YOUR BEST BET?

MARKET DEREGULATION AND PRICE VOLATILITY ARE PROMPTING TREASURERS TO INVEST IN TECHNOLOGY FOR COMMODITY HEDGING. LESLEY MEALL REPORTS

Treasury and risk management have been through a period of accelerated evolution since the financial crisis. On the road to risk reduction, traditionally siloed risk management processes have become more integrated and enterprise perspectives on risk have become more holistic. Meanwhile, treasury responsibilities have expanded and the function has become integral to corporate financial risk management.

Furthermore, treasury and other finance processes have become more automated, treasury and treasury management systems (TMSs) have become more centralised, cross-functional and departmental flows of information have become smoother and faster, and treasury decision-making has become more efficient and effective – to varying degrees.

"The role and responsibilities of treasury beyond the departmental wall have transformed since the financial crisis of 2008," says Sebastian di Paola, global corporate treasury leader at professional services firm PwC. Its *Global Treasury Survey 2014* confirmed that since the crisis, treasury teams have expanded their influence throughout the organisation, as treasury becomes a more collaborative, enterprise-wide process. Treasury is becoming more involved in financial processes, which have traditionally sat outside the department, such as working capital management, operational payment processing and commodity management.

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Although treasurers are increasingly likely to manage FX, interest rate, liquidity and credit risk, those who also manage commodity risk have tended to be in organisations with commodity exposure at the core of their activities (such as airlines and glass manufacturers). But the volatility of commodities such as oil and sugar has increased supply chain risks and indirect exposures for corporates in food, retail and other sectors. "We see a trend towards managing commodity exposures along with other more traditional asset classes, either with commodity risk managed by treasury or in close collaboration with procurement," says Jacqui Drew, director of solution consulting at Reval, a treasury and risk management software specialist.

"Previously, many commodity consumers were reluctant to hedge commodity prices, allowing them to fluctuate according to the market prices," says Drew. But commodity market deregulation and price volatility, and their impact on competitiveness and profitability, have made this unsustainable.

"Even those CFOs who have traditionally adopted a 'no hedge' strategy on commodities are realising that they need a hedging policy," says Julian Eyre, a treasury and procurement expert with OpenLink, a specialist in transaction life cycle software. "Organisations increasingly appear to be looking for systems and solutions that can support a more active approach to commodity risk hedging," he adds.

Finding software solutions

Available options are, to some extent, determined by existing IT resources. There are at least as many variations on IT infrastructure as there are organisations, multiplied by business units, multiplied by variations, including (but not restricted to) the following options: internally or externally managed resources (such as hardware and processing power); and on-premise or public cloud access to software applications (such as accounting software, business intelligence tools and TMSs.) Other influential factors may range from how the organisation (and its treasury function) has grown to the degree of integration that exists between its business and financial planning.

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If an organisation has an enterprise resource planning (ERP) system in place, and it offers commodity and treasury functionality, this may be the solution. But the amount of integrated commodity trading and risk management functionality available varies between ERPs. SAP offers SAP Treasury and Risk Management; SAP Cash and Liquidity Management; SAP Commodity Procurement and SAP Commodity Sales; and SAP Commodity Risk Management. So it can automate the capture of exposure positions from forecasts or physical transactions and compile risk positions to manage hedging transactions, measure their effectiveness and post the results to the general ledger.

So if an enterprise has a SAP ERP in place, opting for its integrated treasury and commodity risk management solutions may seem like a no-brainer. But not all legacy ERP systems can offer the depth of specialist functionality required. When it comes to commodity trading, for example, even the most ardent SAP fan may feel the need to explore other options, such as the specialist add-on from technology consultancy BearingPoint, which provides an integrated energy trading and risk management solution. Some organisations simply prefer to use the best tool for the job. "There has been an active move in treasury away from one-size-fits-all to best of breed," says Eyre.

Best of breed

Where a combination of various point solutions is in place (which may or may not sit on top of or alongside an ERP), if one of them is a treasury and risk management system, this may provide the solution. Reval, for example, offers a commodity risk management solution, including exposure aggregation, evaluation and analysis, and derivative execution tools, combined with market and historical data, to allow corporates to mitigate the risk associated with their exposures and to identify future risks and impacts on their financial statement by hedging more effectively. It also supports compliance with regulations such as the European Market Infrastructure Regulation and Dodd-Frank, and accounting standards such as IFRS 9, *Financial Instruments*.

COMMODITY HEDGING: THE CHALLENGES

The incomplete list of examples below includes some key challenges that companies face when they look to undertake commodity hedging:

- **Finding appropriate hedging instruments;**
- **Identifying the best timescale for hedging;**
- **Information on commodity exposure may be spread across departments (such as sales and procurement) and business units, where business model, risk appetite, definitions and management objectives may vary;**
- **Agreeing a commodity risk management strategy;**
- **Selecting key performance indicators and deciding who 'owns' the process; and**
- **Accessing and analysing the necessary information, using the legacy systems in place across treasury and other departments.**

"A key challenge for corporates looking to bring commodities risk management into treasury would be to ensure that they have a single solution to measure all risks and asset classes," says Drew. They want company-wide visibility into commodity exposures to mitigate risk and improve responsiveness to market fluctuations, and they can benefit from doing this in the broader risk context. A treasurer in a UK-based organisation may need to consider the FX risks associated with exposures for commodities that are bought or sold in US dollars when their functional currency is British sterling, bringing more FX risk that needs to be managed or hedged. "Many companies are missing out by not considering correlations between asset classes," she adds.

Integration matters

Eyre agrees, although he advocates an even more integrated approach to data and systems. "Spreadsheets and silo-bound systems such as ERP systems and TMSs can make it difficult to take a holistic, enterprise-wide perspective on risk management," he says, if only because of the data consolidation and aggregation issues. Complex and globally distributed groups often have multiple, disconnected information systems. So although they may have 'point solutions' that collect and can report data on exposure to raw materials, suppliers, FX and counterparties, this data may need to be standardised, normalised (in terms of format and units of measurement, such as currency) and reconciled, before treasury can analyse it.

A provider such as OpenLink – with a single platform that integrates the management of enterprise risk, treasury risk, compliance, derivatives trading, commodity trading and more – has the potential to streamline and speed up all of the associated data processes. Eyre points out: "In the time it takes for disparate data to be collated, consolidated, aggregated and presented, there is a price risk exposure that could, in a volatile market, have a significant impact on the bottom line." But if you are trying to integrate commodity risk management with other traditional asset classes and take a more holistic approach to treasury and risk management, it's a statement that holds true no matter which software and systems you are using.

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