View Point

Trade banking and finance

Trade finance has been caught in the crossfire of the global economic crisis, both as a symbol of its extensive reach and as a vital piece of the solution.

BY ALEXANDER R. MALAKET, CITP, PRESIDENT OPUS ADVISORY SERVICES INTERNATIONAL INC.

The business of trade finance has been through one of the most dynamic, innovative periods in its evolution as technology has emerged to fulfil its early promise. At the same time, bankers and trade financiers have actively sought to develop and deploy new business solutions in response to the needs of clients across the globe.

Just as these developments have been gaining momentum, trade finance finds itself at the centre of the global economic crisis, both as an illustration of the breadth of the crisis and as a key element of its eventual resolution.

Global sourcing patterns have changed significantly over the past decade, with China becoming a major manufacturer and supplier, and global retailers such as Wal-Mart, Carrefour and Zara exercising increasing influence on their supply chains. These changing realities were closely followed by a shift from traditional trade finance products to open account and supply chain-related solutions. These tend to be less complex and costly for customers (also less secure) but, perhaps more critically, significantly less profitable for trade finance providers. The shift to open account and supply-chain solutions was observed across the globe, even in regions – and with trading partners – previously considered too risky for such terms. The Middle East, where documentary credit and other traditional solutions have enjoyed relatively consistent market demand, was caught in the wave of innovation, and is working to develop new variations to open account, supply chains and working capital solutions.

Almost in parallel, leading financial institutions worked to integrate certain related lines of business such as trade finance and cash management, as well as correspondent banking, under broadly mandated global transaction banking units.

Hedge funds also saw great potential in financing short-term trade, particularly in then-lucrative emerging markets.

These realities, coupled with ongoing global consolidation in the financial sector, and a pattern of profit compression in trade banking, motivated senior bank executives to seek ways to "re-intermediate" themselves, with enhanced profit, into the business of international trade.

The current global crisis has reinforced the attractiveness of trade finance as a line of business, particularly given its countercyclical nature, and has generated both attractive returns and a positive profile for business.

In short, these have been transformational times in trade finance, and that reality will endure beyond the current global crisis. The current financial downturn has also highlighted and amplified the interest, developing for some time, in Islamic banking and Islamic trade finance.

American and European authorities have sought to improve understanding of the stewardship dimensions of Islamic banking and to appreciate the characteristics that have effectively served to screen those institutions from the fundamental drivers of the crisis.

The demise of the documentary letter of credit was predicted and promised for many years, to the chagrin of long-time bankers, and the anticipation of importers and exporters across the globe.

In fact, the observation of a senior banker some years ago – that we were one major crisis away from a rush back to L/Cs – has proved to be correct, given the increase in usage of documentary credits during the current crisis. Numerous previously solid financial institutions were forced to reassure the market on the validity of their instruments and, in some cases, to seek confirmations of the credits from correspondent banks willing to take on the financial exposure.

Just before the crisis, it became increasingly common to hear concerns that trade finance was becoming more like cash management, and cash management becoming increasingly similar to trade finance. Trade, the argument goes, is shifting its emphasis from risk mitigation to financial settlement in the context of open account transactions. Meanwhile, cash management is approaching trade finance in that its reach is increasingly cross-border, as bank clients of all sizes engage in international commerce.

Although we expect the shift to new product solutions to re-engage after the crisis begins to reverse in earnest, the signs that the global economy has bottomed out remain tentative and inconsistent. Trade will, despite recent forecasts of slower growth, remain an important force in the re-ignition of the global economic engine; this reality will ensure the momentum of product development and innovation in trade finance continues.

The current world crisis has reinforced the attractiveness of trade finance as a line of business

Financial and economic crises will undoubtedly influence the next round of innovation. New solutions in open account, supply chain finance and pre-shipment finance, will include renewed focus on the risk mitigation dimension of trade finance, an area that had, until recently, faded into the background. Additionally, the provision of information (on shipment status, financial flows, or indeed any aspect of a transaction) will come to the forefront.

The unparalleled involvement of governments through export credit agencies, and the global financial community through IFIs (International Financial Institutions) provides a stark illustration of the degree to which the global trade finance map has been redrawn. The engagement of ECAs and IFIs – previously decried as market-distorting government

A Chinese textile worker. The primary engines of the global economy – China and the US – are banking on a speedy return to buoyant international trading

interference, has been largely welcomed by global financial markets, and even by the most ardent proponents of free-market economics.

The focus on Islamic finance is likely to continue to expand, among regional financial institutions and the global players who had begun to explore this area as a potential line of business prior to the crisis.

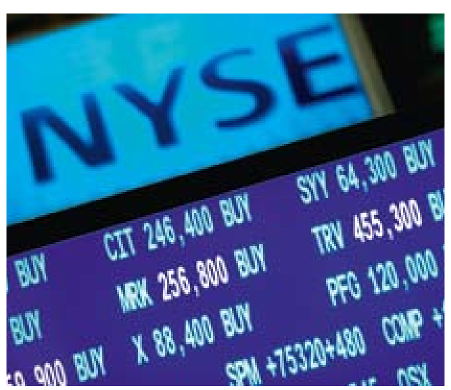
Operationally, trade finance has also shown signs of evolution. Trade bank operations have, in *Cash & Trade*'s view, long been under-valued and underestimated by financial institutions, and by the market, largely the failure of trade specialists in communicating the value contributed by operations teams in the trade finance equation.

The question of a lack of transactional skill among front-line relationship managers must also be addressed.

The shifting landscape of banking, including trade finance, which includes large mergers and an exit of numerous institutions from the trade business, will only partially mitigate this challenge.

Long training cycles (typically three to five years) persist due to the inefficient 'learn on the job' approach adopted by many operations managers. This combines with the ageing nature of the trade operations labour pool worldwide, and the lack of new entrants into the trade back office, to create an ongoing resource issue. The shortage has been widely acknowledged as an area of concern across the globe, from the Americas and Europe to trade powerhouses in Asia and the Middle East.

The situation may have been mitigated to some degree by ongoing financial sector consolidation and the exit of some institutions from the international arena. However, over the longer term, the skills and resource issue will remain on the horizon. Even the advances in automating certain aspects of documentary operations will not sufficiently offset the resource issue. Markets seeking to establish or maintain a serious capability in trade will look to access these increasingly rare resources.



American and European financial institutions have been working hard to develop Islamic finance capabilities

Until recently, human capital management and maintenance were identified as the most critical challenges faced by trade bank executives. The experience in the GCC region is typical: unstable staffing and resourcing in banking, including trade finance, coupled with regular, significant increases in salary scales as financial institutions scrambled to retain staff at all levels, or sought to hire them away from competing institutions.

On a global level, including in key markets across the Middle East, the cost of maintaining an operational capability in trade finance remains a critical question for senior managers. In addition to high fixed costs related to staffing, the escalating costs of implementing and maintaining trade-related technology are often a 'make-or-break' factor in management decisions.

The question of how best to handle trade operations has been part of the landscape for over 15 years; operational centralisation, followed by a wave of outsourcing arrangements, with a few players succeeding in developing a business around trade processing. The outsourcing question will remain central to the future of trade bank operations.

Trade bank clients have seen their business and the competitive landscape reshaped over the last two to three years, and again over the course of the current economic crisis.

Sourcing patterns have changed irrevocably, with international exporters increasingly engaged in import activities to source components or inputs to production, and foreign investment linking increasingly closely with trade activities. This idea of closely related import, export and investment activity has been referred to as 'integrative trade'.

For markets such as Dubai and Hong Kong, long skilled in re-export activities, this concept is perhaps not so new. However, its implications across the globe are significant, and have reshaped expectations in the trade finance sector.

Trade bank clients, from SMEs to corporate multinationals, continue to require each of the four major solutions provided by trade finance specialists: payment facilitation, risk mitigation, financing and the provision of timely (and increasingly detailed) information.

As business shifted to open account, the risk mitigation element was de-emphasised. However, recent events have brought this dimension to the forefront of the trade finance value proposition. Additionally, the provision of information – about a particular shipment or about payment status, for example – has become increasingly valued. Clients, from SMEs to large corporates, are looking for near just-in-time information about every aspect of their trade activities, to the point that multi-bank systems have gained traction over the past 18 months.

Much in the way that customer expectations in the area of cash management have evolved to raise the demands on service providers, clients engaged in international trade are seeking greater value: enhanced expertise and advisory support, more effective technology, and faster response in areas ranging from credit approvals to document-checking, to transaction settlement.

The global financial crisis, triggered by toxic mortgage assets primarily in the United States, was exacerbated by a sudden mistrust among banks relative to the magnitudes of potential exposure. This dynamic sent a chill through the interbank lending markets, with disastrous effects. That fast-developing and harsh reality had the effect of raising the cost of trade finance, reducing its availability and global reach, and ultimately, contributed to the evaporation of pre-shipment financing.

The world's shipping industry is one of the many sectors hard hit by the economic downturn

The global shipping industry continues to suffer as a result, with container shipping costs reduced by 90%, volumes from Asia reduced by over 40% and key ports such as Singapore experiencing unprecedented congestion as ships wait, empty, for the possibility of a cost-covering trip west.

Trade clients, from emerging market SMEs to US and European-based multinationals, are experiencing unprecedented tightness in the trade credit markets despite the intervention of ECAs and IFIs; banks with credit line availability and risk appetite have been able to earn premium pricing, and business in general faces tension between the tough realities of domestic markets and the lure of international trade as one option to sustain revenues and operations.

Irrespective of the harsh current realities, businesses across the globe are looking at this crisis as temporary, even as they acknowledge it may have transformational and irreversible consequences. The key for providers is to meet the challenges, while continuing to position themselves for the inevitable return to normalcy – whatever shape that normalcy might take in the end.

Regulatory and compliance issues have come to the forefront in international business and trade, especially since the spectacular corporate failures at WorldCom, Enron and elsewhere, and also in the context of tighter anti-terrorism measures.

Customer expectations in the area of cash management have evolved to raise the demands on service providers

Regulations which require bankers to 'Know your Client' (KYC), have been extended to a more stringent requirement dubbed KYCC, or 'Know your Client's Client', with the effect, for example, that a Dutch bank must conduct due diligence on a new trader in Antwerp, but also extend that due diligence to the trader's customer in West Africa. Similarly, finan-

An adequate technology platform is no longer a competitive advantage but a basic requirement for any institution to be a credible trade finance provider

cial institutions governed by the KYCC standard will require high transparency about business dealings across the globe, including in the Middle East.

Islamic finance principles, with their close engagement between bank and client, the partnership and shared investment element of certain transactions, and the common practice of having a bank take title to goods being financed, provide a sound basis for higher levels of transparency in a trade transaction. In fact, this close engagement and relationship connection between client and banker is one pillar upon which financial institutions governed under Shari'a Law are supported.

As the international financial situation continues to dominate discussion across the world, the fundamental importance of the global regulatory regime is strikingly illustrated by calls for a wholesale redesign of the economic system, a rethinking of international institutions such as the World Bank and the IMF. Even the long-anticipated Basel II requirements, championed by the Bank for International Settlements (BIS) have been brought into question by the crisis.

The regulatory environment related to trade and trade finance is very much on a path of greater stringency, from anti-money laundering measures, to automated monitoring of OFAC (US Office of Foreign Assets Control) restrictions, to intelligence agencies sifting through international financial transactions facilitated through the SWIFT network – every dimension of trade, from the flow of goods to the flow of money, is subject to tighter controls.

Regulations are here to stay – in fact, to expand – and all parties, from corporates to service providers, have the choice of acting proactively to help shape the emerging regimes, as well as their responses to the changing regulatory environment.

The technology dimension of international trade and trade finance is central to the context within which clients and service providers operate. Since early attempts to 'dematerialise' trade documentation in the 1990s, to more recent efforts to provide full-scale, technology-enabled 'Global Trade Management' solutions, technology has been increasingly influential in shaping business models and value propositions related to trade and trade finance.

While early technology served to increase the efficiency and throughput of transaction processing in trade banks, the current situation is perhaps better characterised as two-pronged: technology continues to support banks' business models, as banks and providers invest in technology to ensure they remain engaged (are re-intermediated) with clients. At the same time, technology has facilitated unparalleled transparency and immediacy of information about every aspect of a trade transaction, and indeed, about every dimension of a client's global portfolio of business.

The fundamental importance of the global regulatory regime is strikingly illustrated by calls for a wholesale rethinking of international institutions such as the World Bank (Robert Zoellick, president of the World Bank, above) and the IMF

An adequate technology platform is no longer a competitive advantage or differentiator, but rather a basic requirement for any institution which purports to be a credible trade finance provider.

Companies such as TradeBeam and its Global Trade Management model, which covers everything from logistics to compliance to financing, or TradeCard, one of the early pioneers in the replacement of paper-based trade with electronic documentation and event-triggered decision-making, continue to stretch the boundaries in terms of application of technology to trade finance.

Technology providers that previously focused on payments solutions are now active in the trade finance space; other organisations such as Bolero, a UK-headquartered firm first established with the active participation of SWIFT (which still retains a small equity stake in the company) has been developing and deploying a multi-banking solution sought by more and more trade bank clients.

Success in finding opportunity in the current crisis will create a competitive advantage that will last well into the recovery phase

Innovative business models and partnerships are increasingly common in the trade finance landscape. From the groundbreaking combination of JPMorgan Chase Vastera to the evolving collaborative model developed by SWIFT as the Trade Services Utility (TSU), these alliances will only grow in breadth, variety and scope over the coming years.

Technology in trade finance has finally reached a certain maturity: it has enabled the beginnings of a transformational period in the industry, as its serves both trade finance providers and ultimate customers. Global trade is set to slow for the first time in decades. The financial crisis that has engulfed the globe includes a shortage of trade finance, the depths of which are unclear, even as some providers reap record profits. With a $250bn injection targeted at trade finance and with the primary engines of the global economy (the United States and China) both profoundly in need of a healthy global trading environment, trade finance will retain significant profile among policymakers, bank executives and corporate leaders.

Trade will be one of the forces to pull the global economy out of its current tailspin, and trade finance, as a business, can take the opportunity to do two things simultaneously: demonstrate the effective and valuable functions of its traditional instruments and solutions, while concurrently innovating to position for the post-crisis economic and commercial order.

While traditional leaders such as the US, the UK, Europe and parts of Asia suffer the crisis and work to recover – sometimes by retrenching domestically – other markets such as Canada and the Middle East, by virtue of some unique features of their respective trade and financial environments, can extend their influence beyond its current state.

Similarly, financial institutions in the Middle East, particularly those governed under principles of Islamic finance and Shari'a Law, have attracted positive attention from various quarters, as a direct result of the relative health of the financial sector in the region.

Success in finding opportunity in the current crisis will create a competitive advantage that will last well into the recovery phase. It is from the ashes of the current turbulence that a new economic environment will rise. ■

While leaders such as the US, Europe and Asia suffer, other markets such as Canada and the Middle East, by virtue of some unique features, can extend their influence