Nordic risk

Harri Toivonen, partner of Kiodynos, discusses the risk management challenges for Nordic corporations, as well as regulatory issues

Q: Do you believe European regulators will ever be able to achieve a truly liberalised market and level playing field across Europe?

A: The Markets in Financial Instruments Directive (MiFID), which is replacing the Investment Services Directive, also includes commodity derivatives. While it currently seems that physically settled power and gas contracts will not initially be within MiFID, the harmonisation of capital markets will also have an effect on the physical commodity markets and participants in the market. However, barriers to a truly non-regional European energy market across member states still remain due to physical delivery mechanisms of the underlying market.

Q: What are the greatest trading and risk management opportunities/challenges for Nordic countries?

A:For our corporate clients, one major concern in the use of derivatives has been IAS compliancy. As in the US, after the introduction of FAS 133, there has not been a major change in the level of hedging, but initially there was a move to 'plain vanilla' products. The two main challenges for Nordic listed companies are cost-effective risk management and accounting compliancy. The shipping industry is very important to Norway and Denmark and freight prices affect all the exporting companies in Scandinavia. Hence, the development of global shipping derivatives markets offers great opportunities. Moreover, the price volatility in oil and gas markets is a major impact for Norway, one of the major oil producers. The volatile energy prices emphasise the importance of commodity risk management for industrial companies across Scandinavia. The launch of pulp futures on NYBOT has also created new opportunities, as the pulp and paper industry is an important sector for the Swedish and Finnish economies. Finally, continuing development of common energy markets in Scandinavia and ensuring a level playing field for all participants in Nord Pool is important for the future of the market.

Q: Do you see opportunities in the emissions and shipping derivatives markets?

A:An increase in the market prices of allowances has caused companies in energy-intensive industries to consider emissions as an additional factor among the company assets. Emissions have major implications for these companies' investment decision-making processes. This provides opportunities for financial institutions to create emission-compliant financial engineering solutions. The inclusion of emissions in the Isda master agreement will further advance the development of emissions markets, by facilitating the active participation of banks and other financial institutions. The high prices of coal and crude oil further underline the strategic importance of energy and emissions risk management for European corporations' competitiveness.

The Chinese economy's demand for raw materials and energy continues to dominate the global shipping market. The continuing volatility of the underlying physical dry bulk and tanker markets offers growth opportunities for both the OTC market and exchange-traded Imarex and Nymex contracts. The size of the global shipping market is US$500 billion – the freight market being US$150 billion and the container market US$100 billion. The growth possibilities for shipping derivatives are provided by both new markets and additional products such as container markets and sale and purchase forward agreements. These products will offer additional risk management tools for ship owners. Moreover, banks involved in shipping finance will be able to provide more innovative financial structures for their clients.

Q: What are the most pressing issues needing to be addressed by quantitative analysis currently?

A: As quantitative analysis is now being used for strategic decision-making, the question quantitative analysis is trying to answer is moving from "what is the price of this transaction?" to "what is the expected risk-adjusted value of our asset portfolio if these scenarios occur?" Our Electrum framework creates a coherent and dynamic forward-looking framework and technological solution for modelling entity-wide sources of strategic risks and opportunities.

Quantitative analysis has to provide solution to price and hedge the newest financial instruments to gain first-to-market advantage. Moreover, it has to meet emerging regulatory and compliance reporting requirements cost effectively. Modelling of operational risk, loss given default, inflation derivatives and hybrid products face the same age-old challenge: lack of transparent data and ability to correctly measure co-movements and spreads for term structures of assets. ■

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