THE RISE OF THE CORPORATE FINANCIAL RISK MANAGER

THE DISCIPLINE OF FINANCIAL RISK MANAGEMENT IS EDGING ITS WAY UP THE VALUE CHAIN. CLAUDIA VILLASIS EXPLAINS THE CONCEPTS, SKILLS AND QUALITIES INVOLVED

There is often a gulf between a job title and our understanding of what that job entails. I realised how abstract the title corporate financial risk manager was when I saw blank faces the first time I mentioned the name of my new role to family members. They understood only that I was managing something. I explained that my role was to look at market trends, review financial trends in currencies and commodities, and make my company aware of how those trends might affect it.

Many people might assume that bankers have a good understanding of corporate financial risk management, but not necessarily. Bank financial risk managers specialise in certain types of financial risk, especially products to manage financial risk. However, they tend to appreciate risk management in a corporate setting from a hedging perspective.

The appointing of corporate financial risk managers expanded after the global financial crisis. Previously, corporates were managing financial risks in a more distributed way, with tasks often shared across treasury teams. When companies realised that they didn't have the information to properly manage all their financial risks and public awareness of issues, such as individuals making unauthorised transactions grew, specialist roles started to appear. Initially, individuals were deployed as risk controllers; they monitored risk, but weren't responsible for managing it. However, these were the first steps towards an independent, specialised financial risk management discipline that focuses on identifying, analysing, managing and reviewing financial risks. In practice, the discipline frequently also includes responsibility for enterprise risk management and compliance tasks.

Today, the core tasks of a corporate financial risk manager are to define the company's credit risk management policy (counterparty and country risk) and market risk (FX, interest rate and, in some companies, commodity price risk), reviewing and challenging it regularly.

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If a business doesn't have a good risk-reporting system, corporate financial risk managers often end up committing a lot of time to the necessary, but unattractive task of data collation and risk reporting. Every minute saved in producing reports is a minute that can be spent on performing the strategic part of the role. Looking for hidden risks and opportunities that are not apparent is a clear function of the role.

A strategic approach

The financial risk management policy's aim should be to support the overall business strategy and not only about reducing or minimising risk. Positive scenarios and opportunities should be also analysed. The corporate financial risk manager should constantly challenge and revalidate current strategy, and look for potential risks and opportunities that haven't yet been considered. The aim should be that other functions and the business understand the role as a business partner who can add value and improve risk outcomes for the business.

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Revalidating current strategy

Challenging the current risk management policy on a regular basis and from different perspectives can uncover some interesting outcomes. Risk management policies usually contain very general principles. For example, a company had the following statement in its policy: "The operating profit should be free from changes resulting from FX volatility". The corporate financial risk manager challenged this statement using the risk management cycle. This led to an enhanced outcome for the business. (See graphic):

1. Identify: The risk source where the invoices were in a currency different from the reporting currency. The transactions were seasonal and were forecasted by the accounting department.

2. Evaluate: A new cost-benefit analysis showed that it was beneficial to fix the exchange rate, ie hedge the exposures.

3. Manage: Risk was correctly transferred using financial derivatives such

as forwards to fix the exchange rate.

4. Review: A scenario analysis of past performance showed that even though the policy was adequate, FX volatility hadn't been reduced. On deeper review of the data, it became apparent the company was actually over-hedging. The volatility of the forecast was higher than the volatility of the exchange rates. Under this scenario, it was better for the company to stop hedging until a better forecast process was developed.

Looking for risk and opportunity

Corporate financial risk managers cannot wait for the risks and opportunities to come to them, they need to work proactively. A level of experience is required to identify exposures, but the most important skill is to be able to think outside the box and engage with the business, including accounting, legal, tax, production, sales and procurement colleagues, all of whom can provide valuable information on sources of risk.

For treasury, corporate financial risk managers are in charge of analysing how the use of new financial instruments modifies the risk landscape. The analysis doesn't only consider financial risk, but also the impact of the new products on accounting, tax and regulation. A cleared product involves very different operational risk to an OTC derivative, for example. Cleared products require a focus on liquidity; and for OTC derivatives, complying with European Market Infrastructure Regulation and Dodd-Frank requirements is also critical.

When financing a capex project, the corporate centre might neglect to consider the functional currency of the entity when determining lending to that entity. While it might make sense for the corporate centre to finance the entity in the group's reporting currency, the FX movements and resulting FX gains and losses arising from the loan can lead to undesirable FX volatility. Since corporate financial risk managers are trained to see the broad picture, they can identify these scenarios before problems arise. Corporate centres are usually in a better position to hedge the currency exposure than individual corporate entities.

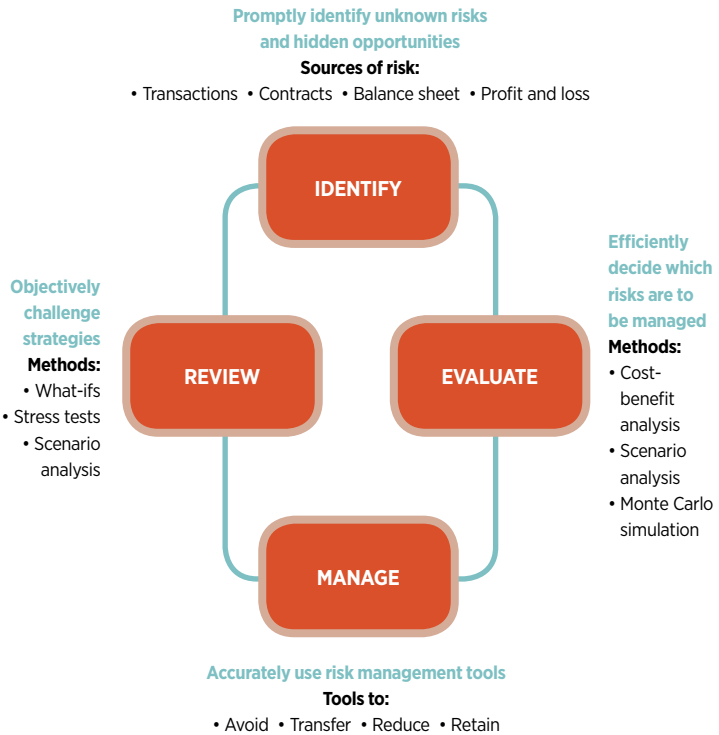
Early discussions with accounting teams could reduce the effort spent on hedge documentation by establishing the right mix of financial derivatives that is used to hedge risks and allows for a higher hedge effectiveness under the current IAS 39 requirements.

A risk strategy can also support sales when they need to maintain a certain price for a tender project or when selling products in a foreign currency. Together, they can analyse the different options and, in some cases, understand and predict what competitors are doing when selling in the same markets.

It is easy to get overexcited about the possibilities and opportunities. It must be kept in mind that new risk management strategies should not introduce additional complexity. A simple example of mistakes that could be made include, for instance, the fact that the propeller of a ship is made of precious metals doesn't mean that the price of the raw material is a large component of the price of that propeller. For some products, the technology behind the product is more expensive than the commodities used in its manufacture. After an evaluation, it might or might not be worthwhile to introduce a hedging process to reduce residual commodity price volatility.

It is not always obvious which risks should be prioritised. When looking for new risks and opportunities, we are ideally guided by the strategic objectives of the company, but, in reality, risk management often comes down to a first come, first served approach. The key is to prioritise the risks that are more likely to occur and have a greater impact in the organisation.

To be a good corporate financial risk manager, you need to think beyond treasury. You can be part quantitative analyst, part IT or accounting specialist. You could become expert on regulatory issues or sometimes fill the role of auditor. You might need to be a consultant and deliver practical solutions and then become a project manager to implement them. Finally, you should hone your influencing skills, as you will need to sell your ideas to colleagues and managers. Acquiring this skill set, however, is worthwhile, as there are few roles that ask for, develop and reward such a broad experience and expertise.



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