# There's a new trade financier in town...

**The business of financing international trade is evolving almost from every direction. There are existing and emerging alternatives and complements to traditional trade bank financing of imports and exports. *Alexander Malaket* considers selected developments in this area for GTR.**

The familiar and long-established practices, products and service offerings related to international trade finance are being challenged and reshaped with increasing frequency and urgency by a combination of inter-related factors.

Many financial institutions continue to face compressing margins and eroding profitability in their trade finance lines of business, which require significant ongoing investments to maintain and upgrade technology and which are becoming increasingly integrated with lines of business such as cash management and correspondent banking.

While there are still opportunities for banks to pursue niche markets in trade finance, the business of financing an import and export trade is subject to increased consolidation on a global basis. Trade finance is not a business for every bank; increasingly, the leading providers of this service are global players, with the necessary financial resources and the global footprint required to make this a viable business.

Even for those financial institutions for which trade finance is a core competency, the challenges are many and varied: from increasingly demanding compliance regimes, to the ever-present requirement to optimise capital usage, and market dynamics such as the shift to open account trade and the increasing acceptance of internet-enabled global commerce – there is no shortage of complexity associated with trade finance.

## Fighters and providers

While many banks committed to, or required to, maintain a trade finance capability are fighting to redefine their value proposition and working to actively counter the risk of disintermediation, there are those – banks and non-banks – who have identified an opportunity and a profitable business in the provision of trade finance.

While it is true that the business of trade finance belongs in many ways, to the large global financial institutions, that same reality and the constraints faced by those large institutions, creates market gaps, which can be profitably serviced by smaller, specialist firms. Where the large global banks will typically try to view client relationships on a holistic, multi-product and multi-service basis, there are providers in the market, who are prepared to offer one-off transactional solutions in support of international traders.

Corporate and commercial clients are becoming increasingly aware of an openness to the option of accessing financing directly through capital markets. This option is becoming available in support of import and export business as it has been available for some time relative to other areas of corporate finance. Additionally, as returns become increasingly attractive in emerging markets, companies pursuing opportunities in international trade are looking increasingly to those higher-risk regions.

There are, then, numerous factors at play, which contribute to the creation of under-serviced market niches in trade finance.

In keeping with the truism about nature abhorring a vacuum, there are those who are enthusiastically prepared to fill that market gap.

## New rules

They are professionals. They are experts in trade finance. They may be former senior bankers, and they continue to contribute to the financing and facilitation of international trade – but do so now, under very different business models.

It is correct to observe that the margins on trade finance business are compressing; it is equally true however, to indicate that certain types of trade finance generate attractive returns. If margins could be increased by removing the high-cost elements of a trade finance business, while pursuing the more profitable (admittedly more risky) transaction types, the proposition would be attractive indeed; perhaps even more so, if the complexities of financial reporting and compliance regimes, or capital adequacy requirements, did not impede the pursuit of business.

A growing number of organisations are identifying compelling opportunities in the provision of trade finance; these firms, which could be referred to as 'non-traditional' providers of trade finance, are growing in profile and importance, even as banks outsource their trade operations, or simply exit the business.

Several hedge funds have identified this niche, and the opportunity it provides to generate attractive returns for fund investors, in a business, which is by its nature, esoteric, highly specialised and complex – perhaps sufficiently so to deter a flood of competitors from entering this space.

In addition to the hedge funds, several providers such as GE Capital, Maple Leaf Trade Finance and UPS Capital are active as alternative providers of international trade finance.

UPS Capital Business Credit, for example, has been active in providing trade finance, for more than 10 years. It has concluded well over 700 transactions, primarily in emerging markets, and mostly in close collaboration with several major export credit agencies such as US Ex-Im Bank, Euler Hermes and others. A senior executive at UPS Capital notes that the organisation focuses primarily on providing term financing in emerging markets, where such financing is generally unavailable, prohibitively expensive or may be called at any time.

UPS Capital does not generally position or perceive itself as a competitor to other trade finance banks, but rather, as a niche player, and in some instances a potential collaborator.

The business model of UPS Capital is to work with US-based exporters to provide term financing to their customers in emerging markets. To do so successfully, the organisation maintains a trade sales capability, and several international in-country representative offices in Argentina, Chile, Mexico, Brazil, Turkey, India and Russia. The company will leverage the global network of its AAA-rated parent as necessary, to support both relationship development efforts, and loan quality assurance and management.

Says the contact at UPS Capital: "Trade finance is a core business for UPS Capital – we look to complement traditional banks by offering specialty trade finance products, and we are a leading partner in providing term loans to foreign buyers in support of US exporters.  We are now entering into a new phase of support to importers and exporters with UPS Capital's portfolio of global supply chain financing products."

UPS Capital is not a deposit-taking institution, and therefore, will happily pursue deals on a transactional basis. This distinction has proved to be an advantage, in that certain banks will approach UPS Capital, typically for deals that are not attractive to the bank, knowing that their client relationships are not at risk. Such partner banks may be equally attracted by UPS's global network.

> Hedge funds may enjoy several advantages in their development and delivery of trade finance solutions

## Hedging your bets

Several hedge funds are also active in the provision of trade finance in emerging markets, and on a global basis.

Hedge funds are, in general, entrepreneurial in nature and culture. Financing international trade in emerging markets appears to be a good match to the higher risk, higher return guiding principle of such organisations.

Hedge funds active in this market have brought in former senior bankers and other specialists to develop highly skilled deal teams, with expertise to match that of many of the more traditional providers of trade finance.

Once again, while it might be argued that trade finance is a business for large global banks, hedge funds may enjoy several advantages in their development and delivery of trade finance solutions. The funds have access to a wide variety of sources of capital, will have a lower cost base than the majority of trade finance banks, and are not subject to the same stringent compliance requirements, nor capital adequacy requirements as defined in Basel II and elsewhere.

These differences have direct implications for the business model and value proposition linked to hedge funds. For example, the absence of capital adequacy requirements makes the ECA-backed portion of deals relatively less attractive given that they are process and paper intensive, while the 10-15% of a given transaction, which does not qualify for ECA cover, certainly qualifies for consideration. Banks, on the other hand, derive significant value from the favourable treatment of ECA cover in terms of capital adequacy.

Overall, hedge funds are likely to be less risk-averse than trade finance banks, and their market focus, combined with the client segments they serve, are said to result in net new liquidity in the trade finance market. Asked about his organisation's client base, one executive indicates that financing solutions are provided to every segment of the market, with the possible exception of pure start-up operations; even then, the subtext seems to be that there are no absolute restrictions, and that each opportunity is reviewed on its own merits.

Hedge fund representatives emphasise that they are not in direct competition with trade banks, but rather are responding to a market gap, adding value which can, when appropriate, complement the traditional offerings of trade finance banks.

Fund executives note that they will generally focus on smaller deals likely of limited interest to the banks. In terms of tenor, some funds are prepared to provide financing out to five years, with some activity extending into longer-term project finance. Given the highly focused nature of their business, trade finance specialists engaged by the funds can respond quickly to opportunities, providing very short turnaround on financing decisions.

In addition to operating with global scope, hedge funds can be fairly open to a variety of transaction or deal types. One fund executive indicates that the presence of an instrument to evidence underlying debt is critical, but notes quickly that the instrument could be (among other things) a bill of exchange, a loan document or a facility agreement through Swift, which might be backed by a standby letter of credit.

The hedge fund specialists we spoke with perceive significant potential in generating attractive returns through the provision of trade finance in emerging markets and elsewhere. They observe acceleration of capital flows on a global basis, recognise the continuing critical importance of trade as a driver of the global economy, and note the dynamics of the established trade finance market. Their conclusion is that trade finance is both a viable and an attractive business upon which to build high yield investment funds.

Suresh Advani, of GML International in London, notes: "Hedge funds like ours are generally very agile and entrepreneurial in nature. We see trade finance as an attractive asset class, supporting a dynamic and growing area, and our focus on emerging markets is linked directly to expectations related to growth and return."

In contrast to the current focus of many trade banks, there appears to be only limited interest in opportunities related to open account trade. This is an area that is still very much in development and links closely to efforts in the marketplace to define a trade value proposition around global supply chains.

With hedge funds focused primarily on structured finance transactions, and having no discernible interest in investing in trade-related technology, this difference in focus may indicate one of several natural distinctions between trade banks and hedge funds active in trade finance.

## Carving niches

A point of agreement seems to be that the involvement of hedge funds in the financing of international trade will only increase over the short-to-medium term, particularly given the markets and the niches, which are being served by these organisations today. It is noted with equal conviction among our contacts that there will be variations in the way new providers enter the trade financing market, and that several distinct niches will be carved out in the process.

Trade finance specialists who speak of the transformational nature of open account trade and global supply chain finance are equally optimistic and convinced of the fundamental reshaping of international trade and trade finance, including the long-anticipated demise of the documentary letter of credit.

As one senior banker notes however, "We are one major crisis away from a rush back to the LC".

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Is the entry of hedge funds, and some 'non-traditional' providers of trade finance an enduring reality, or a temporary anomaly? Will these and other alternative modes and providers of trade financing remain viable over the long term, as some have already succeeded in doing?

An important observation made by several of our contacts is that the hedge funds and other providers are careful to indicate that their strategy does not involve direct competition with the banks, but rather focuses on responding to market gaps and providing complementary expertise, and sources of financing.

Bruce Fields of Rosemount Capital Management in New York City, who spent 22 years as a trade banker, including head of trade finance (Americas), observes: "We see the involvement of hedge funds as a positive development for the trade finance business. Our team is highly experienced, we take a collaborative approach to working with leading trade banks, and our access to capital – together with the ability and willingness to take on risk – will ultimately provide additional liquidity, or financing alternatives, for importers and exporters globally."

With adequate risk assessment and management techniques, and reasonable care in ensuring the legitimacy of transactions and counterparties, it is entirely likely that the trade finance market can indeed sustain (and happily welcome) new service providers whose 'unique selling proposition' includes a combination of speed, responsiveness and higher risk tolerance than traditional providers.

Indications are that the entry of new providers to the trade finance market has been positively received to date, by all key stakeholders, including the banks. It will be instructive to observe, over time, the evolution of the relationship between trade banks, hedge funds and other providers of trade finance.

Trade bankers are often characterised as being conservative and risk-averse; equally frequently, the major trade banks are accused of under-serving the SME market segment. Will the dynamics of the market facilitate a partnership-based model or a collaborative model between the various providers of trade finance, or will its disciplines demand a rationalisation of the product and service options, and their providers?

The entry and engagement of hedge funds and other alternative providers of trade finance in the global marketplace is positive and desirable, if only because it will challenge entrenched views, expectations and standards in the business of financing international trade. Beyond that, the ideal outcome combines greater and enhanced access to capital, together with effective response to product and service gaps in trade finance, partially in competition, but also in collaboration with the established providers.

This is a key illustration of the evolution of trade finance, and development that will prove significant – perhaps even as transformational as the current focus on open account trade and supply chain finance. Stay tuned.