

Iron ore swaps to boost liquidity

New market allows traders to combine contracts with FFAs

Liz McCarthy

INCREASED trading in iron ore swaps can be used to help boost liquidity in the dry bulk freight derivatives market, a major London-based freight derivative brokers said yesterday.

With sales in the underlying physical trade of iron ore shifting from long term contracts to a spot price, traders, banks and shipping companies could take advantage of the newly established market in iron ore swaps.

"For a lot of people the drop-off in liquidity in forward freight agreements has been a big challenge. Well, here is a real chance to kick-start the iron ore routes which represent such a big component of the physical iron ore and shipping markets," FIS managing director John Banaszkiwicz said yesterday.

"The reason that traders, banks and shipping companies have become interested in the iron ore swap as it is a simple, robust product, with a clear link to the highly liquid and standardised FFA market"

Approximately 12m-15m tonnes of iron ore swaps are cleared every year, based on four broker houses trading around 250,000 tonnes per month, Mr Banaszkiwicz said. However, this amount has potential to grow, with physical iron ore shipments forecast to hit 890m tonnes in 2009, up from 845m tonnes in 2008. "I know that the big producers and traders who aren't already in the market are spending money on consultants to research it," Mr Banaszkiwicz told a forum in Geneva.

Traders and shipping companies could make money from the close correlation between spot rates and iron ore prices,



Iron ore stockpiled at Marmagaoa Port in Goa, India, waiting for export: traders, banks and shipping companies have become interested in the iron ore swap as it is a simple, robust product, said FIS managing director John Banaszkiwicz. Bloomberg

which is mirrored in the derivatives market, with forward freight agreements and iron ore swaps falling and rising closely together.

When the spot iron ore price fell to a low of \$57 on April 17 this year, two cape-size shipping routes, the C3 from Tubarao to Qingdao was \$17,660 per day, and the C5, from western Australia to Qingdao, averaged around \$7,020 per day. Then, when the iron price reached a 2009 high of \$111 on August 7, the C3 rose to \$31,900 and the C5 rate rose to \$12,070 per day.

Traders who work with both FFA and iron ore swaps could take advantage of

cross-margining, offered by FIS and the largest clearing house for the freight industry, LCH.Clearnet. By holding a long position in one product and a short position in the other, traders were able cut margin requirements by 35% by applying an inter-commodity spread credit to their transaction.

"The iron ore swap market is off to a great start but we know we have to keep pushing this market forward," Mr Banaszkiwicz said.

The Baltic Exchange, against which FFA contracts are settled, has voyage routes for Brazil to China and Western Australia to

China trade. FIS is lobbying the Baltic to create a voyage route from India to China to create a fob price against which freight and iron ore swaps can be settled. Demand for Indian iron ore shipped on supramax bulk carriers to China has already seen 74.3m tonnes imported between January and August this year in the physical market, up 9% from the same period in 2008.

The Iron Ore and Steel Derivatives Association, established last month, would also help promote the market by bringing together brokers, traders, producers, consumers and even lawyers, Mr Banaszkiwicz said.

Final year for annual pricing

FIS believes the annual iron ore price negotiations will not survive beyond 2010, as steel producers shift from long-term contracts with miners to buying the commodity on the spot market, writes Liz McCarthy.

The widely held view that the 40-year-old benchmark pricing system is no longer relevant reflects developments in the coal market at the start of the decade, when miners shifted from long-term contracts to the spot market.

"We see the same thing happening in iron ore but at a faster pace," Freight Investor Services managing director John Banaszkiwicz said. "I'll make a rash prediction: that after the negotiations for next year's prices, benchmark pricing will be abandoned by all but a few diehards."

In 2008, about 835m tonnes of iron ore was shipped, with just over 10% fixed on a spot basis. For 2009, the prediction is 890m tonnes, with 60% fixed on a spot basis. China was responsible for most of this shift as the country's \$586bn stimulus package kick-started steel production. World steel production could exceed 1.2bn tonnes in 2009, about 48% of it Chinese.

Annual benchmark price negotiations for 2010 are expected to start next week between Japanese, Taiwanese, Korean and some European buyers and major iron ore producers.