

The rise and fall of OW Bunker, the World's Largest Marine Fuel Trader

By Alessandro Mauro

Founded in 1980, at the end of a decade marked by the two oils shocks that changed the oil market forever and saw the birth of modern oil trading, OW Bunker was once one of the world's largest traders of bunker oil. It had operations in 29 countries and claimed to control around 7% of worldwide bunker trade.

OW bought and sold marine fuel (aka bunker fuel) – a residual product of the crude oil-refining process. Bunker fuel is burned in seagoing vessels to navigate around the world. Like many other commodity traders, apart from basic goods transformations (blending), OW Bunker used a profit-driven buy first/sell later business model. It bought the fuel from suppliers (mainly refiners or other traders), and later either sold it to ship-owners and distributors or stored it for a period of time. To run the business, they gave financing to their customers and received financing from their suppliers and banks. Marine fuel trading, like many segments of oil trading in general, is a low margins business due to fierce competition among players. Higher revenues and profits can be made only by intermediating a higher volume of goods.



However, low margins do not imply low risk in the oil trading business. Companies such as OW Bunker face severe market and credit risk, but at the same time well established and widely known risk mitigation techniques can effectively remove most of those risks.

In this low margin and highly competitive environment, OW Bunker had at least one appeal: it was big. In a market crowded by a plethora of small and even minuscule shops, it was large and organized. Its dimension and profitability justified choosing a path normally avoided by the majority of traders. OW Bunker went public with an Initial Public Offering (“IPO”) which took place in March 2014 on the NASDAQ OMX Copenhagen exchange. The IPO was what people called a success. On the 28th of March OW Bunker CEO proudly welcomed “*the more than 20,000 new shareholders*”. The shares price went up about 20% on the first day of trading and the value of the company got close to one billion US dollars. Not bad for a company engaged exclusively in an old fashion and low margin business.

Author: Alessandro Mauro.

All rights reserved. For personal use only. Any other use requests author's approval.

<http://bit.ly/amaurorisk>

During the following months no major event came to disturb the honeymoon between OW Bunker and its happy shareholders. Unfortunately, after spring and summer, the first days of fall started delivering bad news. On the 7th of October the company released a profit warning, mainly due to “unrealized accounting loss before tax of approx. USD 22 million in Q3 2014”, triggered by the slide in oil prices. On the 23rd of October the company further restated the loss at USD 24.5 million and, in an Investor presentation, gave some further details about the drivers of this loss.

No more details were to follow. Abruptly on the 5th of November the shares were suspended from trading on NASDAQ OMX. On the same day OW Bunker management declared a loss of USD 275 million. Two separate issues were behind this drama.

A fraud had been discovered, put in place by senior employees in a previously unknown Singapore-based subsidiary named Dynamic Oil Trading. This fraud resulted in a USD 125 million loss. The second cause was a “*risk management loss*” in addition to the USD 24.5 million already communicated. Apparently the loss was found after a review of “OW Bunker’s risk management exposure” and the total loss was now estimated at USD 150 million.

On the 7th of November, after no other viable solution was found, the company filed for bankruptcy in Denmark. Further bankruptcy filings came in the following days in other jurisdictions.

OW Bunker in 2014

- **March** **Initial Public Offering**
- **3rd of October** **Profit warning**
- **27th of October** **Interim results**
- **5th of November** **Risk management loss**
- **7th of November** **Bankruptcy**

The IPO prospectus

The rest of this article is centred on what OW Bunker management described as the “risk management loss”. The information released by the company, in occasion of the IPO and later till the bankruptcy, allows to go in further interesting details. That is not possible for the fraud matured in the Singapore subsidiary, as it was made public just two days before bankruptcy. Unless otherwise stated, this article is based on public information realised by the Company, the same information that had been made available to its shareholders, counterparties and creditors. Sentences sourced by OW Bunker’s official documents are reported in Italics.

The prospectus produced at the time of the IPO is the crucial source that helps understanding more about OW Bunker, its business and, among others, its risk management processes. This document, as it is habitual for every IPO, is full with warnings about several risks potential investors will be facing by buying shares in the Company. At the same time, some crucial topics are left in the dark. One cannot find much information about the real functioning of OW Bunker’s market risk management process. The few reported data are repeated several times, in order to convey the idea of solid operations in this domain, as in many others the Company was engaging in. A long list of theoretical reasons why things could go wrong is given. If we concentrate the attention on the practical information and leave apart theory, what potential investors were

specifically told at this point can be summarized in these sentences:

- *“The primary goal of our marine fuel and marine fuel component price risk management policy, which is approved by the Board of Directors, is to ensure that our business generates a stable gross profit per tonne by limiting the effects of marine fuel price fluctuations”.*
- *“The overall risk limit set in our marine fuel and marine fuel component price risk management policy is defined by a maximum net open (unhedged) position for the Group. Currently, the maximum net open position approved by the Board of Directors is 200,000 tonnes. However, we operate with a lower internal risk management guideline with a maximum net open position of 100,000 tonnes, which is set by the Company’s Chief Executive Officer (the “CEO”) and applied in our operations”.*
- *“The Executive Vice President for our physical distribution operations is responsible for marine fuel price risk management and reports directly to the CEO.”*

The first point essentially tells that financial derivatives are used in order to hedge Company results against the volatility in the prices of goods the Company buys and sells. An important goal that in recent years could be easily achieved by trading exclusively plain vanilla derivatives, considering oil markets showed risibly low volatility.

With the second point the Company communicates the internal self-imposed rules in place to limit the risk it faces due to oil market prices. In the IPO prospectus it is further clarified that OW Bunker's *"net open position from marine fuel transactions and derivative instruments can be either long or short and is at any time below our policy limits"*. In summary, this information is meant to communicate the market risk appetite of the Company.

However, the benefit of this piece of information is limited. How a potential shareholder, or most of the stakeholders in general, could assess the dimension and the severity of market risk the Company will be facing? How big is the risk of being long or short 100,000 metric tonnes of anything? What is the probability of a negative event generated by this volumetric exposure? Income statements, balance sheets and financial ratios are expressed in US dollars, i.e. money, not quantities. There exist well-established risk evaluation techniques that answer to these questions. The IPO prospectus could have expressed the market risk in terms of Value-at-Risk ("VaR"), a statistically based measure of the maximum possible monetary loss. VaR is widely used by commodity trading firms' risk management. In fact, many public companies frequently report their VaR figures, often comparing it with their shareholders' equity.

Among other benefits, VaR takes in to account physical and financial exposure simultaneously. VaR also allows to communicate market risk current levels and limits without the

need to disclose sensitive information about company business. Unfortunately nowhere, in the OW Bunker's IPO prospectus or in other documents, is VaR mentioned. That raises some reasonable doubts about the real sophistication of OW Bunker's market risk management valuation process and related IT systems. To make things clear, however, it is not 100,000 or 200,000 metric tons an exposure sufficient to cause the large financial loss that materialized just months later.

The third point above opens questions about how risk management governance in OW Bunker, a public company, was shaped. In the Annual report 2013 there was no mention to an employee specifically responsible for risk management. It was reported, as being part of the management team, the existence of an employee which job title was "Executive Vice President – Physical Distribution". In the IPO prospectus this employee becomes also *"responsible for marine fuel price risk management"*. Had this employee sufficient experience in market risk management? Was a sole employee in charge of trading operations and risk management? Was this a self-controlling employee, without anyone else balancing this power?

We will come back to some other specific points of the IPO prospectus while analysing the other documents that were realised some months later.

Fall brings bad news

With the 7th of October announcement the Company, apart from the estimated loss of USD 22 million, started disclosing new important features of the pursued risk management strategy. Information is however ambiguous and in some important parts even contradicting.

“As part of its risk management policy, OW Bunker hedges its commercial inventory and marine fuel transactions within an expected oil price range. Consequently, price fluctuations within such range only have a marginal effect on OW Bunker’s results. Conversely, when the oil price breaks the expected range, it may affect a given quarter by changes in the valuation (mark to market) of the derivatives contracts used for hedging of inventory and marine fuel transactions”. It is difficult to interpret this statement. The starting point should be the exposure generated by the physical business, i.e. *“its commercial inventory and marine fuel transactions”*, before hedging with financial derivatives is put in place. Any exposure can be either “long” or “short”. A long exposure will gain money if price increases and will lose money if price reduces. For a short exposure, the opposite would happen. In the IPO prospectus it is stated that *“Our typical open position before hedging varies from a long position of 250,000 tonnes to a short position of 100,000 tonnes”*. However the company never clarified if the physical exposure,

**“OW BUNKER
HEDGES [...] WITHIN AN
EXPECTED OIL
PRICE RANGE”**

in the months preceding the bankruptcy, was actually short or long.

Let’s assume that the physical exposure was long, but the reasoning would be still valid in the opposite case. In order to hedge this long physical exposure, the company needed to be short on financial derivatives, by selling Futures, Swaps, Options or combinations of them. In this way, apart from problems related to the efficacy of the derivatives hedging instruments (*“marginal effect”*), the combined physical plus derivatives transactions should deliver rather predictable financial results. In the statement reported

above, the company clarified that this was the case, but the global hedging strategy was more complex. In fact, at that point OW Bunker’s hedging strategy was active *“within an expected oil price range”*, i.e. within a high and a low price boundary, normally identified as “cap” and “floor”, constituting overall a “collar”.

A collar can be built exclusively with derivatives instruments, not with physical deals, and it consists of a combination of long and short options. If we believe in what the company management was announcing, then the derivatives collar was counterbalancing the physical exposure only inside a price range. If prices would move outside the range, then the derivatives will become inactive and the company will be simply un-hedged on the physical business.



The price of Brent crude from the peak in June, 2014 to November.
Source: Thomson Reuters Eikon

If the physical exposure was long, a reduction in oil prices under the collar floor would have finally determined realised losses on the physical business without any benefit on the financial derivatives side.

The company further announced that *“The recent slide in the oil price, in particular during September, is outside the range expected and OW Bunker will as a consequence of its risk management policy report an unrealized accounting loss before tax of approx. USD 22 million in Q3 2014. This is based on a mark to market valuation of OW Bunker’s derivatives contract as at end September 2014”*. At this point it seems that the company is not giving a complete picture, because it is discussing exclusively the derivative contracts. It is true that the value of the collar derivative contract should change even when prices are outside the collar range. However, at the same time, also the physical exposure would change in value. If, for

every metric ton of physical exposure, one metric ton of collar was executed in the financial market, then the change in value of the physical exposure should be more important than the change in value of the collar contract. In fact the physical exposure is linear while the collar one is not.

Issues related to accountancy rules do not seem to bring an explanation to the incongruence of the announcement. In the IPO prospectus the company had stated that its derivatives did not qualify for hedging accounting treatment. Consequently, *“Changes in the fair value of these derivative instruments are recognised immediately in the income statement”*, while changes in value in the physical transactions would be recognised at a later stage. This is quite common for commodity trading firms and it does not bring any surprise. Why, then, in the 7th of October Company announcement nothing is said about the value of the physical transactions and the fact that the loss recognised on derivatives in

Q3 2014 will be balanced later by the physical part of the business? The obvious explanation of the omission about the physical business can be only one: the volume of traded derivatives was much bigger than the physical exposure. At least at this point in time, the main driver of company results was constituted by the derivative contracts. Profits or losses on the physical business could not counterbalance the derivatives results. Amusing conclusion from a starting point in which derivatives were meant to counterbalance the results of the physical commercial activity!

Furthermore, the 7th of October Company announcement informs that the loss of USD 22 million *“includes a substantial element of protection taken up against further falls in the oil price”* and that *“We have taken action to minimize risks against further oil price falls [...]”*. This information is not sufficient to make clear what was put in place. However the “Investor Presentation of the Interim Results Q3 2014”, released on the 23rd of October, would incidentally clarify that this was a purchased Put option and it was already in place by the end of September, 2014. This part of the announcement seems then rational: in order to enter in a long Put option and hedge from possible further oil prices reduction, OW Bunker had to pay a premium and this was included in the communicated USD 22 million loss. As a side note, we should remark that the paid premium

was to be considered as already realised, and consequently it was not accurate to classify the USD 22 million loss as fully unrealised. Moreover, the impact of this loss on the 2014 outlook was reduced by making the simplistic assumption of USD 10 million of *“expected regain on hedging”*. This point was made clear only later in the Investor presentation of the 23rd of October.

“If the oil prices rise again, we will gain on our derivative contracts [...]”. This part of the 7th of October Company announcement is not simple to decipher, but can finally clarify OW Bunker’s exposure to oil prices. The company indirectly suggests again that the physical exposure is negligible in the global picture. Excluding the results of the additional long Put option already mentioned, what we know at this point is that:

- OW Bunker was losing money on derivatives because of the reduction of oil prices.
- OW Bunker would gain money on derivatives if prices would increase again.

This position is nothing else than a combination of a long Call and a short Put, where the strike price of the Put is lower than the strike price of the Call. By adding later the long Put, the company allegedly covered against further downside, but preserved the upside. Not much more can be said, based on the public information that was released at this point.

Bigger clouds on the horizon

On the 23rd of October the Company produced an Interim Financial report for Q3 2014 and a related Investor Presentation, shedding some more light on what was happening. In summary:

- The losses for Q3 2014 reached USD 24.5 million, 2.5 million higher than before.
- The forecasted “regain” of USD 10 million on derivatives was cancelled.

Using Company words, “*The estimated unrealised risk management loss of approx. USD 22 million as announced [...] on October 7, 2014, ended at a USD 24.5 million loss when final calculations were made*”. It was just an additional 2.5 million loss, but it was a symptom of a serious illness. First of all why “*final calculations*” were necessary? The IPO prospectus

clarified that the company traded in financial derivatives which fair value was classified, according to IFRS definition, as “level 1” and “level 2”, i.e. value essentially based on prices promptly available from market sources. Were or were not OW Bunker’s state of the art risk management system able to calculate the value of positions at least daily (baseline in this industry)?

Additional information allows to have a better idea regarding the derivatives position in place. In fact a “*possible reduction of the unrealised risk management loss, including the*

additional USD 2.5 million risk management loss, requires a Brent oil price of around USD 92 per barrel. In case of an average Brent oil price of USD 92 per barrel in Q4 2014, the unrealised risk management loss may be reduced by around USD 12.5 million [...]. In case of an oil price below this level, OW Bunker does not expect a reduction of the unrealised loss in 2014. However, OW Bunker is protected against further losses than the above mentioned without additional cost to protect against further oil price falls.”

The described position resembles again the payoff of a long call option. By paying a premium,

the Company allegedly secured profits in case of an increase in prices, but would not suffer from a further reduction. However, the wording above suggests that the option was not a simple call option, but something similar to a “digital” call option or a “knock-in” one. These options

deliver a payoff different from zero only if the underlying price reaches a certain level. We may use simple algebra and the hypothesis that the possible USD 12.5 million profit was based on a comparison between 92 and 84 USD per barrel, 84 being the Brent crude price in the middle of October as reported in the Interim Financial report. In this way we obtain a necessary volume of derivatives of approximately 70,000 metric tons for each of the three months in Q4 2014, i.e. about 210,000 metric tons in total. We need to consider that these derivatives were options, and the exposure they generate is less than linear.

**“OW BUNKER
IS PROTECTED
AGAINST
FURTHER LOSSES”**

Moreover, these options were out-of-the money, which further reduce the exposure.

Once again nothing is said about the exposure generated by the physical business. If that exposure was positive, then the company was long on physical and long on derivatives, i.e. the derivatives were not hedging the physical business. If the physical exposure was short, than an increase in oil prices would generate money on the derivatives but lose money on the physical business. As said before, the only way to believe what the Company management was communicating at this point is to suppose that the exposure generated by derivatives deals was much bigger than the physical one.

Consequently we need to conclude that this derivative position was not built for hedging purposes but it was instead a bet on prices going up. That would still not constitute a breach of the limit of 100,000 metric tons. In fact the IPO prospectus clarifies that, inside that limit, even pure derivatives positions could be put in place. Moreover, the CEO could have approved a limit extension to 200,000 metric tons, which was under his powers without approval needed by the Board of Directors. However this is not mentioned in the Interim Financial report or in the Investor presentation.

In the latter document, some additional piece of information is given. The loss of USD 24.5 million is allocated to three main factors:

1. Purchase of Put option derivative contract to protect from further price reductions.
2. Change in forward oil price market structure, from Backwardation to Contango.
3. Change in the absolute level of oil prices.

The first two factors raise some suspicions. Regarding the first point, this form of insurance is said to be in place already at the end of September, and *“Subsequently protection has been moved down in light of oil price decrease”*. It must be considered that, once a protection with

a long Put option is in place and the underlying price moves down surpassing the strike price, this financial instrument delivers money to the holder in a linear way. Consequently, why OW Bunker did need to move down the protection?



The sentence could be explained by the fact that the long puts, already in place at the end of September, had a short term maturity. Later on other put options were bought at a lower strike price, consistently with the additional price reduction that underwent in the market in the meantime. Incidentally, the Investor presentation communicates that the underlying of the Put options is gasoil price, while it suggests a couple of times that the benchmark price for OW Bunker business is the price of bunker and fuel oil. This should have raised some questions

about the efficacy of these Put options as hedging instruments.

The second bullet point above mentions the impact of “Contango” in the market. This is a situation in which prices for prompt delivery of goods are lower than prices for forward delivery. The opposite is true in case of “Backwardation”. Exploiting price time-structure in Contango when it appears in the markets is one of the simplest, lowest risk and most profitable way to make money for commodity traders. It is sufficient to buy the goods, store them, and then sell the goods for forward delivery or sell derivatives maturing in some months and the game is done. The fact that OW Bunker lost money because of market prices going from Backwardation in to Contango tells something more about the radical payoff modification that was achieved by trading derivatives. Essentially, the Company was long on short-dated maturities and short on longer ones. This short time-spread position would deliver money in a market that moves in to Backwardation. On the contrary, such position would lose money in a market where Backwardation reduces or even changes in to Contango, and the latter was the case for OW Bunker. However the Company affirms that it would not be caught by surprise again: *“With the current hedge, OW Bunker will not be impacted by changes in market structure (i.e. a reverse of the current contango market structure to backwardation)”*. Even this assertion sounds

***“STRATEGY WITH
LOW PRICES
IS TO INCREASE
LONG EXPOSURE”***

strange. In order to become insensitive to changes in the market price time structure it is necessary to have all exposures concentrated in the prompt month.

The third point above communicates that, in addition to the time spread position, the Company had an outright long position and this lost money due to oil market prices reduction. Here again the Company does not miss the opportunity to confuse stakeholders. In the Investor Presentation one can read that *“Typical implications from [...] oil price changes to the business”* are that *“the strategy with low prices is*

to increase long exposure as prices fall”, while under high prices *“it is preferred to be long going into an environment with rising prices”*.

All in all, the message delivered to the markets was negative for the moment being but reassuring for the future:

“Current marine fuel price exposure: Downside risk protected and upside potential kept”. The Company had neutralized possible further losses on derivatives in case prices would continue to reduce. At the same time, should prices go up again, either the financial profits will be stable or they could even rebalance the previous loss. However, again nothing is said regarding the exposure generated by the physical business, which is appalling for the World’s number one trader of physical marine fuel. At least this point, management principal or even unique matter of concern was the financial derivatives position.

The point of no return

The catastrophe was disclosed on the 5th of November. A fraud had been discovered in Dynamic Oil Trading, an OW Bunker subsidiary in Singapore, generating a loss of USD 125 million. Moreover *“a review of OW Bunker’s risk management contracts has revealed a significant risk management loss in addition to the loss of USD 24.5 million announced on October 23, 2014 [...]. As of today, the mark to market loss is around USD 150 million”*.

The breaking news compare with the *“Downside risk protected”* picture depicted on the 23rd of October, less than two weeks before.

At that time the loss was supposedly USD 24.5 million. That would imply that in eight business days (markets are closed on weekends) OW Bunker cumulated an



additional unrealised loss of around USD 125 million, i.e. a daily average of USD 15.6 million. Considering the price change in the same period, i.e. approximately 4 USD per barrel down on crude oil, a rough estimate brings to an exposure in excess of 4 million metric tons. It is very improbable that this loss was cumulated on new derivatives contracts executed after the 23rd of October. The 5th of November Company announcement suggests that the loss was substantially there already on the 23rd of October and even before, but it was not made public. Probably on the 5th of November the people familiar with the outstanding derivatives position

could not conceal the catastrophe anymore because the counterparties issued margin calls and OW Bunker was not in the position to pay for the margin increase.

If we still believe in the information released before and after the IPO, then we must infer that the loss was necessarily the result of a radical change in the amount of market risk the Company was facing. In the Annual Report 2013 one can read that *“If the commodity prices increase by 1% [...] with all other variables being held constant, the profit for the year will be increased by USD 0.3 million (2012: increased by 0.1 million 2011: lower by 0.5 million) as a result*

of the changes in the oil derivative contracts as of end of the reporting period.” If the risk profile in 2014 was really kept similar to the 2013 one and the exposure was linear, then a loss of USD 150 million

would request a price reduction in the order of 500%, i.e. price should become negative. Another absurd conclusion.

We can guess some possible explanations about the lack of communication related to the change in risk profile and the subsequent loss:

- The top management knew about the derivatives position and they authorized that. They knew losses were cumulating, but did not communicate it till the 5th of November, hoping that the market prices trend would change.

- The top management did not know, but the risk management function did know about that and did not communicate to top management.
- Nobody knew about the total derivatives position and/or the financial loss, due to issues in risk identification, analysis and valuation.

Whatever the truth is, it is highly probable that the total exposure of the company was in excess of the well-known 100,000 or 200,000 metric tons by some multiples. OW Bunker built an exceptional position in derivatives, probably utilizing combinations of options, that overall resulted in a long exposure to oil prices.

A broken risk management process

This catastrophe shares many common points with other horror stories in which derivatives trading turned sour. From now on OW Bunker will be in good company with the likes of Metallgesellschaft, Amaranth, MotherRock and China Aviation Oil, just to name a few which got in trouble by trading financial derivatives on commodities. As far as the OW Bunker case is concerned, it is actually difficult to find any original point or lesson to be learnt for future memory and which was not already included in the horror stories gallery. For example, many other disasters did happen because of sudden changes in market conditions, after they had shown a stable and profitable pattern for a long

period. Often the mechanisms and the ultimate responsibilities behind these disasters have not been completely clarified. However, as OW Bunker was a public company, we have here a certain amount of information delivered to the market, which has been the basis for the previous pages of this article. Far to say that this information has been clear or exhaustive. Anyway, it needs to be noted that even this limited information should have justified some reasonable doubts in the company stakeholders.

From the narration and the analysis of the events and company documents, it is evident that OW Bunker actively engaged in the trading of financial derivatives. By saying that *“a significant risk management loss [...] is around USD 150 million”* it was finally made clear that in OW Bunker *“risk management”* was synonymous of *“derivatives trading”*. In the IPO prospectus the company specified the operational aspects of this trading activity: *“Daily marine fuel and marine fuel component price risk management is handled for the entire Group by our central risk management department. All operations hedge their exposures with the risk management department, which, in turn, hedges the Group’s open position in the market.”* In this sentence, even the word *“hedging”* should be read as *“derivatives trading”*.

Derivatives trading activity was put in place to reach objectives that often surpassed the pure hedging of exposure originated by the physical business. This is normally called speculation and it is not forbidden by any law or any best practice or standard in risk management. Inside the

general risk management process, derivatives trading is an effective way of “risk treatment”, the sub-process that allows modifying the risk profile of a company. Risk treatment, and consequently also derivatives trading, allows moving from a certain risk profile to another, the latter being closer to the company risk appetite. Risk treatment does not necessarily mean risk reduction, and it can be actioned also with the objective of risk increasing. OW Bunker’s fault is not in the increase of exposure to market risk by using derivatives but in the lack of communication of this strategy to its stakeholders, in the first place its shareholders.

Communication of risk is a crucial part of any risk management process. Communication should be correct and clear, but OW Bunker failed on both. From the pages before it is

evident that the released information was lacunose and misleading. Additionally, OW Bunker’s risk communication was flawed by design. As already discussed, trading limits expressed in metric tons do not tell much about the amount of risk a company is facing. Modern risk communication should be based on risk measures of monetary loss, such as Value-at-Risk and stress testing.

An important objective of risk communication is to make sure that the level of risk the company is bearing is aligned to the level preferred by its stakeholders. If this is not the case, either the company should modify its risk

profile or the stakeholders should leave the boat. In fact, stakeholders’ risk appetite is the king, not the company management one. Even if stakeholders, and shareholders in particular, liked to bet on oil prices, this does not imply that OW Bunker was authorized to place those bets or was best placed to take those positions in the interest of its shareholders. Nowadays there are different ways to get exposure to commodity prices, for example by investing in commodity Exchange Traded Funds (ETF). Everybody can invest a sum of money directly in oil prices-linked financial instruments. Trading shares in public companies is far from being the first best if the investor is looking exclusively for oil price exposure.

Risk treatment and risk communication do not exhaust the list of risk management sub-processes. Risk assessment is another

crucial step. It should come before risk treatment and should be performed periodically, even more frequently than daily. In fact new deals and the modifications of existing ones, both physical and financial, continuously change the exposure to risk. We have clarified, in the previous pages, the reasons why there are doubts about the quality of risk assessment techniques in OW Bunker. While this is a serious issue in any case, it becomes of dramatic importance whenever a company actively engages in financial derivatives trading. There are reasons to believe the dynamic and massive utilization of financial derivatives, beyond the scope of hedging the physical

“RISK MANAGEMENT”
=
“DERIVATIVES TRADING”

business, was already there when the company started the IPO process. One can read in the Investors Presentation of the Q3 2014 Interim results that *“Historically we would have moved our hedging out in time [...]”*, where again “hedging” is the word OW Bunker used in order to identify “derivatives trading” activity.

Other doubts should be raised around the crucial topic of risk governance. In the IPO prospectus the company proudly discuss the *“Robust Risk Management System and Culture that Underpins Stable Performance”*, clarifying that *“Our conservative operating philosophy and corporate culture are reflected in our overall governance approach, including our risk management function”* and that *“Our risk management department [...] is responsible for centrally managing our global risk exposure in line with the risk management policy approved by the Board of Directors”*. Well, we have not seen a copy of this risk management policy. How then risk governance and controls were shaped, if they were, in OW Bunker?

We have already discussed the controversial role, inside the OW Bunker’s organization, of the employee in theory responsible for the risk management function. In the Company announcement of the 5th of November, it was made sure to communicate that the *“Head of Risk Management and Executive Vice President”* was dismissed as *“a consequence of the risk*

management loss”. There is no more mention to the fact that the same employee was first of all in charge of physical distribution. Why the head of risk management was dismissed but not the head of trading? Is not the trading function, in a trading company, the first responsible for the results of trading activity? Has the head of physical distribution/head of risk management been another scapegoat in the gallery of scapegoats we have seen in the past? Was OW Bunker a shop in the same mall described by Daniel Pennac in his famous novel *“Au bonheur des ogres”*?

The IPO prospectus does not use even a single time the word “segregation”, let alone “segregation of duties”. It is probably out of fashion now, but we were taught that best practices in risk management included giving responsibility for creating value and responsibility for controlling it to different employees, in order to properly manage conflicts of interest. It seems there was not such a segregation in OW Bunker. In general this is bad, but it gets much worse when money-making objectives are assigned to the risk management function. Nowadays we continue to hear that the modern trend is that risk management should be a “business partner”, where “business” means “trading”. OW Bunker had probably embraced this new trend and went one step further: risk management function was part of the trading function. There was probably some specialization in place: “traders” were managing the physical



deals while “risk management” was taking care of the financial derivatives. In this setup, who will control risk management employees while they are striving to make money?

OW Bunker’s risk management function had monetary value creation objectives. In fact, the company was selling other services to its customers, including “risk management solutions”. In the IPO prospectus we may read that *“we are also able to provide risk management solutions as part of our customer offering [...]. Our risk management solutions include a broad range of financial and trading instruments, such as physical fixed price contracts, swaps, caps, collars, three-way options and other tailor-made solutions.”*

It is true that the IPO prospectus further specifies that this was a marginal driver of value creation. However marginality is not sufficient to justify lack of control. In this type of setup the incentive for cross-subsidization, i.e. using profit in one business unit to subsidize another, is very high. This cross-subsidization is normally put in place ex post, when profits or losses materialize. Probably in OW Bunker there was no segregation between the hedging part of the derivatives portfolio and the part that was held to support the risk management solutions. Using a food analogy, this situation normally cooks a big soup in which becomes impossible to distinguish single ingredients, until one becomes so preeminent and even disgusting that you need to throw the soup away. The incentive to conclude “discretionary”, i.e. speculative, deals grows higher because these deals can be easily reported

as part of the “risk management solutions” portfolio. Later, if profits materialize, they will be considered in traders’ bonus compensation. On the contrary, if losses are realized, then these deals will be ex-post considered as meant for hedging purposes, consequently dampening the result of the rest of the physical business but not traders’ compensation. When results are just too bad, the entire company is affected.

This could be the setup possibly used to conceal the real situation to the eyes of top managers in OW Bunker, if they were really not aware. They were told that the massive amount of derivatives deals, the same ones that finally brought to the catastrophe, were entered in order to support “risk management solutions” products. However those products did not exist in that scale.

Parting thoughts

This was the story of a company that destroyed one billion US dollars, value owned by its shareholders, in a matter of months. The last question to be answered is: could this catastrophe have been avoided? This is the most important question if we want to learn lessons from this case and try to avoid similar outcomes in the future.

The analysis above has demonstrated that the risk management process failed in every step and fell short of respecting risk management best practices and standards. Differently from financial institutions, commodity trading firms are not subject to laws and regulation directly addressing their risk management process. However, these firms can apply risk management standards and best practices which are valid in general. Their proper application in the commodity trading space can assure that risk management is in tune with the strategic goals of the organization.

However, in which way stakeholders can be sure that a company is actually applying risk management best practices and standards while shaping the risk management process? For example, a company management could easily communicate that they are performing state of the art risk evaluation, and inform periodically about the Value-at-Risk and stress testing results. Stakeholders would feel reassured that the company risk profile and risk treatment techniques are in line with their own preferences.

Later they could discover that this was a nice staging.

Help could come from the existing and incoming new regulation that is reshaping the financial markets, with repercussions on commodity markets and traders. In the plethora of rules, there is a specific provision that could have potentially prevented OW Bunker masking the real dimension of the positions taken in the commodity financial market. In fact, traders in financial derivatives have been requested to promptly report their derivatives deals to centralized trade repositories.

This provision, together with the obligation to promptly reconcile deals with counterparties, should possibly allow to have clear and comprehensive data related to the derivatives deals and the net open position of companies. It is evident that this will not form the entire market prices exposure for most of the companies, as there is not a similar reporting obligation for physical deals. However critical cases, where the hypertrophy in derivatives trading is not justified by the normal course of physical activity, should become easier to detect.

OW Bunker was a company domiciled in the European Union. Consequently the “European Market Infrastructure Regulation” (“EMIR”), was applicable to OW Bunker. In the IPO prospectus, OW Bunker classified itself as “Non-Financial Counterparty” (“NFC”), which could be proven to be wrong when the true dimension of its derivatives operations will be disclosed. The NFC classification allows to skip or postpone a number

of EMIR obligations, but not all. In particular, all EU-based counterparties have to promptly report their derivatives deals to central repositories. This requirement potentially allows public bodies (authorities, central banks, etc.) to have precise knowledge of derivatives positions, exercise control over derivatives activity of every company and stop OW Bunker-style behaviour. The assumption that commodity trading firms trade derivatives in order to exclusively hedge physical exposure should be ascertained case by case.

Although spectacular and dramatic, OW Bunker's case does not represent the unique example of a company exiting the oil market during these months.

More are and will come, triggered by the relevant and sudden oil price reduction that started in the middle of 2014. Much lower prices and higher volatility, like strong winds and high waves at sea, are showing the good and the bad ships, and finally force the latter to sink and disappear. The prodigious and efficient mechanism of natural selection is again at work. The only trouble is that on ships such as the OW Bunker's one there are passengers who would avoid the journey, if they knew the full story. OW Bunker boarded more than 20,000 once happy shareholders.