RISK MANAGEMENT

Five Top Trends for Best-in-Class Currency and Commodity Hedging

By Geri Westphal

iTreasurer recently spoke to the team at Openlink, a trading, treasury & risk management solutions provider, to discuss their views of how treasurers are taking a more proactive holistic approach to managing risk. Based on our discussion, we identified the five top trends that promise to drive further transformation and change how treasurers identify and manage currency and commodity risks.

By combining both currency and commodity exposures and the related hedges within the treasury department, corporate treasurers have been able to more effectively manage the company's risks. This is a move away from the siloed approach of having treasury manage currency exposures while procurement took responsibility for commodity exposures. Driving this move toward an integrated approach is technology, which has vastly improved the functionality of most treasury management systems (TMS), offering more detail, transparency and ultimately a better view of risk across the entire enterprise. With this in mind, here are the five trends shaping risk management.

1. TREASURERS ARE MORE STRATEGIC THAN EVER

Treasurers have been asked to step outside of their traditional role as they continue to be more directly involved in the management of supporting other enterprise-wide systems. These include accounts receivable, credit and accounts payable as well as IT and supplier relations, all of which help improve cash flows and protect the enterprise against fraud. They are in a better position than ever to directly or indirectly evaluate and analyze alternatives, oversee integrations and steer appropriate resources across silos while driving awareness of issues that impact all forms of risk.

One area that is becoming more strategic for treasurers is currency exposure risk management. Based on results from a recent survey of Treasurers' Top Priorities conducted by NeuGroup Peer Research, FX and commodity risk management is a top issue for treasurers for 2017, with many taking steps to improve the way they collect and manage exposures for both traditional currency risk and any added commodity exposure. According to Openlink, "In the current state, Treasury and Procurement are often working in isolation and many times they do not have visibility on hidden risks in the supply chain such as basis risk associated with physical goods and embedded currency risk if goods are bought with a currency other than the company's functional currency." He adds that Openlink, "has seen large multinationals with massive exposures being managed on spreadsheets and homegrown solutions which exposes them to huge risks."

This scenario was never ideal, but it was manageable when commodity price volatility was relatively low and the Fintech didn't exist to manage it. However, times have changed. Over the past decade, international commodity markets have entered a new era of high volatility. Spreadsheets are no longer acceptable.

In support of ongoing Fintech innovation, Openlink continues to build on its pioneering development of cross-asset trading and risk management products for energy and financial services companies, and now offers a suite of solutions (including treasury) designed to meet the specific needs of clients.

2. CFOs ARE MANDATING BETTER VISIBILITY

A volatile world demands a more integrated approach to treasury management for today's treasurers, and as globalization continues, more and more corporations are exposed to significant levels of currency and commodity risk on a day-to-day basis.

Openlink identified a noticeable increase in the number of CFOs who are mandating better visibility on exposures beyond currency risk to include a full view of their commodity procurement. CFOs want a full view in real-time for all global exposures. This is no small request.

Business implications of commodity volatility include negative cash flows, lack of margin optimization and headline risk. It can cause significant earnings loss because of an increase in input costs and, importantly, unmanaged volatility can give a public perception that the company does not understand its business drivers.

Openlink's TRMS Software

With 600+ clients and 38,000+ users around the world, Openlink's solutions are preferred by the leading energy and commodity companies, financial services firms, multinational corporations and commodity-intensive corporates, public utilities, hedge funds and central banks.

Their commodity and treasury enterprise risk management platform helps organizations with exposure to commodities to protect their margins and their profits. It brings together cash management with risk, helping organizations to optimize their hedging activities and manage their FX risk, credit risk, market risk and other exposures.

By breaking down the barriers between commodity procurement and traditional currency exposures, businesses can now have a holistic view of risk and opportunities to maintain and improve margins, while at the same time reducing administrative costs.

Key features of Openlink's TRMS Software:

- Cash management / global cash forecasting
- Integrated commodity and treasury risk management
- Physical and financial trading in one solution
- Inventory management optimization
- Freight logistics
- Price risk and hedging
- Supplier default risk
- Commodity contract management
- Future risk exposure, stress testing and predictive analytics

Based on a recent EY Global Capital Confidence report that surveyed more than 1,600 executives from 1,800 sectors, 34% of respondents named increased volatility in commodities and currencies as the greatest economic risk to their businesses over the next 6-12 months.

Hedging commodities is far less transparent than hedging foreign currencies or interest rates. It is critical to have the knowledge and market know-how to make sound decisions and to understand the associated regulatory requirements.

It is important to have program goals for monitoring and benchmarking the results of any hedging program. Good goals for a commodity hedge program might include a quantitative measure of risk such as Cashflow At Risk (CFAR). Quantitative measures work best when your trading model simulates the hedging program dynamically through time. A static snapshot can lead to suboptimal decisions and should be avoided.

3. INCREASE IN TECHNOLOGY SPENDING

Technology and TMS implementations ranked fourth in the NeuGroup Treasurers' Top Priority Survey, highlighting the continued quest toward better systems and tools to more proactively manage treasury and cash management activity.

Nearly 70% of respondents to a recent NeuGroup World Class TMS Survey indicated that they did not have their desired treasury technology end-state and that they were continuing to evaluate new technologies that would allow them to make moves toward more dynamically run programs to allow for better management of their portfolio of exposures.

The good news is that treasurers could start seeing the cash to get to that desired state. Openlink points to results from a recent survey from Strategic Treasurer that showed nearly 70% of treasurers plan to spend money to upgrade their technology in 2017. NeuGroup data research also has noted this trend, seeing an increase among its membership, year-over-year (since 2008), as businesses continue to improve their global systems with the goal of adding greater integration both to improve their visibility and to enhance the holistic view of exposures across the entire organization.

And these technology advances and improved functionality of TMS platforms now allow the integration of commodity procurement with treasury management, giving a single, detailed, transparent view of risk across the entire enterprise. As well as providing efficiencies in the time required to collect and manage the data, this new integrated approach is paying dividends in terms of added sophistication and predictive analysis, proactive management, better hedging and smarter purchasing decisions.

From the need for greater transparency across different business lines, to a plethora of new regulations putting a greater emphasis on automating reports, there has never been a more appropriate time for risk officers to take their seat at the table.

This means the siloed approach to currency and commodity risk management is becoming obsolete and suggests a review of current structures in one's company to make sure they're not obsolete.

4. THE WHOLE IS GREATER THAN THE SUM OF THE PARTS

Innovative CFOs, Treasurers and Heads of Procurement are blazing the way for improved treasury and commodity risk operations and are looking for an integrated solution that will support business growth, and provide a single view of all exposures. By implementing a combined system, corporates can increase productivity, reduce manual processes and associated risk, incorporate more SWIFT payment channels and significantly reduce payment costs.

By breaking down the barriers between commodity procurement and treasury, a business can now get a complete view of risk and opportunities to manage and improve margins while at the same time reduce costs. Treasury can now play a broader role in risk management across the business. "In organizations that have historically separated treasury and commodity risk management, there is now a strong investment case for merging these exposures to gain very strong synergies," an Openlink subject matter expert says.

5. REGULATORY UNCERTAINTY DEMANDS GREATER ENGAGEMENT

With the proliferation of regulatory updates, there is an increased desire for a more robust, sophisticated enterprise risk and credit management alternative. Treasurers and CFOs are becoming increasingly aware of the deeper connections between currency and commodity risk, and those who empower themselves to manage both risks in a more centralized and holistic approach can gain a critical edge over their rivals.

The year 2017 began with a call to break up NAFTA, the threat of trade wars and the danger of a potential tariff program. The vagueness and uncertainty on the horizon has corporates putting some of their business development plans on hold. But that would be unwise, according to an Openlink subject matter expert. "I don't think corporates can stand still until the regulations have stabilized," he says, "either by repeal of existing regulations like Dodd-Frank or by the potential of new executive orders. They need to be prepared for uncertainty, which in all cases, involves getting an accurate view of all your exposures across all asset classes and stress testing a variety of potential outcomes."

RECORD LEVELS OF UNCERTAINTY DEMAND GREATER OVERSIGHT

Source: Openlink interview notes

"The new platform has allowed us to better manage risk and will allow us to successfully navigate challenging conditions within the industry."
– Openlink Client

Not the Ideal Situation

Typically, trading and treasury are separate areas of business with limited or no integration between them. The traders work to sell commodities at the best price or to profit from trading, while the treasury function with its concern over available cash, navigating future investments and doing so in the right currency and at the right location, has a range of responsibilities, including FX and IR hedging, broader credit management, debt and capital management and more. Usually, the treasury department gets a fixed time view of trading positions to work with and can't miss opportunities to protect profits or control costs since these exposures change rapidly. Even large oil and gas majors have experienced the situation where trading has a good month but FX rates moved against them to give an entirely different result. Despite believing that they were hedged, FX markets went against the company, leaving it with significantly eroded traded profits.

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www.openlink.com • info@openlink.com

CASE STUDY

A leading integrated oil and gas company with operations in 42 countries and over 26,000 employees globally selected an integrated treasury and trading platform from Openlink that supported trading operations for oil and refined products, derivatives, FX and IR with consolidated credit and collateral management across the Group.

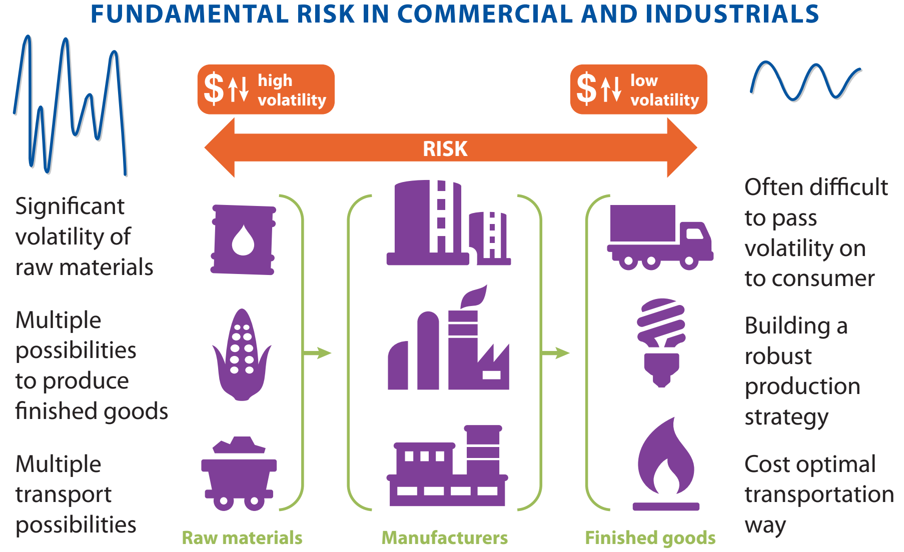
The single solution generates significant business process synergies across the business lines and a single and consistent view of risk across the company's divisions. It also resulted in substantial cost savings and reduced integration points by using one platform rather than two independent solutions.

The benefits include:

- Physical crude and related derivatives, refined products and freight trading.
- Managing physical logistics of moving crude and refined products by vessel, barge and pipeline across the world.
- Group-wide FX/IR management and liquidity risk management reducing cost of finance by automating cash and liquidity management processes to reduce demand for cash and banking costs.
- Market risk, credit risk and collateral management.
- Commodity Risk management with risk analytics, mark to market calculations, stress testing, scenario analysis and value at risk.
- Integration with over 40 third-party systems including ERP systems, market data repositories, real-time market price providers and other in-house applications.

Having a single platform not only enables a complete overview of physical and financial trading positions and exposure across the group. It also reduces risk and leads to better operational efficiency because there are fewer manual processes. The result is a more robust system at a lower cost.

FUNDAMENTAL RISK IN COMMERCIAL AND INDUSTRIALS



Source: Openlink

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