What happened and what was the reaction of the management to the problems?

What are the risks MGRM incurred after setting up its hedging strategy? Mention also the differences in cash flows between a forward and a future position.

- Basis Risk
- Credit Risk
- Liquidity Risk

How would you judge MGRM’s hedging strategy? Use also the article by Kuprianov (1995) for this question.

- Does the Hedging Strategy Serve its Purpose?
- Is the Strategy as a whole RATIONAL?
- Are there Risks that have been underestimated?

Molycorp: Morgan Brothers' Reverse Convertible Notes (C)
Molycorp: Morgan Brothers' Reverse Convertible Notes (C)
Caseism.com

Group 2:
Jonas Vetter
Amaury de Barsy
Wouter Koerselman
What happened and what was the reaction of the management to the problems?

Supervisory Board

- The oil price fell
- Margins were doubled
- OTC Counterparties
  - Pull Contracts
  - Demand Higher Collateral
- Benson expected support from Creditors and Parent, when cash struck
- Financial Distress

Fired Benson and Management Decided to liquidate the contracts

Statement

"The Supervisory Board was not sufficiently informed"

Liquidity the Hedge
NYMEX withdrawn Hedging Exemption Futures Limited
Contracts ended at no cost to Customer Paper Lessons Realized

How would you judge MGRM's hedging strategy? Use also the article by Kuprianov (1995) for this question.

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How would you judge MGRM's hedging strategy?

- THE STRATEGY IS RATIONALLY JUSTIFIABLE
- THEORETICALLY IT WORKS AT A GOOD HEDGE CONSIDERING THE AVAILABILITY
What are the risks MGRM incurred after setting up its hedging strategies? Mention also the differences in cash flows between a forward and a future position.

- Basis Risk
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Basis Risk

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The hedge and underlying position have different maturities

Both products reacted differently to spot price variations
Position was not entirely value hedged.

Even more so in a long contango period (14 months max.)
Basis Risk


Hedge ratio should be equivalent to the ratio of the forward position on the spot price variation.

<table>
<thead>
<tr>
<th>Time to Expiration</th>
<th>Heating Oil Futures</th>
<th>Gasoline Futures</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$\beta$</td>
<td>$R^2$</td>
</tr>
<tr>
<td>Two month futures</td>
<td>0.735</td>
<td>0.84</td>
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<td>Three month futures</td>
<td>0.625</td>
<td>0.79</td>
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<tr>
<td>Six month futures</td>
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<td>0.80</td>
</tr>
<tr>
<td>Nine month futures</td>
<td>0.492</td>
<td>0.79</td>
</tr>
</tbody>
</table>
Credit Risk

Customers might default on forward contracts if prices fall too low.

Further enhances the basis risk
Liquidity Risk

Margin calls
Futures gains/losses need to be settled on a daily basis

Cash-out option
Embedded in the forward contract

- Could produce negative cash-flows for MGRM
- Customers would be in-the-money if cash-out gain was equivalent to NPV of future deliveries
- But could still exercise it even if not in-the-money for liquidity issues