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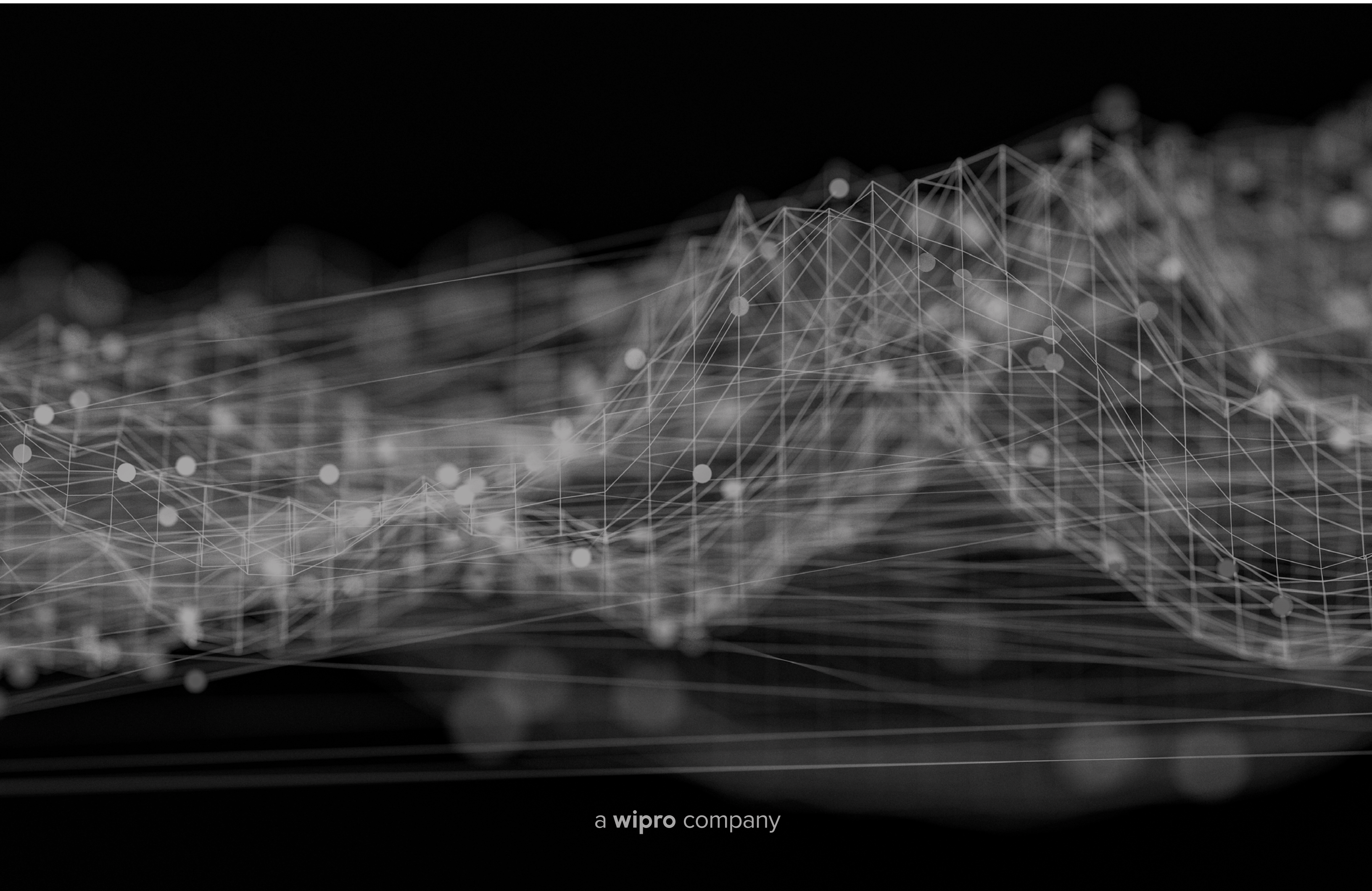
INCREASING MARKET RISKS AND THE ROLE OF CFO



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INCREASING MARKET RISKS AND THE ROLE OF CFO

The Chief Financial Officer (CFO) role in a commodities trading organization is distinctly different from other industries and continues to evolve as the markets those firms serve are also changing rapidly. As in all industries, the role of the CFO includes:

- Leadership and management of financial-related groups and processes.
- Acting as a contributor to corporate strategy.
- Providing oversight of a diverse group of departments from HR to IT.

However, a CFO of an Energy & Commodity (E&C) trading organization must also be constantly mindful of a diverse set of unique risks and the impact those risks could have not only on profitability, but potentially the firm's financial viability.

In a recent conversation with Christophe Salmon, Group Chief Financial Officer at Trafigura, he noted " the primary responsibilities of the CFO can now be defined as 1) warranting the liquidity of the company, both short-term and long-term, 2) being the gatekeeper, taking ownership of credit risk and compliance, and 3) supporting business development, through the combined finance and marketing offer. The role of the CFO is less about being in the details of the financials, now handled by the financial controller, and more about acting as a strategic sparring partner for the CEO, challenging decisions on investment strategy, strategic risk management, balance sheet management, and more."

As Salmon notes, a key responsibility is monitoring and managing internal and external risks that can impact liquidity. With the current global pandemic and its direct and knock-on impacts across the entirety of the commodities complex, the need to monitor and measure these risks is more critical than ever.

RISKS ABOUND

Even before the pandemic struck in late 2019/early 2020, falling prices and shrinking margins struck the energy markets. They were experiencing the impact of various regulatory, financial, and operational changes that drove prices and margins to record lows, increased the costs of doing business, and in several cases, forced companies to exit markets and restructure. These changes and risks include:

- ***Regulation and Compliance*** – Beginning with the global financial crisis of 2008 and accelerated by the growing green movement, the number, and intensity of new regional and local regulations have impacted all aspects of commodity supply chains and trade, from limits on trading positions to the current IMO2020 rule limiting marine fuels sulfur content. In this regulatory environment, CFOs must ensure their businesses understand existing regulations and are in constant compliance to avoid potentially crippling fines, sanctions, and reputational damage.

- ***Financiers and Stakeholders*** - Trade financing is, for many E&C companies, the lifeblood that allows them to continue to operate. Though some businesses may have balance sheets that provide enough credit and financial coverage to self-finance their trading activities, many smaller and mid-sized companies rely on banks, funds, and other financial sources. Trading companies that back their activities via lines of credit, loans, guarantees, or other financial support means have come under increased scrutiny. Their financial backers seek assurances that they have in place and are constantly applying and exercising sound risk management practices. Once, a CFO could satisfy lenders and financiers by ensuring their company stayed within the lender's covenants and financial ratios. Today they must also ensure they meet their financial backers' expectations related to risk management systems, strategies, and processes.

- ***Credit Risk*** - With the dramatic fall in oil prices in the last year, including the settlement of the May 2020 crude futures contract below zero dollars, credit risk has come roaring back to the forefront of many CFOs' minds. Though oil prices have since recovered, the damage caused by that crash resulted in several large independent oil & gas producers declaring bankruptcy and others struggling to avoid a similar fate. Even with improved prices for oil and gas in 2021, the impact of 2020 has again brought to bear the importance of more active credit monitoring and assessment across all energy and commodities companies.

- ***Operational Risks*** – Operational risks in physical commodity businesses increase dramatically as the supply chain lengthens and more assets are deployed across jurisdictions and countries. Operational risk management has grown in importance for E&C companies as they try to improve asset performance and seek out new markets. For these companies, new investments are required to optimize supply chain operations – including new approaches and tools for asset management, inventory management, and predictive maintenance. Areas demanding increased scrutiny by CFOs include traceability (for such things as green branded power), improved document management, and faster and more accurate trade management from contract to settlement.

- ***Foreign Exchange and Operational Liquidity Risks*** - having sufficient cash on hand in the right place in the right currency at the right time is an area of growing concern for CFOs whose companies are expanding their supply chains and entering new markets.

E/CTRM SYSTEMS AS THE NEXUS OF RISK MANAGEMENT FOR CFOS

Outside of the energy and commodity companies, most CFOs primarily rely on their ERP systems (and their attendant financial statements) as an almost singular source of data and information regarding their company's financial health and stability. However, given the CTRM system's central role in capturing, managing, and analyzing the data and information related to trading, marketing, or consumption of commodities, these systems are (or should be) front and center as a primary source of information for CFOs.

Unfortunately, risk management has historically been weak in many CTRM solutions despite the RM in the category's name. Many of these systems lack, or have poorly deployed, risk management capabilities, particularly when it comes to advanced analytics (VaR, PaR, EaR, NPV, etc.). Simulations and stress testing are also common weaknesses or are lacking entirely in many systems. The ability to manage FX risk is also often an overlooked area in many systems. Still, a few have been built from the ground up (primarily those like Openlink that originated in the financial markets) to recognize and address FX risk and its impacts on liquidity.

Some vendors have emerged recently to specifically address shortcomings in CTRM solutions via the development and deployment of risk platforms that "overlay" and integrate with one or more CTRM systems. These overlays can provide tools to better monitor, measure, and manage risk at an enterprise level – primarily where multiple CTRMs are used for different commodities or business units. Additionally, these risk solutions can integrate other systems, including treasury management systems, and provide an enterprise view of risk and risk exposures, particularly as they apply to liquidity risk.

However, sophisticated risk analytics tools are, by themselves, generally inadequate in informing the CFO of the financial exposures, health, and stability of an asset, business unit, or the entirety of the company as the data and information provided by these systems may be cryptic or without full context. Additionally, given the breadth of responsibilities of the role, few CFOs have the luxury of time to spend interpreting such data. To adequately address the CFO's needs to quickly identify exceptions and potential threats to the company's financial wellbeing requires a risk management solution that presents a consolidated picture of risk valuations and exposures in an easily consumable manner via dashboards and rich visualizations.

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ABOUT CAPCO

Capco, a Wipro company, is a global technology and management consultancy specializing in driving transformation in the financial services and energy industries. With a growing client portfolio comprising of over 100 global organizations, Capco operates at the intersection of business and technology by combining innovative thinking with unrivalled industry knowledge to deliver end-to-end data-driven solutions and fast-track digital initiatives for banking and payments, capital markets, wealth and asset management, insurance, and the energy sector. Capco's cutting-edge ingenuity is brought to life through its Innovation Labs and award-winning Be Yourself At Work culture and diverse talent.

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