Will Compliance replace Risk Management In the corporate jungle of energy trading firms?

The answer is, it looks like it. There is so much going in today's electricity, gas and other energy commodity markets. A myriad of new regulations like Dodd-Frank, REMIT, MAR, EMIR and MiFID II need to be dealt with. In the past 5 years black swan events have turned the electricity and related markets unexpectedly upside down. Events such as the Fukushima disaster, the Brexit vote and government renewable-energy policies, which have introduced a weird new logic into energy trading. Factors that could not be predicted or quantified by risk models.

All this has changed the way risk managers are looked at and what is expected from them. Their traditional role was to focus on internal dangers coming from rogue traders and others who might cause financial damage. The risk manager of 10 years ago was almost entirely focused on financial risk; how market price changes or credit risk might impact the business. Today, such risks are no longer a priority question, mainly due to the unpredictable, difficult-to-model factors in the markets.

As such, strong specialist financial risk or quantitative skills are no longer a prerequisite. Chief Risk Officers need to be equipped to tackle other threats to their businesses that include liquidity, operational, compliance, IT, regulatory and reputational risks.

One of the brand new risks energy companies do have to deal with is the enforcement or compliance risk. Here is where the risk management and compliance function do meet.

To most energy trading companies the compliance officer is a new function and many are still struggling how to exactly fill in this job. Nevertheless it is clear what based on best practices their roles should be. But will that be at the expense of the influence of the risk managers?

The compliance officers' role is not only the traditional one of writing compliance policies and procedures, but is much broader than that. They will have to interpret, understand and comply with a myriad of technical requirements of laws and regulations, have robust risk management capabilities and technological know-how, be proficient at developing and maintaining strong relationships with internal and external stakeholders. On top of that they will be sitting at the table with the board and management to help steer the organization in the right direction and in several cases taking over the CRO's position at the table.

The growing importance of compliance can be highlighted with the way misconduct by traders is handled nowadays. In the 'old days', losses incurred by a rogue trader would be a blemish at best, or at worst a material loss reported in the company's financial statements, with only a few rare cases resulting in a complete, Barings Bank-style collapse of the firm. In the new world order though, a report of even minor trader mischief might threaten the company's license to operate. In comes Compliance. To make matters worse for risk, traders are trying to be nice to compliance, while risk managers are still getting the traditional brush-offs.

Because of all these trends, risk managers need to deal with new and broader duties. And they don't necessarily involve creating Monte Carlo simulations in Matlab or modelling gamma risk in an electricity options portfolio. Instead, the focus has increasingly shifted to people skills: the ability to collaborate and communicate effectively with traders, executives and compliance officers, as risk managers regularly do understand the business of the company much better than the compliance people.

Due to the low profitability in today’s commodity markets, many companies have cut their budgets. A lot of what is left of those budgets will go into compliance at the expense of risk management, who will have to do more with less. However, nobody expects traditional risk reporting on market, credit and liquidity risks to be dropped, putting up the pressure for risk departments while their headcount remains the same or even shrinks.

Whether allowing risk management to lose out against compliance is a wise approach remains to be seen. As long as the markets will stay relatively stable it will be okay. But what if the almost inevitable will materialize: an Enron-style bankruptcy that will send shockwaves through the markets. What if one or - even worse- more of the leading utilities in Europe such as Uniper, RWE, Enel, or Dong will be in financial distress?

Risk management could really save the day by helping to detect this in an early stage and thus allowing proper actions to be taken. Therefor it is advisable to find ways to keep the risk management resources up to the required standards and at the same time lift the compliance function standards to deal with all the implications of the new regulations.

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