

# The new risk management imperative

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**Michael Schwartz**

Ask 10 people about the future of the commodities and energy markets and you will get 10 different responses. The long-term economic consequences of government bail-outs and stimulus packages are far from clear, and predictions about what will happen to prices vary enormously.

However, among these huge uncertainties, there are several things of which we can be sure. Firstly, commodity price volatility is here to stay. Crude oil prices surged in July 2008 to a record \$145 a barrel and then dropped to about \$33 in December. Today, oil trades around \$70 a barrel. In 2008 alone, we saw three or four '100-year risk events,' and we are almost certainly going to see more of these extreme events that are simply outside of normal expectations.

Secondly, the recession has made everyone take a closer look at credit. Credit risk managers used to triage potential counterparties into three groups – definite yes, definite no and everyone in between. Now there is no chance that a potential counterparty will be automatically accepted – everyone is either rejected or sent for assessment. The profile of the credit department has risen and it is not going to sink any time soon.

Finally, the markets will be more closely regulated. The precise form of regulation is still being worked out, but there is no denying the growing importance of accounting standards that require additional transparency into valuations and accounting methods such as IAS (International Accounting Standard) 39, FAS (Financial Accounting Standard) 133, FAS 157 and FAS 161.

We are now entering a period in which enterprise risk management will determine who survives and who perishes in this new, harsher environment. Leading analyst firm, Gartner, has backed up this scenario by developing its first ever Magic Quadrant for energy trading and risk management software. This is a clear indication that energy and commodities firms should take a serious look at how they could transform their operations by investing in more sophisticated enterprise systems and moving away from using a complex web of disparate software solutions and spreadsheets.

Corporations whose business processes lack transparency are at substantial risk without even knowing it. There is no escaping the fact that trading is a complex process. The workflow of a single trade crosses several departmental boundaries including trading, credit, scheduling, risk management, hedge accounting and settlement and touches multiple systems. Of course, while everyone does their best to co-ordinate across the organisation, it is almost impossible and hugely time consuming to navigate the tangled web of systems and spreadsheets. The problem is that when individual departments become isolated, their stovepipes of data and uncommunicative systems make it impossible to get a clear picture of the corporation's global exposure. Consequently, firm-wide risk is substantially increased.

Any firm that is serious about succeeding in this complex environment needs to deploy a real-time enterprise trading and risk platform that can manage the four key

risk areas set by the Committee of Chief Risk Officers: market/price risk; operational risk; regulatory risk and counterparty credit risk. This creates a seamless risk management process that is no longer dependent on a patchwork of individual spreadsheets. Instead, all departments and risk areas are integrated into a single, highly functional system that creates useable information for proactive decision-making.

However, a recent CommodityPoint survey of energy and commodity executives discovered that 70 per cent of companies are using spreadsheets or internally assembled systems to manage risk. At the same time 60 per cent of the companies surveyed felt the need to upgrade their credit risk systems to manage counterparty risk effectively in the current business environment.

Indeed, Triple Point Technology's discussions throughout the industry indicate that spreadsheet dependency is still a huge problem. One individual explained: "Many systems don't automatically interface with each other and we have to manually re-enter data that already exists in one system..." Another said: "We use multiple systems to perform a specific function and the reconciliation of separate systems wastes a lot of time." While another said: "We rely heavily on spreadsheets... many times we use our enterprise solutions as just the system of record."

This type of evidence is supported by more comprehensive research on the accuracy of spreadsheets. A University of Hawaii study showed that 91 per cent of audited spreadsheets contained errors. KPMG has found that 78 per cent of models had no formal quality controls, with errors in terms of inputting, logic, interface and cell range.

And that is just research based on fairly basic, uncomplicated spreadsheets containing relatively straightforward data. Imagine the level of errors contained in highly complex spreadsheets containing curve management, complex pricing formulas and detailed physical supply chain schedules as used in the energy and commodities trading business.

The potential consequences in terms of risk and compliance issues can be huge. Firms that rely solely on spreadsheets are likely to be basing

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key decisions on out-of-date or incorrect data. If spreadsheet culture was dangerous two years ago, it is absolutely lethal now.

The demise of former masters of the energy universe is a testament to how easy it is for even the biggest names to fall from grace. Constellation Energy provides us with a terrifying example. In August 2008, the US power producer destroyed its reputation for rigorous risk management by revealing it had made an accounting error and underestimated its potential liabilities in the event of a ratings downgrade. Following its announcement, Constellation's credit rating was summarily downgraded by two ratings



**Focussing on risk management: Triple Point Technology's Michael Schwartz**

agencies.

Constellation's size and apparent dependence on multiple lines of credit from various banks that were either faltering or sinking created a perception that it was at risk. Despite the firm's efforts to reassure investors of its excess liquidity, strong balance sheet and solid commodities-trading

exposure at all levels, enabling them to measure performance against any given set of key performance indicators.

In this day and age, every commodities business should have substantially increased focus on risk and risk management. Many organisations have already invested in managing market risk, through the deployment of ETRM or specialist commodity trading platforms. They now need to protect that investment with fully integrated enterprise systems that manage all aspects of credit, regulatory and operational risk with automation, accuracy and auditability.

The financial impact of getting risk management wrong can be huge. The collapses of some of the leading players in the financial and energy markets are a testament to how easy it is for even the biggest names to fall from grace. Yet many companies have still not embraced the imperative for integrated, enterprise risk management. They fail to do so at their own peril.

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business, it was sucked into the vortex of Lehman Brothers' death throes. Over a three-day period in September 2008, Constellation's stock shed almost 60 per cent of its value.

Yet some companies have yet to learn the lessons so powerfully illustrated by these high profile cases. Instead of managing risk in a holistic fashion, based on consolidated, auditable data from across the organization, businesses are continuing to rely on error-prone and flawed processes that perpetuate yet more inaccurate data.

What is more, all necessary data should be collated into a management dashboard to provide executives with an accurate picture of the company's