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Market Research & Intelligence for Financial Institutions

Next-Generation Trade Finance

Expertise as the Greatest Asset

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Trade and supply chain finance are enjoying an unprecedented level of profile and visibility, yet this particular discipline within finance and within transaction banking remains poorly understood, certainly among C-suite executives, and even among seasoned bankers and finance specialists. At the same time, senior industry leaders in trade finance have demonstrated the capability to engage effectively with their client base, and with a variety of stakeholder groups, to articulate the value proposition of this business, and to champion the equitable treatment of trade finance by regulatory authorities.

Trade Finance: Past Meets Present . . . and Future

The business practices, products and solutions developed in the context of trade and supply chain finance possess a long history, and have proven to be robust and effective in a wide variety of circumstances and contexts, over a period of at least several hundred years. Some practitioners will argue that even the "new" propositions under the supply chain finance banner are little more than a repackaging of long-established products and solutions, however, this assertion misses the point that supply chain finance takes a far more comprehensive view of trade, as a network-based collection of relationships, rather than the traditional bilateral and transactional view of international commerce.

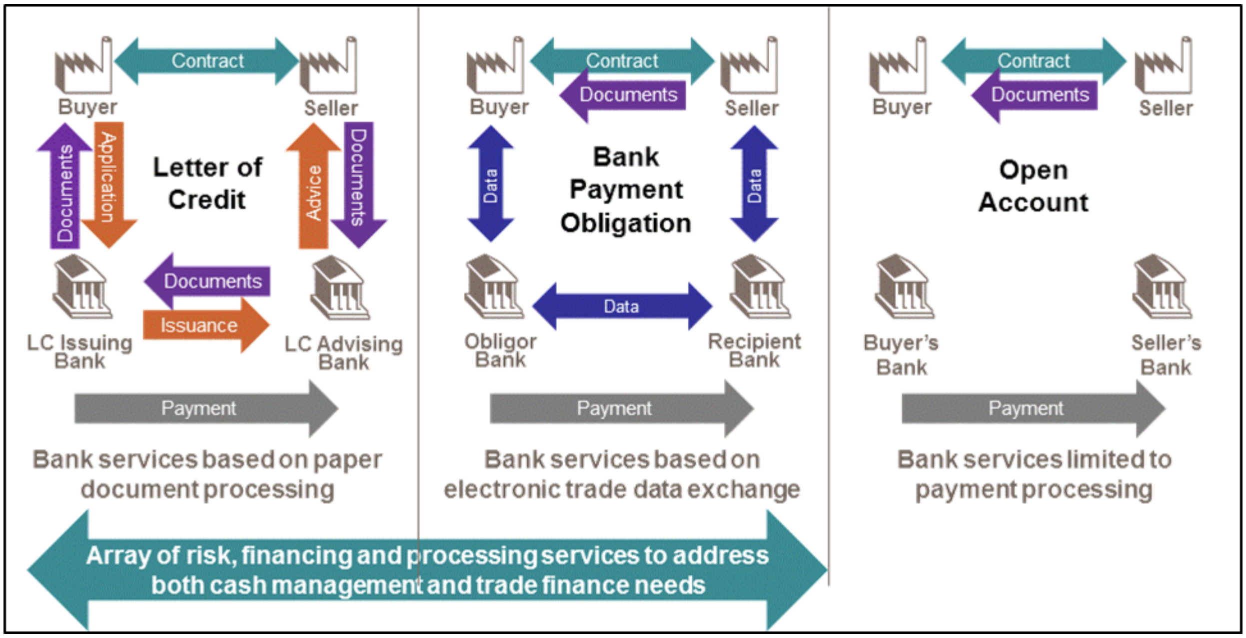
Historically, there has been little motivation to innovate in this domain, partly due to the effectiveness of existing mechanisms and partly, one might argue, as a result of complacency born of a lack of alternatives for businesses engaged in international commerce. The development of the supply chain finance proposition, still very much underway, was a defensive response by the banking industry, to the shift to open account terms and the likely disintermediation of banks from the business of trade finance and risk mitigation.

Aside from early attempts to innovate around technology-based models, the development of supply chain finance is the most significant innovation in trade finance, both in terms of the related proposition and in terms of market adoption.

Even as the solution set around supply chain finance continues to develop, from a single product in some organizations, to a complete suite of end-to-end financing and risk mitigation options among top providers, the leading edge of the business combines a response to the needs of companies trading on open account, together with evolving capabilities enabled through technology.

The ICC/SWIFT Bank Payment Obligation (BPO) is very much an example of the linkage of technical advancement with a maturing business proposition: a promising development in the financing of trade, now supported by the ICC's Uniform Rules for Bank Payment Obligations, formally approved and adopted in April of 2013.

The BPO is positioned as a solution that responds effectively to the needs of open account trade, on the basis of data flow as opposed to paper document flow, and on the basis of objective, data-driven payment decisioning, as opposed to subjective and inconsistent document-checking processes.



The Bank Payment Obligation, ICC/SWIFT Industry Education Group, 2013

The question is, what will define next-generation trade finance, in a world where the business of financing trade has a long history of being undervalued by corporates and banks alike, where pricing is razor-thin in all but the highest-risk transactions, and where differentiation among providers is difficult to achieve. Trade finance has clearly shifted from a product maintained by some banks as a potential loss-leader and a channel to greater share-of-wallet in commercial and corporate relationships, to being a decidedly strategic, even high-profile business, linked to the facilitation of global trade flows, and since 2008, to the recovery of the international economic system.

Leveraging Unprecedented Global Profile

That enhanced global profile has only partially translated to stronger positioning within banks, though the contribution of trade and supply chain finance is acknowledged as significant within the broader transaction banking business areas now common among many banks. The concerted effort to champion trade finance in response to inappropriate regulatory treatment of the trade business under Basel II and Basel III (admittedly a result of factors that extend beyond just the actions of the Basel Committee) must continue now, as a broader campaign to articulate, communicate and champion the value of trade finance to a wider audience, including senior bank executives, finance and treasury specialists and other important stakeholders.

Bankers, as the providers of the majority of trade and supply chain finance globally today, have both an opportunity and a professional responsibility, to promote the strategic value of trade and supply chain finance. Just as the banks have succeeded in re-intermediating themselves into the business of financing open account trade flows – now well over 80% of trade flows globally – the next step is to "de-commoditize" the business of trade finance. That is, to reverse the long and unfortunate trend of price compression related to trade finance.

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The pursuit of business opportunities in international markets is well understood to involve degrees of complexity and risk that are significantly higher than the conduct of business in familiar domestic environments. The financing of international commercial activity is commensurately more complicated, requiring incremental domain knowledge and expertise, together with specific competency related to the conduct of business in foreign markets.

Trade finance combines a variety of elements in its overall value proposition, including the provision of timely and secure payment on a global basis, the effective mitigation of a wide variety of risks, the provision of financing for any or all parties involved in a trade transaction or relationship, and the provision of rich data and information flows about both the financial and the physical transaction. Trade and supply chain finance is not piece-work, to be priced on the basis of the amount of manual intervention in a transaction, or the number of transactions that can be completed by operations specialists in banks.

The provision of trade finance in the context of certain markets and trading relationships is about a combination of factors, including:

- Availability of capital and liquidity
- Risk tolerance and mitigation capability
- Knowledge of the markets, goods and trading relationships
- Transactional expertise

While advances in technology will certainly enable powerful innovations in the financing of international commerce, as we are observing already, the fundamental evolution to a next-generation model of trade and supply chain finance will require a de-commoditization of the business, globally: a redefinition of trade and supply chain finance, from process and transaction -based, to solution and value-based.

The core of this transformation will rely on a recognition that next-generation trade and supply chain finance will be defined and differentiated on the basis of competency and expertise, not on the basis of transactional efficiency or throughput, as those latter elements will be no more than the price of admission – table stakes – to the business of financing trade.

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There is, among bankers, a common debate about whether they should lead clients to new business models or propositions, or wait for customers to be "ready" for such models. This debate was evident in the context of the development of integrated trade/cash propositions, just as it has been visible in the context of the development of the supply chain finance proposition. Interestingly however, the drive to a solution-oriented, relationship-based and consultative approach to transaction banking – especially trade banking – is well underway, and is being demanded by leading finance and treasury specialists in companies of all sizes.

Corporates want their bankers to provide advisory support, and welcome a consultative, differentiated approach to meeting business requirements, yet resist attempts to assure adequate compensation for this expertise-based approach. Bankers, on the other hand, speak of adopting more strategic, commercially-oriented approaches in sharp contrast to the historic, product and silo-based approach, however, are timid in making the case for value-based compensation, and have been largely unable to make the case for a revenue stream based upon the provision of highly specialized advisory support.

While we can envision a model of next-generation trade finance differentiated on the basis of competency and expertise, including transactional ability and specialized market or sector knowledge (most will agree that commodity finance is a specific niche with unique expertise, for example), there is a looming shortage of domain expertise in trade finance that threatens such an evolution. This is in addition to the tendency to undervalue trade and supply chain finance by allowing the proposition to be defined in transactional and processing terms, rather than in value terms.

Trade bankers face a shortage of competent technical resources in trade finance, largely due to a lack of interest among next-generation bankers, in a business that is perceived to be esoteric, out-dated and mired in bureaucracy, with limited profile, limited compensation and uninspiring career prospects: most perceptions inaccurate, but also very rarely corrected.

An industry-wide shortage of specialists with the requisite domain expertise and practical understanding of the nuances of international trade finance is a serious issue, for which mitigation plans must be devised well in advance of the crisis, much in the way that a supersonic jet must calculate its glide path and prepare for landing long before the pilot sees the runway. The continuing consolidation in the banking sector, and rationalization among trade bankers has delayed the crisis somewhat, as resources shift within the industry, but already, the anticipated shortage of skills and resources is reflected in a near-global demand for trade and supply chain-related training and advisory support among financial institutions and others.

The foregoing realities link directly to the overarching demand from commercial and corporate clients for a more relationship-based, less transactional approach to banking, in particular trade banking and trade finance, all in a near-global context of on-going rationalization of relationships initially by bankers, but now also by finance and treasury executives exercising leadership positions in large companies.

Differentiated development of trade-related propositions, together with differentiated delivery of solutions and services – to underpin a relationship approach – can be achieved through a new approach to trade finance: one based on expertise and high value-added, as opposed to the traditional cost-plus models of pricing, be it in terms of processing fees, interest income or commission revenue.

The redefinition of trade and supply chain finance as a value-added, expertise-based set of solutions will require much more than a simple redrafting of fee schedules – a process which, on its own, will fail if ever it is attempted. What is required is a clear and unequivocal effort by trade financiers to offer greater, strategic value, and to demonstrate to commercial and corporate clients that the combination of such expertise, with highly effective instruments, processes and technology, is worth more than the familiar set of fees, commission and interest associated with traditional trade banking.

One corporate executive speaking at a conference in Europe some years back, bemoaned the average €400 fee his company paid for a documentary letter of credit, but relented, when reminded that in a single transaction, he was able to leverage that modest fee into a comprehensive payment, financing and risk mitigation solution for a multi-million Euro export to a high-risk market that would otherwise be unreachable.

The global consolidation of relationships, both bank-to-corporate and bank-to-bank, comes with an increased sense that commitment and staying power are core to satisfaction with remaining relationships. Once again, such commitment aligns well with the notion of high value-added solutions and services, based on a combination of expertise, and intimate understanding of the business objectives and priorities of a corporate or financial institution client.

Value, and expertise, must be perceived in order to be equitably compensated, and in the case of trade finance, a recalibration is long overdue.

While it was clearly the case, that consolidation involved exit strategies for higher-risk or lower-profitability relationships, it must follow longer-term, that the remaining relationships must generate commensurately more value, and more profitability. In that context, and given the decidedly reduced appetite for international risk over the last several years, the notion of high-value solutions in trade and supply chain finance will resonate on several levels.

Just as trade finance has benefitted from an unprecedented level of profile, from the G-20 meetings to the WTO, from Basel to Number 10 Downing Street, it is true that senior bankers now exhibit a better appreciation for the contribution and importance of trade finance in the context of transaction banking business units. Trade executives demonstrate a more sophisticated understanding of their own P&L, and of the contribution of trade, both directly and indirectly, to the bottom line of their respective financial institutions.

A growing number of second-tier and regional financial institutions understand the need to maintain some level of capability and capacity around trade finance, whether in-house or through a partner financial institution. FImetrix research indicates that financial institutions from various markets, regardless of whether they transact in the primary global currencies or in other strong currencies, are looking for substantive and far-reaching partnerships from their core FI relationships, paralleling what is being observed in the FI-to-Corporate space.

Commitment is Key to Satisfaction Worldwide

Trend in Global Key Drivers of Satisfaction with Bank-to-Bank Services

	Global Key Drivers from Regional USD,/Euro/Sterling Studies										
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
RM Follow-up	■	■	■	■	■	■	■	■	■	□	□
Operational Product Quality	□	■	■	■	■	■	■	■	■	□	□
Customer Service Quality	■	■	□	□	■	■	■	■	□	■	■
RM Responsiveness	■	■	■	■	■	■	□	□	□	□	■
Commitment to the Long-term Relationship	■	■	□	□	□	□	□	■	■	■	■
Competitive Pricing	□	□	□	■	■	□	□	■	■	□	□
RM Product Knowledge	□	□	□	□	■	□	□	□	■	□	□
TSS Capabilities	□	□	□	■	□	□	□	□	□	□	□

	Key Drivers in Other Currency Studies		
	CND 2011	AUD 2012	NZD 2012
Commitment to the Long-term Relationship	■	■	■
Customer Service Quality	■	■	□
RM Responsiveness	□	□	■
RM Follow-up	□	■	□
Operational Product Quality	■	□	□
Competitive Pricing	■	□	□

Source:
FImetrix Bank-to-Bank
Regional & Global Studies

The development of competencies relative to trade finance is identified as important or very important, by a large percentage of survey respondents across the globe, sharing priority with other areas such as regulatory and compliance issues, which have been especially pervasive in the post-2007 environment.

A well-known veteran of the trade finance world once commented that trade financiers are not known for seeking the limelight, that they are culturally more at ease in the shadows and in the background. The luxury of operating in this manner is no longer available, given intense and growing competition for limited bank capital, and given the shortage of next-generation trade financiers that will require a concerted recruitment effort by the industry, particularly if the notion of high-value, solution-focused and relationship-based approaches will define the future of this business.

Expertise and advisory support will need to shift to the forefront of the proposition around trade banking, and this will require trade and supply chain finance businesses to attract new talent and to leverage every dimension – sales and relationship, product and operations – in a holistic and complementary manner, and in a way that relatively few trade banks succeed in doing today. The development of a credible and sustainable next-generation model of trade finance demands a significant cultural shift, and a more effective approach to engaging with the business partners and clients across the globe.

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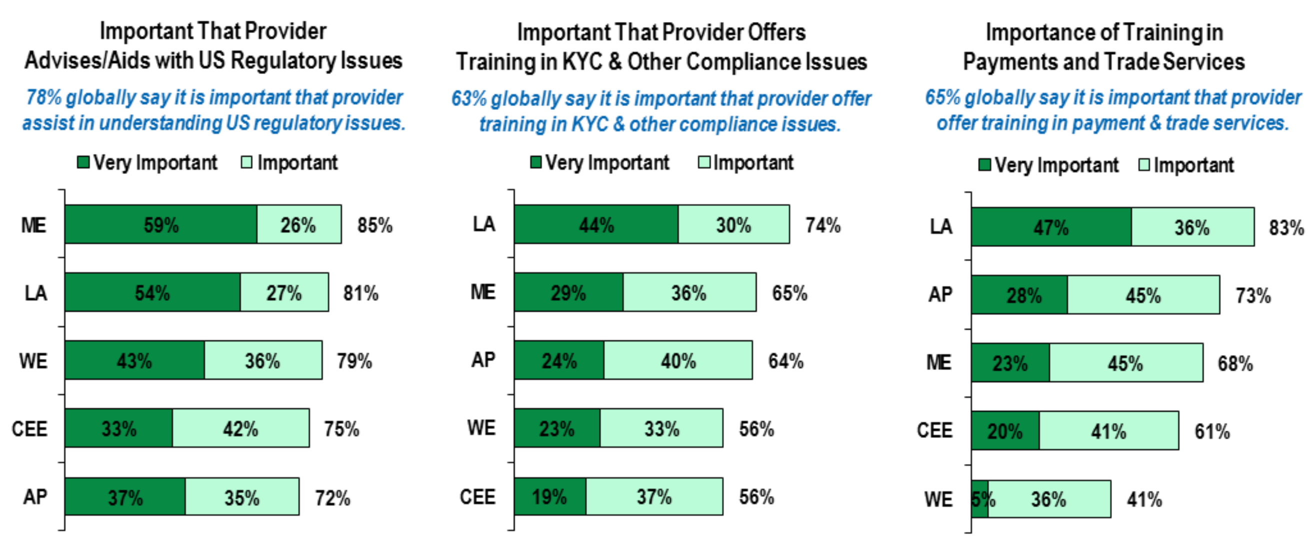
Several indicators in the market suggest that the timing is appropriate, for the visioning and development of a new model of trade and supply chain finance: one based on expertise and competency as the core value-added, and as a fundamental differentiator between competitors, particularly those that have understood the demand from corporate clients, for a more relationship-based and value-driven mode of engagement.

The nature of the support sought by financial institutions from their FI partners also reflects something of a shift and a desire to acquire expertise and competence, as illustrated in the below figure derived from FImetrix research. Training and the development of internal competencies is an objective of a significant portion of survey respondents, in core areas such as compliance and lines of business such as payments and trade.



Source: FImetrix 2012 Global Bank-to-Bank Services Report

The demand for such support links back to the growing shortage of skilled resources in banks, but also to the shift away from pure transaction, to more of a competency and expertise-based approach to the conduct of business. The pressure from both sides – increased market demand, with reduced capacity due to resource constraints – creates a compression that must be addressed by trade financiers.

The critical role of expertise and domain knowledge has long been allowed to be undervalued in trade finance; current realities, globally, should motivate trade financiers to rectify this situation, by working to de-commoditize this high-value business, and to sharpen, then actively champion, the full value proposition provided by trade finance in support of the successful conduct of international commerce.

The world is still looking for a comprehensive and sustainable solution to the various flavours of economic crisis faced by key jurisdictions, and robust, growth-oriented trade is one of the relatively few areas where policy and commercial activity can unite to create global economic value. Trade finance is indispensable to the conduct of trade. Time to give trade finance its due, recognize its value, and ensure that international commerce is adequately supported by the necessary liquidity, capital and expertise required.

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