

The power of technology

John Veson, president of Veson Nautical, discusses drivers and challenges surrounding FFA trading and how to maximise performance while keeping risks under control

The recent increase in freight rate volatility has fuelled the growth of the freight derivatives market – for some to hedge risk and for others to explore the opportunities of speculating on freight market swings. Managing and tracking paper trades is so novel that many companies in the maritime industry are still developing the technical and fundamental know-how to record, monitor, and account for their trades and positions. As a commercial marine software developer, Veson Nautical set out to develop a comprehensive solution, covering all such needs of players in the FFA market. To that end, we conducted our first FFA Summit in Boston during January 2007.

We invited a number of our clients – representing a spectrum of owners and charterers in both the wet and dry markets – to join in the two-day forum. Veson and the participants discussed maritime industry drivers and challenges that are intensifying the need for sophisticated FFA solutions. We also heard first-hand from these companies how FFAs were being handled up to today. The consensus was that organisations are seeking the ability to move away from a defensive risk posture and into a position of active control of their FFA portfolio. Our goal was to create a blueprint for an essential FFA technology solution that would provide consolidated, accurate, and user-friendly information to set the stage for intelligent business decisions leading to increased management control and profitability.



Shipowners need accurate and accessible data

Industry drivers and challenges

FFAs are one of the fastest growing areas within the commercial shipping industry for several reasons:

- The recent boom in commodities trade due to the strong growth in emerging markets worldwide has created a new reality for the maritime industry and new challenges in the management of freight costs and risks.
- This boom causes commodity prices to fluctuate more than ever before, increasing the uncertainty faced by participants in their trade.

- Spot traders are often in need of liquid instruments offering protection against this uncertainty and volatility, such as FFAs.
- FFAs may also help deal with counterparty risk exposure.

Despite the advantages of FFAs, most companies using them still rely on Excel spreadsheets with little or no link to accounting or front-office functions. FFA operations as practiced today are time consuming, inefficient, and not transparent.



Many companies still update spreadsheets manually

Real world examples: how FFAs work today

Skilful traders are the key to maximising FFA profitability. In addition to a deep knowledge of their specific freight market, traders need to be able to quickly gather and analyse any information that may affect future prices. In the case that they are also managing physical time charter and cargo positions, they need to keep an updated snapshot of their overall exposure. It is vital that any technology solution adapts to this fast-paced environment and does not burden the trader with more keystrokes than necessary.

During our forum and subsequent in-house research at client sites, we have found that traders have been generally successful using ad-hoc tools. However, despite the size and sophistication of our clients' operations, all uniformly felt there was a need for increased automation around position tracking and risk management. In fact, even with clients operating in completely different markets and varying scales, there were several commonalities in their existing processes.

First, the organisations spend a significant amount of time manually updating Excel spreadsheets with market data from the Baltic Exchange and Imarex. They also keep scratch areas where they can apply their own forward curves and assessments for what-if scenarios. Invoicing for actual settlements and for the brokers is also completed manually based on the information in these worksheets. Firms typically have a separate risk management team that is responsible for keeping limits within acceptable ranges based on corporate policy.

Second, there is a challenge in compiling a

unified view of the company's physical and paper freight positions. Without this consolidated view, or even a means of capturing the information pursuant to the trade, the company actually strips itself of most of the benefits the FFA could offer, ie a well balanced and hedged portfolio with matching physical and paper trades according to its specific risk profile. It is left with isolated islands of data, no linkage to accounting and very little in the way of reporting tools. The end result is that the company cannot assess its margins on volatile freight rates nor utilise FFAs as a profit centre.

Key features quickly became clear – domain expertise was a necessity for system managing FFAs just as it is required for traders of FFAs. Traders and managers need real time data on their cargo commitments, TC open position and FFA exposure. They need to be able to test scenarios in a marine specific environment that can capture all the intricacies inherent to shipping. One centralised programme would increase the efficiency of the trader, and allow it to quickly judge the physical freight position of the company at all times. This, in turn, would allow it to hedge its risk at any given time and make informed voyage decisions.

Can technology provide the solution?

It has become clear that commercial maritime organisations need to start implementing strong risk management processes to protect their businesses from volatile freight markets. As this market continues to grow, more and more companies report that they have outgrown the Excel spreadsheet method and in fact, need a

much more sophisticated, automated system. How can technology be used to better exploit FFAs to hedge freight cost risk exposure? And how can it be leveraged for maximising trading profit?

The companies we worked with during our FFA Summit all agreed: they needed a shipping-centric software system to manage their physical freight commitments, FFAs and options. One powerful system would ideally allow management to view its entire portfolio in real time, instantly, and provide access to analytical tools that would help them make intelligent, active business decisions, and help quickly and reliably evaluate the company's risk exposure and profit and loss expectations (realised and unrealised).

Requirements checklist

To help turn this into a reality, we created a list of critical capabilities. These elements became part of a "requirements checklist" that we developed in response to our customer's input. Based on feedback from the FFA Summit, the technology solution must:

- Manage wet and dry FFAs as well as options;
- Automatically download market information from the Baltic Exchange, Imarex and other data sources;
- Generate an interactive exposure report of overall cargo, TC and freight derivatives position (by month/quarter/year and by trading books/graphical output);
- Consolidate long/short position with market-to-market capabilities;
- Track credit levels and monitor exposure to counterparties;
- Deliver batched positions: one unified view of P&L on several trades simultaneously;
- Automate the processing of invoices and integrate with corporate accounting;
- Security, audit and alert tools.

Conclusion

The ideal technology platform should provide the shipping community – owners, charterers, traders, and brokers – with a simple, flexible, yet comprehensive tool for understanding and managing their FFA exposure. This should be a user-driven tool which enables a company to understand its risk position, hedge it according to their risk appetite, account for it, present it, and ultimately turn it into a new profit centre. Above all, the tool must continue to evolve along with the burgeoning FFA market, which is still in its early days of maturity.