

Getting to Know Commodity Price Risk Management - Into a Brave New World

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Does complaining solve problems?

For managers or policy makers, it can be very convenient to complain about commodity price volatility, or for that matter, currency fluctuations. It is much easier to pose as a victim than to take responsibility for one's own destiny. Following the current is an easy and safe strategy. If everything goes well, one has done a good job. If things go badly, certainly some outside factors to put the blame on can be found. Complaining can be a lot of fun. Except for the real victims, who do not have the means to do anything about the risks to which governments and companies are exposed. The workers who lose their jobs, the farmers who get paid less than they had expected, the operators of a mine who have to keep it going despite a lack of money for spare parts, the shareholders who see a technically efficient company go down the drain.

Inertia in the face of a highly risky price environment may appear attractive to decision-makers, but it can be hardly afforded by their organizations or their countries. Over the years, the idea that the problem of volatile prices would shortly be made to disappear through international action (commodity agreements, compensatory finance and the like) has become less believable. While waiting for the new international economic order which may one day come into existence, governments may have to do something by themselves - and from the point of view of those working in their commodity sectors, sooner rather than later. It is evident that risks have shifted at a country level, through a combination of factors such as a liberalization of trade and prices, a reduction of subsidies, and the privatization of state companies. Poor farmers in developing countries are now mostly exposed to the vagaries of the world market, a burden still considered too heavy for the sophisticated and rich farmers here in Europe. The new private sector risk takers do not have the deep pockets that governments thought they had, or at least not their capacity to borrow abroad to compensate, in part, for earnings shortfalls or cost overruns. The market mechanism may be magnificent, but it is not perfect: some outside action, including by governments, is necessary.

Making the jump into the brave new world of price risk management is, of course, not an easy one. After all, the first thing that comes to many people's minds are the well-publicized victims of poorly conceived risk management programmes (2 billion US\$ lost by Metallgesellschaft; 1.6 billion US\$ by Showa Shell Sekiyu, and 1.5 billion US\$ by Kashimi, another Japanese oil company; 1.4 billion by Orange County; 1.2 billion by Barings; and so on). And indeed, before making this jump into the deep, one better makes sure that the safety harness is well-fixed and the cord will not break.

¹ The opinions, interpretations and conclusions in this paper are the author's own and should not be attributed to UNCTAD, its Secretary-General, or any of its member countries.

A selection of guides to set up a proper control structure for risk management strategies

- * Arthur Andersen, Global Derivatives and Treasury Risk Management Group, *Customized Derivatives Risk Management Review*, New York 1994.
- * Banque de France, Commission Bancaire, *Livre Blanc: Les nouveaux instruments financiers et le risque bancaire*, Paris 1993
- * Bank of England, *Report of the Board of Banking Supervision Inquiry into Circumstances of the Collapse of Barings*, London, July 1995
- * Basle Committee for Banking Supervision, *Operational Risk Management* Sept. 1998
- * Comité de Bâle sur le Contrôle Bancaire, *Lignes directrices pour la gestion des risques liés aux instruments dérivés*, 1994.
- * Ernst & Young, *Derivatives: Managing the risks*, 1994
- * Futures Industry Association, Global Task Force on Financial Integrity, *Financial Integrity Recommendations for Futures and Option Market Participants*, Washington, June 1995.
- * Futures and Options Association, *Managing derivatives risk: guidelines for end-users of derivatives*, Washington, December 1995.
- * Global Derivatives Study Group, *Derivatives Practices and Principles*, Group of Thirty, Washington, July 1993.
- * JP Morgan and Arthur Andersen, *Guide to Corporate Exposure Management*, August 1994.
- * Hatton, Charles L. and Demler, Frederick R., *Issues in Hedge Administration and Control*, ED&F Man, Metals Department, New York, June 1994.
- * International Organization of Securities Commissions and Basle Committee for Banking Supervision, *Framework for Supervisory Information about Derivatives and Internal Control Systems* Sept. 1998
- * Robin Kendall, *Risk Management For Executives; A Practical Handbook for Preventing Financial Disasters*, Pitman 1998.
- * Robert Klein, *Derivatives Risk and Responsibility: The Complete Guide to Effective Derivatives Management and Decision-Making*, Irwin 1996.
- * UNCTAD, *Company Control and Management Structures - the Basic Requirements for a Sound Use of Market-Based Risk Management Instruments*, Geneva, 1996.

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Adopting a risk management approach

Developing a risk management approach is a process, not a one-off action. This is true for governments which wish to set up their own risk management unit (an option recommended, for example, by African Ministers of Finance in a meeting of the United Nations Economic Commission for Africa), and also for private companies. Fortunately, information is far from scarce - the box to the left cites some literature, most of which is available at little or no cost.

However, lack of information is not the only bottleneck towards developing a risk management strategy. Within government departments as well as companies, there are stakeholders in this development, and there are others who may wish to stop it either through guerilla tactics or through open warfare. A sound risk management strategy is not an individual's responsibility: it is an institutional responsibility, but this, of course, implies that many people are in a position to prevent any progress towards the development of such a strategy when they feel threatened by it. Indeed, the adoption of a risk management programme is generally a slow and painful process, even in western companies. But generally, those that have adopted one are not willing to do without. Even the large hedge disasters of the past few years have not scared these users away from the markets.

Preventing disasters

Like any activity where money is involved, improper use of risk management tools can result in losses. This should not be an argument against adopting a risk management strategy, just a reason to adopt one which has safeguards in place to prevent large losses - it is never possible to develop a protection that is a hundred per cent sure. In any case, it should be remembered that the losses on derivatives markets are small compared to the losses banks have made in real estate, for example.

Setting up an internal control system to control the use of risk management instruments is primarily the responsibility of each entity which wishes to adopt a risk management programme. Should governments worry at all about whether their country's companies will use risk management markets in an appropriate way? After all, in risk management markets, one company's loss is another's gain - the money lost by, say, Barings went to other, presumably better managed or perhaps just luckier companies. The welfare loss for the world economy as a whole is small.

There are strong arguments for governments in developing countries to play at least an information-providing role. In many of these countries, the supporting environment allowing an independent evaluation of a risk management proposal is largely absent, and it is the banks and trade houses, or the brokers, offering risk management instruments who are the guardians of the fairness of a deal. This information-providing role can be as simple as making literature available through the Chamber of Commerce. One can go beyond that, of course: the Government could limit the range of tools available to its private sector companies to those which it considers sufficiently safe.

Some practical tips for introducing a risk management programme

1. **Be well prepared** and have all the arguments ready. A careless attempt to sell a risk management programme in a company or government department can backfire: it can result in the build-up of resistance so strong that a later, better-prepared approach is also rebuffed. To quote Machiavelli: "There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things."
2. **Timing** is important. A time of high price volatility often provides the best moment for attempting to introduce a risk management programme.
3. **Adapt** to the skills level and level of understanding present in the company or country. It is often advisable to go for a risk management programme which is sub-optimal, but which is easy to manage and explain. For example, risk management programmes which aim to obtain the year's average prices are likely to be acceptable even to the most conservative public. The proposal to use an over-the-counter instrument like a swap, which locks in prices for a whole year, can be decided on by the full managing board, while to use futures, the board has to feel confident that nothing will go wrong in the day-to-day management of positions - so the over-the-counter market could be the one most easily acceptable.
4. **Calm** the fears. For many decision makers, a "futures market" is a place to speculate, and then go bankrupt. In effect, a good control structure to avoid risk management programmes from turning sour can be set up without too much difficulty; and looking at the cases of large losses in the past few years, one cannot fail to notice that they are all the result of very basic management errors.
5. **Anticipate** the possible reactions to the various potential outcomes of a risk management programme. It can be difficult for many people to understand why an entity finally receives a price that is lower than that actually quoted on world markets - the difference between opportunity costs and real costs, as they impact on the company's or government budget's bottom line, are not well understood. Therefore, it is very useful to develop a mechanism whereby senior management can express its views on prices - otherwise, their forecasts will be adjusted only ex-post to fit reality, and the risk manager/trader, who does not have the benefit of hindsight, will be told that he should have known, like "everyone else", where prices would be moving.
6. **Plan** for possible future scenarios. For example, given the volatility of commodity prices, it is well possible that from time to time, and only during a limited period, a price level is reached that allows a company to lock in a tremendous profit, or a country to fix an export price more favourable than any received over the past few years. If this occurs, decision makers need to be able to evaluate a proposed risk management deal and decide, fast. If discussions only start at that moment, it is likely that a consensus is reached too late. One needs a prior concept of what to do in exceptional circumstances, whether these be highly favourable, or highly unfavourable price levels.
7. **Don't** make it look like a boardroom coup. The people who have been pulling the strings will continue doing so. They need to delegate some operational authority, but will still determine the framework of action.
8. **Understand** who controls the purse strings. An innovative marketing manager or budget officer may propose a perfectly sound concept for risk management, only to see it torpedoed by those who authorize financial transfers. Risk management is indeed a way to ensure future cash flows, to make certain that in future, the company or government department has enough money to do what it wants to do. But in order to get this far, funds may have to be immobilized for a period of time. For example, when Mexico's Ministry of Finance decided to lock in the extremely high oil prices prevailing at the time of the Gulf crisis, in the early 1990s (a highly profitable decision), it had to put up an estimated 200 million US\$ in guarantees.
9. **Be transparent.** There is no reason to keep a risk management approach secret, or to have an under-the-table mechanism for entering into over-the-counter contracts. For exchange-traded products, the fair prices are known. But for over-the-counter contracts, there is no such objective yardstick. To avoid being accused of corruption or incompetence, it is therefore advisable to ask always for price quotes, for given instruments, from several companies.
10. **Think** of the wider public. Some opinion makers, in politics or in the press, consider that risk management instruments are "like alligators in a swamp". Explain, in publicly available material, what is the purpose of the risk management strategy, and what it consists of.

The brave new world of risk management can be a scary one, and a world which many probably feel they could have done without. However, it is there now, and there is little use in depriving oneself of the new tools available. Once, people were happy to take the boat going from Europe to the United States - as long as you had the means, it was comfortable and cosy. Now, we use planes. They're noisy and are rarely relaxing. But they get us where we want to go faster. And, yes, once airplanes were considered scary.