Traditional trade finance: twilight or watershed?

Trade finance is, most would agree, a mature business with a well-established, admirably global value proposition, but one which has historically lacked a creative energy. Is this mature banking service heading into a twilight period, or are recent developments akin to a watershed event in the life of trade finance? Alexander R. Malaket illuminates some of the challenges and opportunities that preoccupy senior specialists across the globe.

Trade finance in flux

Trade finance is, some argue, at the most dynamic and interesting cross-roads it has encountered as an industry in perhaps a quarter-century or more.

International trade is vibrant and dynamic, the global economic order is being reshaped, technology is enabling the conception – and implementation – of significantly new business models and value propositions, and new trading partnerships are redefining the landscape of trade finance.

There is a palpable energy and enthusiasm around trade finance, and for some, a renewed optimism about the potential and the value represented by this esoteric line of business, both among established players and among new entrants to the finance of international commerce.

Asked about some key challenges and opportunities which figure prominently in their respective views of the world of trade finance today, several senior executives appeared to agree on one thing at least: it is difficult to usefully distinguish a challenge from an opportunity, or vice versa: much like the symbol of Yin and Yang (with apologies for the simplistic interpretation) , they are intertwined, sometimes indistinguishable, complementary, and each necessary for the existence of the other to make sense.

"One of the challenges, and opportunities, we are looking at is the shift from traditional trade products to open account and supply chain finance. This relates to resolving the 'one-to-many' challenge: how to devise a replicable transaction model which allows us to deliver client-specific solutions while enabling the efficient handling of large volumes of transactions across the globe", observes Keith Karako, global head of trade finance at Citi in New York.

The changing value proposition

The value proposition around trade finance is inexorably changing, in obvious ways such as the shift from traditional products to open account and supply chain finance (SCF) as well as in more subtle ways, such as the increased reliance of importers and exporters on trade-related advisory services – obtained from their bankers.

Trade customers, we are told, are increasingly ignoring the distinction between domestic and international operations as far as payments and financing are concerned. The search for an integrated, market-independent solution – especially at the upper ends of the market – is well on.

As James Hogan, group head of supply chain management and head of trade services North America at HSBC in New York sees it: "We are seeing increased demand and higher expectations from clients about the scope and level of expertise of trade financiers in broader matters related to international trade: our clients increasingly look to us for advisory support in areas such as sourcing of raw materials, local pricing and margins. HSBC can leverage an unmatched global footprint, together with the expertise of our in-coun-

try trade teams to respond effectively to client requirements in these areas, going as far as to introduce clients who might successfully do business together."

The change in value proposition is acknowledged across the globe.

The United Arab Emirates, more particularly Dubai, has depended heavily on traditional trade finance mechanisms such as the letter of credit (LC), yet trade financiers there – where the market is very active right through into the project finance end of the business – see the shift and the changing value proposition clearly, and are actively looking for ways to respond.

"We are very active in trade and project finance at CBD, and more widely across the region. Liquidity is high, with minimal exposure to the current sub-prime crisis, and the business pipeline is very healthy. Trade finance here is traditionally based on LC's, however our attention is being engaged by a shift to open account. It will take some time for banks and corporates to find an effective model to work together, but we are actively assessing options and looking for innovative trade financing options," notes Lakshmanan Sankaran, head of trade finance at the Commercial Bank of Dubai (CBD).

There is some expectation that in this 'new' market, that the advantage of the 'first entrant' in terms of providing viable solutions will be an important differentiator and will generate substantive business benefits. Top-tier trade banks are working to devise value propositions based on their global footprints, while visionary large and mid-tier banks invest energy in carving out differentiated niches, or in enlarging their footprint through carefully devised, correspondent-based partnerships.

The debate of whether supply chain finance or open account trade represents a meaningful development in trade finance does not enter into the discussion, when considering the 'challenge and opportunity' question.

Fundamentally, the debate turns on how best to understand the development, and then, how to most effectively (and profitably) respond to it. As one executive noted, '...in our market, virtually every customer we speak with is interested in supply chain finance – and that, despite the (temporary) shift back to LC's resulting from the sub-prime crisis'

Notes Sanjiv Sanghvi, president and CEO, Wells Fargo HSBC Trade Bank in San Francisco: "Payables management will be an important element of the value offered by banks to their trading clients; we view sellers as agnostic to payment methods, however, the market is clearly responding to the current credit crisis, looking for ways to extract value from settlement processes. Buyers are keen to make things easier for their suppliers from a transaction point of view. A holistic cash and trade solution is one way banks can respond to the needs of their clients on both sides of a trade deal."

This is clearly not 'smoke and mirrors' for a number of senior trade specialists. Less so, in fact, because supply chain finance is event-triggered, and with the right delivery, generates demonstrable financial returns beyond the pure availability of a financing solution, through reduced transaction costs.

The tailoring of custom solutions is a key differentiator for some. It is not enough to make a successful transition from an LC processing model to an integrated 'working capital' processing model. Devising customer-centric solutions, in close consultation with customers across a variety of geographies and market segments, is the clear path the follow. The high rate of customization available in the market today is also, arguably, a function of the fact that product solutions – and best practices – are still very much in development.

According to a major European bank, trade financiers need to get closer to their customers, and in particular, must better understand and integrate with those clients' global supply chains. The banks must question current product offerings in response to emerging demands.

Supply chain-based trade finance, as it is evolving, offers numerous levels of value, such as diversifying sources of working capital finance for clients, improving importer balance-sheet management by shifting liabilities from bankers to suppliers, and enabling the derivation of financial efficiencies across a supply chain. Buyers can also extend payable cycles – generally an additional 60 to 90 days – without adversely impacting supplier cashflow.

The effective development of a comprehensive supply chain finance solution by one trade bank, in a vertically integrated industry – such as mining, or the production of mobile phones, for example – illustrates the compelling opportunities to derive cost savings through SCF.

"At ANZ, we have opted to understand the working capital requirements end-to-end within a supply chain – not necessarily to provide the full range of possible solutions, but rather to ensure that our offerings generate value for both buyer and seller, thereby assuring uptake, and allowing us to best serve the needs of our customer", observes Wayne Jobson, head of funding and supply chain products, working capital, at ANZ in Melbourne.

Risk and the economic landscape

Current economic conditions, linked at least in part to the sub-prime crisis are understandably cited as a challenge in the trade finance business – as much due to the lack of clarity on the scope and possible duration of the crisis, as in terms of an appropriate 'solution' to be offered to importers and exporters.

While some markets are reeling, by the reckoning of at least one senior trade executive, the major markets in Asia are asking "What recession...?". The question then becomes, whether these markets are well-insulated or even decoupled in some way (despite the obvious co-dependence inherent in the trade flows today) from this crisis.

Is the crisis 'purely financial', asks a senior European banker, or will it reach materially into the goods involved and into the businesses engaged in trade?

Whatever the answer, and despite a trend noted over the last quarter that has seen a shift back toward the use of LC's, the contention is that one of the consequences (both opportunity and challenge) for➤

➤trade, is the need for the development of far more nuanced risk mitigation models and solutions, at the transaction level and at the level of each key counterparty.

This will be especially true for those trade financiers who indicate, as some do, that they retain an appetite for financings at the longer end of the market despite some pullback to short-term trade finance.

The economic landscape has also reinforced a development which became apparent in the latter part of 2007.

Expertise and staffing

Staffing, expertise and 'talent management' are both a major challenge and a key differentiator in the emerging value propositions around trade finance.

From the United States to the United Arab Emirates, the issue of staffing around trade finance is identified as one that demands attention. The industry is in an 'up-cycle' according to a trade executive in New York, and a combination of trade finance skills together with fundamental banking competencies will be critical to assuring effective product development and service delivery in trade finance.

Observes Sankaran at CBD, "We face several interesting challenges and opportunities in the Emirates, including effective management of a very multicultural workforce, together with high turnover rates resulting from a shortage of trade finance specialists – at the operations and the structured finance levels. Talent management is critical in this market, and includes consideration of engaging and developing Emirati Nationals in banking and trade finance."

Similar challenges are identified by senior trade specialists at leading global banks. Talent management, and as one executive refers to it, trade-related intellectual competence, will be a central consideration for trade finance businesses, as product complexity increases, sales cycles extend and the need for professional interactions at all levels – including operations – increases.

For trade bankers who perceive a greater demand for advisory support, including expertise in local pricing and margins, international sourcing and a wide range of areas traditionally not within the value proposition of most financial institutions, the importance of banking, credit and risk management skills comes to the fore.

While some banks work to develop integrated, silo-independent trade operations groups to ensure effective delivery, others indicate that they have succeeded in defining delivery requirements related to SCF, open account and related products, in a manner which closely mirrors traditional trade operations activities – allowing also that they have achieved a high rate of 'straight through processing' under the new offerings.

For global banks, or those with extensive international operations, the need to deliver services at uniform levels of quality and competence across their business – and across various points of contact with their global customers. Similarly, the larger players must allow for the different skillsets required for effective in-market service delivery, as opposed to those needed for optimal centralized processing staffs – further refining skills related to SME versus MNC expectations and delivery requirements.

The retention of staff is a strikingly common concern across mature trade finance markets as well as in newer areas of trade finance activity. While sales and business development roles may, by the nature of their position in a financial institution , imply higher rates of turnover, there is also attention at the operations level, where significant historical perspective resides in trade banking businesses.

One financial institution indicated previously that its team had refined its operations training to the point that it is capable of ramping up a competent trade operations specialist within six months as opposed to the more common two to four years: a competitive advantage indeed, especially when met with the skepticism which some competitors express at this model.

Technology

Information technology is central to the developments and evolving requirements around trade and trade finance, just as it is fundamental to the solutions being contemplated, designed and implemented – by trade finance businesses ranging from local to global.

While one US-based executive describes the advent of a technology 'arms race' in trade finance, an Asia-based trade financier perceives that emerging demands will not successfully be met by a single bank, but notes rather that 'interoperability' will be critical to the long term viability of the trade value proposition.

Several executives expressed, in varying ways, the need to move beyond a one-off transaction based model, to a platform-based, 'mass production' model in the delivery of SCF, payables management and outsourced accounts receivable/payable offerings.

In addition to driving out processing efficiencies and reducing transaction costs (familiar objectives which drove the trade processing factory models and the offshoring efforts of the recent past), trade bankers see an opportunity to leverage technology to mine the vast data stores of global importers and exporters, not only to better service those clients, but also to be able to cross-reference this data in service of other clients across the trade finance line of business.

US-based clients seem a bit resistant to the concept – though discussions are advancing – whereas European clients are less resistant in principal, but less well disposed to the extent that this will require process changes or incremental effort on their part.

Irrespective of the issues involved, the mere fact of exploring this type of information-sharing and transparency has significant implications for a concept which will be next in the evolution: from physical supply chain to financial supply chain, we are inexorably shifting focus to the global information supply chain: another challenge/opportunity which will be faced by trade financiers over the coming near future.

Interestingly, attention to the 'information supply chain management' (shall we add the acronym I-SCM to the growing list?) will relate very closely to a perennial challenge which is almost deafening by its absence in these discussions: the regulatory and compliance aspect of trade finance. ■