior managers had committed fraud. The problem was that OW Bunker's senior management had not come out clearly to state they were taking a high degree of market risk given the hedging strategies they were employing at the time.

There are countless hedging strategies that do work. Alaska Airlines, for example, will only buy call options to limit their price exposure to rising oil prices. This strategy limits their cash expense by the cost of the option chosen for a period of time, rather like buying collision insurance every year for your car. Buying options has a cost, but it is finite and clear to all parties. When using futures that include selling options or using swaps, some strategies can be risky and potential losses are often difficult to estimate without sophisticated risk management systems. Even with the best systems, hedging choices can lead to unwanted risk. For example, choosing a hedge that may become illiquid could create unwanted risk. If you own something that no one will buy, it has very little value. Quite often, financial products become less liquid when markets become volatile.

The oil markets are very risky by nature. Whether you manage a small bunkering business or a global fuel supplier, volatile oil prices are part of the business. No doubt, OW Bunker's management was very well qualified to do the job. However, in this case they proved to the market (again) that every business is subject to bad decisions, whether about strategy, tactics, hiring or hedging. Fortunately, these hedging gaffs are rare, but when they do occur they tend to be rather spectacular, albeit painful for many. In the case of OW Bunker, the entire bunkering industry has been shaken to the core and, as a result, hedging activities will likely be under increasing scrutiny. Senior managers ought not to focus on hedging itself as a problem, rather their own decisions and controls.

Chris Thorpe is a Managing Partner of Brick Consulting Partners and Brick Investment Partners.

Tel: +1 646 790 5777
Email: thorpe@brickipllc.com