Trade Finance: Toward a Partnership Model of Risk Management and Compliance

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- Exporters and importers worldwide have relied on banks and insurers to mitigate risk in international trade.
- New realities of international commerce, including increasingly stringent regulatory requirements, demand greater engagement from traders in the management of risk.
- Transparency and communication between traders and banks will be crucial.
- The Middle East needs to ensure that it is well-positioned to shape the evolution of a more collaborative risk management model.

The financing of international trade, certainly in the short- and medium-term, is fundamentally about the following "four pillars" of trade finance:

- Facilitation of secure and timely payments across borders;
- Financing of one or more of the parties involved, whether it be the importer, exporter or a financial institution;
- Risk mitigation, through banking instruments such as documentary credits, or through various insurance or guarantee products; and, increasingly importantly,
- The timely flow of information about trade transactions; be it the physical movement of goods or the related financial flows.

Whether we consider trade finance in the context of traditional products, services and business solutions, or focus on some of the newer value propositions surrounding supply chain finance and open account trade, the "four pillars" and their fundamental value to the secure and efficient conduct of global trade remain at the core of trade finance.

In most transactions, each of the four pillars is represented to some degree. What tends to vary is the importance placed on each pillar relative to the others, depending, for example, on the markets involved, the nature and maturity of the trading relationship, or the price-volatility of the goods being traded, as well as the probable term or duration of a transaction (which relates directly to the level of risk associated with that transaction).

The export of automobile parts from Canada to the US, which generally involves long-standing and closely connected trading relationships between two secure and stable markets, is more likely to involve greater focus on the payment facilitation, as opposed to risk mitigation.

In contrast, the shipment of price-volatile commodities from sub-Saharan Africa to Europe is likely to involve greater consideration of the risk mitigation aspect of trade finance, given the higher overall risk of the transaction and the need to focus on effective risk management strategies. In either scenario, the importer and exporter will wish to ensure the successful conclusion of a transaction and the ongoing viability of the trading relationship, and will work with their bankers and other specialist advisors to ensure that the interests of both parties are protected in a balanced and commercially viable manner.

The combination of macro-factors, such as the markets involved, and micro-factors, such as the nature of the commercial relationship between the buyer and seller, will vary with each trading relationship and with each transaction – to the point that a straightforward shipment of goods between Germany and Poland might involve, for the parties concerned, greater risk than a more complex shipment of coffee from Ethiopia to France, where the buyer and seller have dealt with each other for decades and know the mechanics of the business very well.

Recognising the uniqueness of each transaction and the constantly changing factors affecting global commerce, it is nonetheless possible to make broad generalisations about the probable emphasis required on each pillar of trade finance for a particular type of transaction involving certain markets and types of trading relationships.

With that in mind, we propose that the risk mitigation pillar of Middle Eastern trade finance is a critical element, particularly when one of the trading partners is not from the region, or has only limited familiarity with the many nuances and unique features of the markets that make up the Middle East.

Risk: Reality and Perception, Art and Science

Risk and its assessment are grounded in fact and supported by science, yet both are inextricably linked to perception, and shaped by subjective analysis that is far from scientific in nature.

It is this blend of objective and subjective reasoning that allows equally valid and defensible assessments of a commercial opportunity to arrive at completely opposite conclusions. This dynamic is what allows markets to work; stocks, financial instruments and currencies to be traded; and certain business entities to pursue international commerce, while others remain fully focused on domestic business. It is this same dynamic of risk and risk assessment that drove pioneers to Africa and China, or that attracted investors to Dubai and the United Arab Emirates (UAE) over the course of the last 30 years.

The combination of objective risk and perception-based risk is critical in shaping the trading environment faced by countries and companies from the Middle East. Political realities aside for the moment, we have observed many instances over the past 20 years or more, where perceptions were permitted to outweigh objective fact in shaping the risk assessments of importers, exporters, trade financiers and other specialists, in the Middle East and elsewhere.

One North American financial institution saw an opportunity to finance the export of certain commodities to Iran years ago, and was only able to gain approval from its credit committee after flying a senior credit executive to Tehran to help shape a more balanced assessment of the risk/opportunity profile at play during that period.

More recently, the pre-financial crisis real estate boom in Dubai attracted the attention of a North American government agency responsible for promoting real estate and construction-related exports from its home country. Concrete action followed only after members of the agency's executive were briefed in some detail about the opportunities and market conditions, and further educated through a fact-finding mission.

Risk assessment, whether at the country, bank or company level, is a sophisticated but still evolving discipline and, even in ideal circumstances, where high-quality information is available and trusted, there is always an element of judgment.

In the Middle East, where relationships remain core to business and the availability of fundamental tools of risk assessment – such as audited financial statements – is far from assured, judgment and local knowledge become crucial to effective risk assessment and mitigation. As one senior credit officer in Kuwait described some months ago, his efforts at instituting objective credit assessment discipline was immediately challenged by one supplier seeking credit, who offered several sets of (very different) financial statements in an effort to meet the requirements of the buyer's credit team.

While trade has been interwoven in the history of the Middle East since its earliest days, doing business in the region can be a challenging proposition – both in perception and in fact – for those not familiar with the unique features and dynamics of the region. Is it sufficient for importers and exporters based in the

Middle East, or pursuing business in the region, to continue to rely on their trade banks, insurers and other service providers, in matters related to risk management and mitigation?

Regulatory and Compliance Requirements

The complexities of assessing and effectively managing risk in the Middle East are further compounded by regulatory and compliance requirements faced by importers, exporters, bankers and others engaged in international business in the region.

The compliance requirements imposed upon trade finance banks have become far more stringent over the past three to four years than was previously the case, and the full implications of the evolving regulatory and compliance regime across the globe are, to date, not fully understood.

At the most fundamental level, the now-familiar "Know Your Client" (KYC) rule, which originated in investment banking, and has since been applied to other areas of financial services – including trade finance – has been slowly but inexorably extended to a variation dubbed the "KYC-C rule" or "Know Your Client's Client". A seemingly simple change with profound implications for the responsibilities, accountability and potential liability of trade finance banks.

Through a combination of factors, from anti-money laundering and anti-terrorism measures, to financial oversight objectives arising from spectacular failures such as Enron, WorldCom and others, the compliance requirements imposed on financial institutions have increased significantly.[1] The requirement for banks to maintain adequate financial reserves against various types of loans, as defined under Basel II,[2] also factor into the regulatory and compliance challenges faced by financial institutions across the globe.

Trade finance executives at a major trade bank in Europe summed up the challenge by noting that the evolving framework requires them to know their own clients, but also to know something about the trading partners of their clients – even in remote parts of Africa where information about businesses, financial flows and specific transactions is difficult to come by.

The challenge to bankers is made even more difficult by the reality that the regulatory and compliance environment is in a state of dynamic evolution and compliance specialists will concur that the full implications of the emerging regulatory environment need to be fully studied to be understood.

Banks throughout the world are working to respond to the convergence of various compliance programmes and are faced with the challenge of balancing compliance requirements against the need to facilitate the successful conduct of business.

Risk Management: Towards a Partnership Approach

In light of the foregoing discussion on risk, as well as in consideration of the increasing regulatory and compliance requirements faced by trade banks across the globe, it is our view that traditional, one-sided reliance by importers and exporters on their banks to provide risk management solutions will be increasingly ineffective and unsustainable.

The Middle East, with its unrivalled history in trade and abiding respect for the importance of business relationships, is well positioned to lead in the development of a partnership-based approach to risk management between financial institutions and their clients. Transparency in trade, both at the transaction level and at the level of trading relationships, will be the most effective counter-balancing force to the dynamics of risk-perception and stringent compliance described earlier.

While issues of commercial confidentiality must be considered, a trade financier should ideally be a trusted partner. In the end, transparency leading to a reduction in risk ascribed to a transaction will lead very

1. *High-profile corporate scandals at corporations Enron, WorldCom and others led to the passing of legislation such as the US Sarbanes-Oxley Act 2002, to introduce new and better standards for accounting and investor protection.*
2. *The revised accord issued by the Basel Committee on Banking Supervision in 2004 to create an international framework for bank capital requirements.*

directly to tangible financial benefits. Reduced risk generally leads to lower transaction costs, which should flow through to the importer or exporter contributing to increased transparency.

At the same time, this increased transparency and clarity will tend to reduce the overall risk profile of the trade bank's portfolio of transactions in the region, likely extending the institution's capacity to support further trade – a winning outcome for all concerned.

Given the emerging realities of global commerce, the old, one-sided and passive approach to risk management practised by businesses around the world no longer makes good commercial sense. The more information that can be contributed to the creation of an accurate risk profile, the more effectively the trading system will work for all concerned, and this requires importers and exporters to take an active role in painting the risk and compliance picture around their business relationships, transactions and even specific shipments of goods.

New trade finance solutions and models built around the dynamics of global supply chains have recognised the importance of free-flowing information and have, to varying degrees, relied upon increasing levels of transparency – both among members of the supply chain, and between those members and their bankers.

While the Middle East has taken steps to move towards the open account and supply chain-based trade finance models, the region remains relatively active in the use of traditional instruments such as documentary credits, and therefore effectively bridges both traditional trade finance solutions and emerging models of trade finance. The region also remains more "traditionalist" in its ongoing reliance on relationships and a firm handshake – which should make the concept of a partnership-based risk management model both compelling and intriguing.

It may even be appropriate to suggest that the partnership-based approach to risk management and to transparency are very well suited to complement certain principles of partnership and ownership that are elements of Islamic finance, including the increasingly important dimension of Islamic trade finance.

Overall, the global landscape of compliance and risk management has changed significantly in a very short period, and will continue to evolve over several years – perhaps precipitated by the current global financial crisis. The questions now facing the region is how the Middle East will respond, and whether there is an opportunity for the region to take a role in shaping the response of the trading community to the demands of compliance and regulation.