EXTERNAL PRESSURES

Hardi Wilkins, global head of risk and trade compliance at Export Trading Group (ETG), discusses how agricultural commodity risk management strategies have evolved in response to recent market shifts spurred by the latest global financial crisis

The financial crisis of 2008 set in motion a chain of events that has shaped the price risk management policies of agricultural organisations in recent years, and the landscape of trading across the financial markets has changed irrevocably as a result of tighter financial regulations. Various monetary policy initiatives, put in place by central banks in an attempt to repair the economy, have also had an impact on the market. New rules covering reporting and capital, as well as liquidity requirements, have changed the face of many markets, including commodities. In addition to affecting how financial markets operate, these interventions have also affected participants in those markets. Organisations of all shapes and sizes have exited the commodity trading space in recent years and have been replaced, to some extent, by new players with fresh ideas and capital.

How have agricultural companies developed risk management strategies in response to the market shifts brought about by the 2008 financial crisis, as well as the various policies put in place by regulators and central banks in its aftermath? Organisations that remain active in markets such as agricultural trading have been forced to rethink risk management and trading, reformulating strategies to tackle this brand new financial world.

Thinking ahead

There are several major factors that any participant in the agricultural trading markets should take time to consider before putting a new risk management strategy in place. Questions that should be asked include: who can – and should – you transact with? What processes are in place to assess the new market participants that have begun to enter the market in recent years? How have the tools used to trade and manage risk changed as a result of new regulations, and how has that affected your risk management strategy? What will these changes mean for the internal structure of your business? How should an organisation position a growing trading and risk management function? What about the information technology infrastructure that underpins your entire organisation?

There are many important factors to consider as the markets continue to adapt to the post-crisis world. At Export Trading Group (ETG), a global supplier of African agricultural products, we believe we are on course to develop a viable and competitive risk management infrastructure fit for today's agricultural trading markets.

Regulatory impact

On the whole, the impact of new financial regulations has been material and I believe that, while first-movers such as ETG are absorbing the initial impact of the new regulations, we will ultimately be the first to benefit from these changes to the structure of the financial markets.

However, following the financial crisis, the push toward tighter global financial regulations has affected our trading space. At present, the playing field remains uneven, since these new rules have resulted in mispricing to some extent. Rallying to meet new regulatory requirements in various regional markets has also inevitably resulted in casualties, having an impact on where and how we trade, as well as

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with whom. At present, ETG's trading partners are a good blend of established trading houses and small to medium-sized traders with strong ties to our market space. As they rely, to varying degrees, on our operational and financial capabilites, for ETG, existing relationships and a strong track record in the relevant market also count for a lot when it comes to choosing the partners with which we trade.

In addition to tighter oversight of the financial markets by global regulators, central banks brought interest rates to record lows following the financial crisis in a bid to bolster the markets. Now that sufficient time has passed, central banks around the world are beginning to change gears, implementing policies of monetary normalisation, which could result in volatility throughout the global financial markets.

Speaking at the International Symposium of the Banque de France in Paris on November 7, 2014, US Federal Reserve chair Janet Yellen said that while "the headwinds associated with the financial crisis will wane", the normalisation of monetary policy "could lead to some heightened financial volatility".

The Fed has pledged to provide clear guidance regarding future monetary policy in an effort to minimise any disruption to the financial markets. However, uncertainty about the global economic growth trajectory, the strength of the US dollar and the likely direction of interest rates could still play havoc with commodity prices. As a result, this has been a strong theme in the risk management strategy ETG has developed over the past two years, and it will continue to be a major factor

when making decisions in this area of the business. Against this backdrop of monetary policy normalisation and an increasingly important African continent with growing import and export demand, constructing a successful risk management strategy has not been a simple task.

Finding the right tools

Risk optimisation should be the main aim of any agricultural price risk management effort. As such, hedging can be a very effective tool for an organisation that wants to de-risk its trading book while maintaining its physical market position. ETG has developed successful and cost-effective risk management strategies by hedging total risk attribution, as well as focusing on combinations of different types of risk – such as price, currency, operational and credit risk. It is important that such strategies are flexible enough to operate in a constantly shifting environment.

The level of sophistication of the tools used by ETG to hedge price risk is generally dictated by the trading environment. In our experience, a string of vanilla products can often produce a better result than a more tailored product, so we tend to favour such structures over complex, packaged off-market paper.

Over-the-counter (OTC) products are appealing in certain circumstances due to the benefit of deferred settlement but, as a rule, if a contract cannot be priced, it should not be traded. As a strong player in the credit market, ETG has access to a range of vanilla OTC and exchange-traded products on both the buy side and the sell side.

Risk infrastructure

Of course, such tools and strategies must be underpinned by a strong internal infrastructure in order for an organisation to successfully manage its exposure to commodity price risk. The significance of an integrated view cannot be understated when it comes to structuring the risk management function within a company. Strong processes and procedures are crucial, and must be based on solid systems and a robust risk framework that are well-understood across the company. By putting such an infrastructure in place, a centralised specialist team can use available data to monitor exposure and risk to constantly develop metrics and effect real mandate shifts in line with changing market events and emerging trends. This type of structure has resulted in a transparent environment for ETG, with dynamic detection capabilities and risk share via a network of accountable stakeholders trading in 11 core commodity types across 40 countries.

A strong risk management function also requires a sound IT infrastructure. Twelve months ago, ETG set out to identify the best commodity trading risk management (CTRM) solutions provider for our business. Given ETG's focus on African agricultural markets, we were particularly keen to partner with a CTRM software solutions provider that has a proven track record in emerging markets. After researching our options, we chose to partner with Just Commodity, because we felt the company had the necessary products and experience to deliver on the particular requirements of our markets, traders and risk managers.

As we did not have legacy trading systems, when it came to implementing the new software, integration with our existing enterprise resource planning system has been relatively easy. Our goal is now to produce a world-class integrated treasury, supply and trading system with a forward-looking focus. We believe this partnership with Just Commodity will help ETG develop such a system.

Risk management strategies will always be under pressure to remain flexible in the face of external market forces – whether that relates to monetary policy, new regulations or even just the vagaries of supply and demand in the commodity markets. Agricultural organisations must plan ahead, ask the right questions and partner with excellent third-party vendors in areas such as technology in order to build a solid base for their price risk management activities.