

# Revolutionary changes require new tools for risk management

*A revolution for agricultural and food processing businesses means taking a new approach to managing risk.*

By **DALE ST. DENIS\***

**E**VERY risk manager who has seen a market cycle or two starts to believe it is never different any time. For the most part, that is very good advice; markets and businesses do tend to follow the same rules and evolve very slowly.

However, what happens when the game changes, not in an evolutionary manner but, rather, in a revolutionary one? That is the situation every agricultural and food processing business finds itself in right now.

The revolution — and, yes, you have heard this before — is the growing and likely permanent link between the food and fuel markets.

The price of gasoline affects the ethanol market, which in turn drives the market for corn, which in turn drives the economics of livestock production, soybean plantings, sugar and other sweeteners and rail tariffs, just to name a few. The price of diesel fuel affects the global fats and oils markets, which affects the prices of soybeans, canola and palm oil, among others.

Make no mistake about it: Higher volatility is not just a problem for agribusiness processors who primarily find themselves on the buying end of the commodity supply chain. It is a problem for producers as well.

The livestock feeder who must decide on herd or flock sizes in response to feed cost uncertainty or the farmer who has one chance per year to make the decision to plant corn or soybeans has an incrementally higher probability of getting it wrong due to higher volatility.

Indeed, as variance rises as the square of market volatility, risks increase exponentially throughout the agricultural sector of the economy. The end result is that each step of the supply chain has an incentive to add insurance costs in the form of either higher inventory or lower production levels, both of which raise physical supply risks to food processors and lead directly to higher food price inflation.

Commodity managers who have mastered the economics of substitution under one historic regime now have to learn a new set of market relationships, production schedules, shipping and operational chokepoints, taxes and tariffs and storage and physical inspection requirements. Hedge ratios, spread trades and basis differentials calculated and tested over long periods of time may change rapidly and push existing Financial Accounting Standards (FAS) 133 documentation into obsolescence.

Not only will this external market environment become more volatile and treacherous for setting price indices and managing contracts, but inter-subsidiary transfer prices will become more volatile as well.

## Top-down view

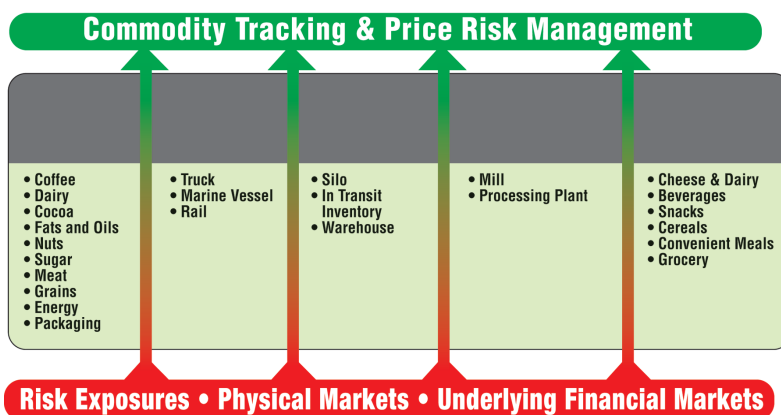
The FAS 133 requirement for a financial hedge to be linked to an underlying physical transaction is a double-edged sword in a large, integrated corporation with many business units.

How hard is it to imagine one unit emplacing a short hedge on, say, high-fructose corn syrup (HFCS) held in inventory while another is emplacing a long hedge against forward purchase commitments? The end result is two perfectly valid trades done at cross-purposes for the benefit of two separate accounts that do nothing for the overall corporate welfare.

A more logical solution, and one that can be implemented with full respect for subsidiary policies and goals, is to centralize risk management so hedges, accounting and control and supply chains can be managed on a “top-down” basis as opposed to integrating separate business unit risk management plans on a “bottom-up” basis.

In the case of the HFCS hedges noted above, the risks need to be added in quantity and across time to a net corporate risk. The net residual risk is what will be managed using external financial instruments. Then, on a notional basis, the two operating units’ separate risks can be allocated back to separate internal accounts. The net result is a minimum of external transactions and a maximum benefit to the corporation.

## Managing the Margin



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What is required to make a centralized risk management system work? The first factor is a clean and clear directive from corporate senior management that is accepted by operating unit management. Without operating unit buy-in, the system will fail.

As operating units only accept central corporate directives if they are certain their interests are respected and they will have a say in the operation and direction of the corporate risk management system, no centralized risk management system can work if it is perceived as imposed from above.

The second factor is establishing fair performance benchmarks and making sure they make sense economically.

The aforementioned purchaser of HFCS may be held, just as an example, to a third-party index of syrup prices and transportation costs to delivery points. In this manner, the purchasing agents are measured against a base case of whether their decisions added value to a benchmark or simply remains floating on the price on a ratable purchase basis.

Each industry segment has to have independent benchmarks, and these benchmarks, in turn, must reflect both absolute price and the risks associated therewith.

The world of investment management and performance analysis has a great deal to offer on this last point: A fund manager who achieves high absolute returns but whose performance is too variable will rank well below a more sedate rival on a risk-adjusted basis.

Performance measurement affects behavior profoundly; the last thing you want is to have your buyers and your traders regarding the risk management enterprise as some sort of giant game whose goal is to “be right” on the market regardless of the outcome for the corporation.

The third factor is a devilishly tricky one, and that is an effort to treat the physical and financial sides of the transaction equally. Notice how this is put forth as an “effort” and not as a “requirement.”

Veterans of corporate risk management understand how financial hedges are treated as add-ons to the real business and, therefore, are held to a different standard.

In general, most management places a burden on the financial side of making money, which by definition must mean the physical business is losing money; if the opposite occurs, the financial transaction is viewed in hindsight as a foolish waste.

While we must make business decisions in advance, internal critics feel quite free to point out what should have been done in retrospect. This will never change; it must be accepted and, dare I say, managed.

The fourth factor is establishing risk tolerance levels. Nothing will defeat a risk management program and demoralize its practitioners faster than letting the best be the enemy of the good.

While risk reduction is a laudable goal and indeed a necessary one given the current and prospective levels of volatility in the agribusiness markets, the simple fact is that hedging is insurance, and no one ever got rich by buying too much insurance. If risk tolerances are set too tightly, costs will rise, and all involved in the process will feel they are in a no-win game.

The fifth factor is creating an environment wherein risk management is viewed as strategic tool allowing operating units to become more aggressive competitors. Once again, the world of investment management provides guidance. Those who establish

risk control parameters in their market position and turn the linear profit profile of an unhedged business into the truncated profit profile of a managed position can seize a huge advantage over their competitors.

### Information management

Those five points lead to a sixth and perhaps most important factor: information, information, information.

Nothing leads to acceptance of and confidence in a program more than a feeling like it is under control. This means individual transactions and contracts can be entered into a system and seen by designated management on a real-time basis, that hedging requirements are updated and documented in accordance with FAS 133 and appropriate Securities & Exchange Commission requirements at the time of the transaction so there are no reasonable questions thereafter as to what was done for what purpose and that the combined physical and financial positions are reported back to the operating units for performance measurement and income statement purposes.

The ability of modern enterprise risk management software to handle all aspects of this process — physical risk decomposition and mapping over multiple business units, risk-adjusted performance measurement and analysis, regulatory and compliance documentation, accounting and control and integration of financial hedges with the physical transactions on a real-time basis — makes it possible for management to implement a centralized risk management system.

The alternative — to do nothing in an increasingly risky and volatile environment — is not much of an alternative at all.