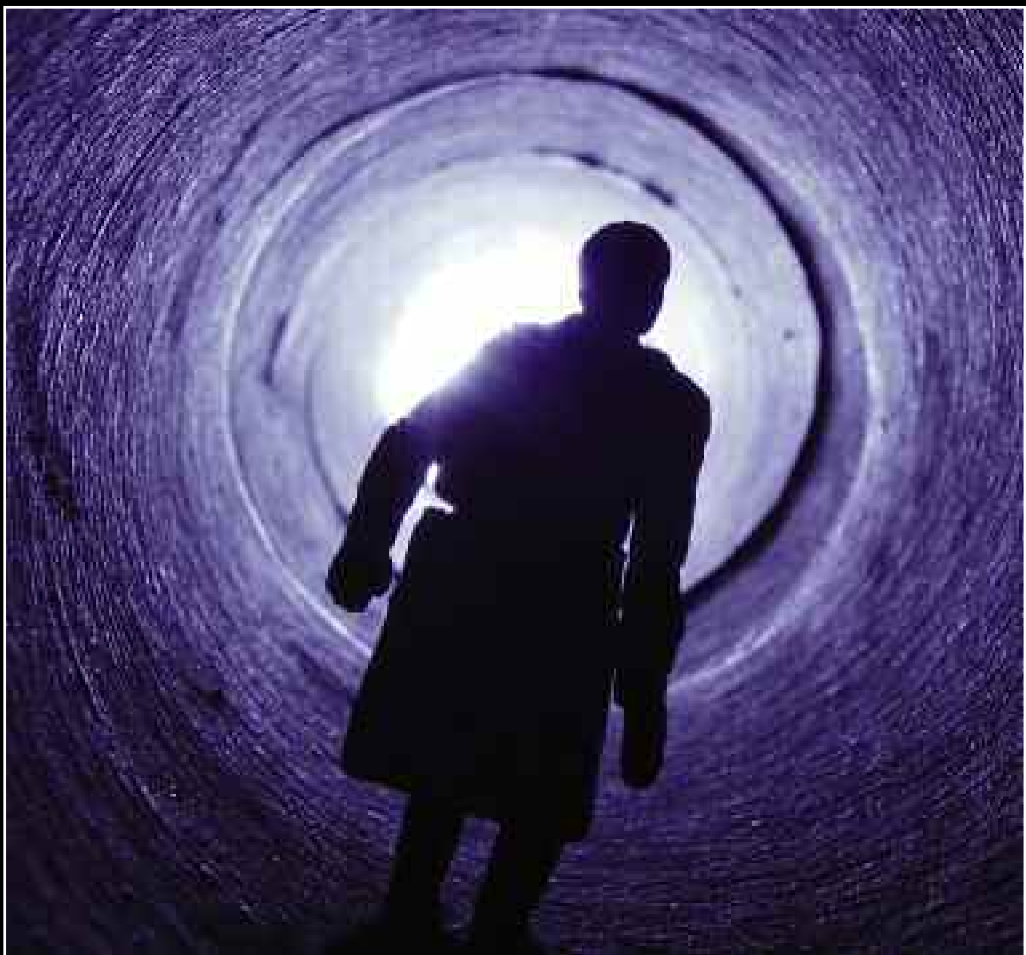
Cover Story

Light at the end of the tunnel?

The global financial crisis, sparked by sub-prime lending and the use of high-risk, poorly understood financial instruments, has set off a worldwide downturn unlike any seen in a generation. Falling commodity prices, and the spread of recession, hundreds of billions in government bailouts – and with all this, dare we contemplate the idea of trade – and trade finance – coming out of the tunnel? The realities are harsh, and their full implications are not yet known; is there room for tactful, cautious optimism? Alexander R. Malaket takes a forward-looking view on some aspects of the questions that are on the minds of leading trade finance specialists across the globe.



Trade finance in crisis

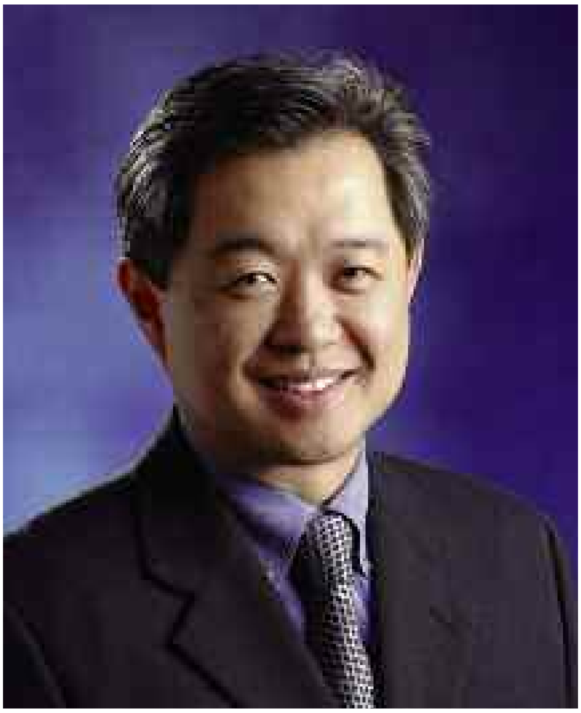
There is no denying that the world has been dealt a serious shock, as close to the Great Depression as we have come since those dark days, by some accounts more serious than the oil shocks of the early seventies, the meltdown of the mid-eighties and the various regional and local crises we have worked through since then.

Market analysts have noted that further implosions – likely more severe than that triggered by the sub-prime debacle – will follow, and that the full impact of those follow-on crises is even more opaque and unpredictable than the mortgage-related crisis. In reality, this is no longer a financial downturn, but one which encompasses whole industries, and has no particular respect for geographic borders or locally-focused remedies.

We are witnessing hundreds of billions in government bailouts, public-sector engagement at the highest levels, even from staunch free-market advocates; a complex balancing act for world leaders as they work to protect national interest (and political futures), all the while realising that global interdependence and interconnectedness has outpaced our ability to comprehend its scope and implications; unprecedented levels of coordination and collaboration ... and in the midst of all this, one of the great engines of global growth stands both as symbol of hope and an illustration of the depth of the downturn.

Trade, long a driving force of the global economic engine, has been directly impacted by the crisis – whether through restrictions on credit and financing, congestion in shipping traffic, or increased risk-aversion on the part of traders and bankers alike – the consequences are apparent, confirmed by a reduction in the rate of growth of global commerce.

The financing of international trade – both at the long-term end, as well as at the traditionally more robust short-term side, has been caught in the storm.



Kah-Chye Tan at Standard Chartered in Singapore

The seriousness of the situation was strikingly illustrated by a call for urgent discussion of the issue, directly from the highest levels of the WTO.

Crisis and opportunity: two sides of the trade finance coin

All realities acknowledged and rose-coloured-glasses firmly set aside, it remains true that despite the clear challenges, and significant contractions in certain regions (and industries) – including hard-hit emerging markets and the SME segment – trade remains a growth business.

Perhaps more importantly, international commerce retains a high profile on the agendas of governments, international agencies and board rooms across the globe. The recognition of the importance of trade, and the acknowledgment of interdependence, have motivated positive rhetoric and firm action in support of the world trading system, even as the brightest minds give urgent consideration to the redesign of the global financial system.

Trade finance has given equal time to both sides in the course of this crisis and the ensuing downturn – crisis and opportunity have both been in evidence, as can be seen from a consideration of some of the enduring themes and issues facing our industry.

Kah-Chye Tan, global head of trade finance at Standard Chartered in Singapore, sets the stage in our consideration of the situation, observing that "the financial crisis continues to have serious consequences across the globe, yet we are seeing signs that allow for cautious optimism. Trade continues to show net growth, remains a key driver of the global economy, and will be key to unlocking real value in the international system. Trade finance is a core business for Standard Chartered, we continue to invest and innovate, focus on a relationship approach to business, while seeking to refine our risk and capital management practices. In the end, we have been fortunate to achieve a record year in trade finance despite the turmoil."

Consolidation and capacity

A recent estimate indicated that there is a global financing gap in international trade, exceeding $25 billion. Traders report difficulty in accessing funding, and pricing was materially above normal for some period, to the point that some trade banks were charging a 'liquidity premium' in financing other banks in need of support.

Financial institutions – including investment banks that had become active in financing trade through the capital markets – are in the midst of a crisis-fuelled consolidation which has seen serious players in trade finance taken over. Does this wave of M&A activity, and the industry-level consolidation suggest the reshaping of the trade finance landscape, and if so, does it follow that capacity on a global level will contract?

Some perceive that one outcome of the crisis will be a significant consolidation of providers of trade finance, arguing that the business of financing trade will become (more quickly than was already the trend) a business for global banks with deep pockets. Staying power, global footprints, access to capital, and the internal support necessary to sustain investments in➤

➤technology, they argue, will drive marginal players to outsource, or to exit the business altogether.

The other side of the argument suggests that partnerships between global financial institutions and regional/local players will become increasingly important, and that this dynamic will assure a certain diversity among providers of trade finance.

While some banks indicate that the business of insourcing trade processing is developing momentum, others note that financial institutions, like their clients, are looking to new partnership models to enable their business models. Some level of consolidation is inevitable on a global scale, given that it has been a firmly established characteristic of the industry for years, yet senior executives with several global trade finance providers have indicated that enough opportunity remains, and enough demand is in the system, to sustain – indeed require – the continued engagement of regional and niche providers of trade finance.

Elizabeth Atkins, head of sales and working capital solutions at Wells Fargo HSBC Trade Bank in San Francisco does see something of a silver lining in the current circumstances. Notes Atkins: "We are seeing a unique and encouraging dynamic – a flight to quality – as a direct result of the current crisis. We have had customers thank us for being able to stay with them through the downturn, and given the strategic nature of this business for us, we are fortunate to have strong support from our senior credit officers, which has allowed us to operate at levels closer to capacity than one might expect. In addition to business on the commercial side, we have seen correspondent banks in certain markets sending their clients to high-quality US names in trade finance. There is opportunity in crisis."

Risk appetite

Trade bankers are often taken to task for being risk-averse, particularly in financing trade in emerging markets, and in supporting the international aspirations of SME's.

Elizabeth Atkins at Wells Fargo HSBC Trade Bank in San Francisco

The International Chamber of Commerce (ICC) in Paris, the International Trade Centre (ITC) in Geneva and others have reported that the crisis has adversely affected both emerging markets trade finance, and the availability of funding in support of mid-market and SME clients, to a greater degree than other markets and client segments.

Commodity trade finance has been impacted, and long-trusted instruments such as standby letters of credit (LC) and confirmed LC's have been more difficult to secure, and less readily accepted (in some circumstances) than has been the case historically.

Perhaps more concerning is the reality that banks (and/or their clients) are abusing the system by actively seeking immaterial discrepancies in export documents, to avoid exposure or to avoid paying altogether when such an 'out' is deemed necessary. Banks remain, by at least one assessment, extremely vulnerable due to heavily leveraged balance sheets, and despite the infusion of government monies.

Is this all indicative of a destructive risk-aversion and conservatism within the circles of trade finance?

Not necessarily.

New guarantee programmes have been developed and rolled-out, leading export credit and insurance agencies have been actively working to support a smoother functioning of trade and trade finance, and the activities of multilateral institutions through their various trade finance programmes have been happily visible and substantive. Some have been working with top trade banks to devise new programmes tailored to the current situation.

While some trade financiers are retreating in terms of risk appetite and market coverage, others are taking a more strategic view – often buoyed by internal support that is lacking within their competitors' financial institutions. The strategic view here includes the realisation, incorporated into internal decision making, that the risk profile of clients has changed materially, and the adjudication disciplines in place will need refining.

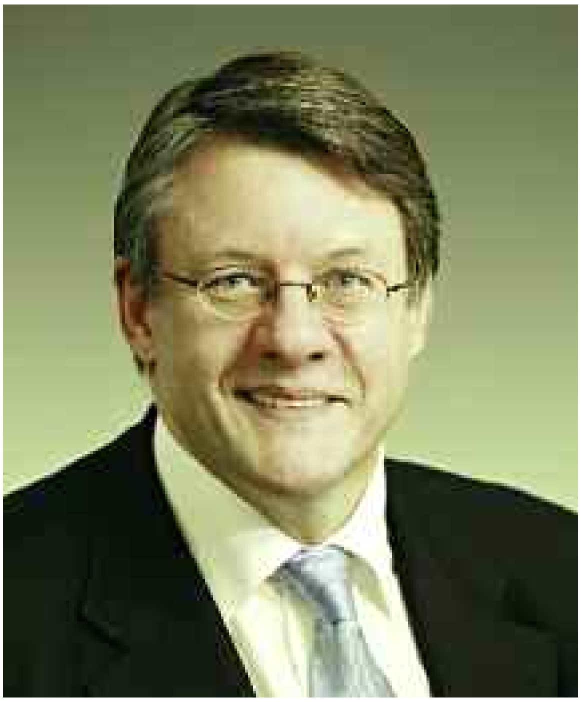
The present high demand for financing, and internal battles for capital and credit lines which occupy many senior bankers is raising awareness of the favourable risk, capital and profitability profile of trade finance.

Senior bank executives with little or no trade experience are now hearing the long-played tune: trade finance, with its contingent liability structure, favourable treatment under capital adequacy requirements, and tangible underlying transactions, offers an interesting option in terms of usage of bank capital and credit lines. Nuances previously lost to disinterest or poor communication now resonate – very likely to the long-term benefit of trade finance.

Leading trade financiers advocate a return to the fundamentals: the financing and facilitation of international trade, with focus on the underlying goods, as opposed to balance-sheet based financing and transactions. Trade finance, the message seems to be, needs to return to a focus on tangible assets and transparency in transactions, and will be happily differentiated, given that lack of transparency provided highly combustible fuel to the current crisis.

For one executive, it is equally important to consider risk management as it is to discuss risk appetite. Discussion on this point led to the conclusion that trade financiers have done well in designing the airbags around trade transactions, but failed to ensure lubrication for the engine – and therefore rendered the airbags useless.

Daniel Cotti, head of global trade finance at RBS in London, observes: "We are now dealing with the effects of the financial crisis, and it is a question of facing an economic cycle unlike anything we have seen in decades. While the situation remains serious, we believe the value proposition in trade finance remains compelling, despite a forced return to the fundamentals: sound credit skills, and a refocusing on providing liquidity by financing the actual movement of goods and the successful conclusion of a trade transaction. Trade finance is an important fuel of the global economy, and at RBS, we continue to leverage our client franchise across all market segments, across geographies offering a full suite of trade finance business solutions – even as we work our way through and out of the current cycle."



Daniel Cotti, head of global trade finance at RBS in London

Innovation

We have argued that trade banking and trade finance have seen the greatest period of creativity and innovation in a quarter-century or more.

As experts describe an increase in demand for confirmed letters of credit, and an increasing number of bankers describe some degree of return to traditional trade finance products, are we seeing the revival of the letter of credit? Will the idea that the industry was always one major crisis away from a panicked return to the LC, prove to be prescient?

Banks, technology providers and others have spent millions in the design and development of new products, services and technologies related to open account and supply chain finance – even as some players argued that there was nothing fundamentally transformational in these models, and that the solutions were not viable or sustainable.

Trade banks cannot reverse the cycle of innovation. This statement may be taken as prescriptive, in that the industry (and those for whom trade is a strategic business) can ill-afford to take a step back, especially during a downturn which will force competition for capital, credit lines and resources. The same statement is also nothing more than a statement of fact: trade financiers cannot turn back, because importers and exporters have become accustomed to the 'new' models, with large global retailers and others already having invested in technologies and business processes in support of open account trade and supply chain finance.

Over the last two or three years in particular, the acceptance – even demand – for open account terms even in what were once high-risk markets, has been accelerating steadily, and the under-appreciated letter of credit is unlikely to rise out of the ashes of the current downturn.

The drive to innovate, such as it has been in our industry, will not lose its momentum as a result of the crisis. Trade executives make the point rather convincingly, that this is precisely the time to keep innovation going, and this too, suggests a fundamental and enduring confidence in the value proposition around trade finance. Innovation, for one executive, was about offering flexibility and options – not replacing existing solutions.

The importance of business partnerships combines well with the need for ongoing innovation in the minds of thought-leaders.

Marilyn Spearing, global head of trade finance and cash management corporates at Deutsche Bank in London, observes: "One of the developments we are seeing is a greater emphasis on partnerships in all aspects of the trade finance value proposition – be that in relationships between banks seeking to leverage technology, market presence or risk appetite, or indeed between corporates. Our discussions are focusing on clients taking a more holistic view of their global supply chains and distribution networks, realizing that their own success is closely linked to the health and viability of key business partners. Deutsche Bank remains very engaged in trade finance, and we are working with our clients to facilitate solutions across supply chains, in partnership mode, through this crisis."

The people factor

Trade finance is, most would agree, an esoteric and poorly understood business. In fact, we have been seeing an emerging shortage in professional skills in this domain, both at the transactional/operational level, and in the credit and structured finance side of the business – the former because less young people are enticed by long-term careers in detail-oriented documentary operations, and the latter, because truly tested executives who have seen and understand the downside of the market were, until now, a dwindling group.

Only months ago, one could engage in conversations in Europe, Asia, the Middle East and all points beyond, about the shortage of trade finance specialists and the ➤

➤ premiums commended by leaders in the field.

Given the present situation – from consolidations to shrinking deal pipelines to finance-related lay-offs numbering in the tens of thousands, one could ask, is the situation about to take a 180-dgree turn, leading to a glut of trade financiers at a time when the industry is in contraction?

As with the innovation discussion, the business of trade finance set certain things in motion over the last several years that may prove very beneficial as we work through the crisis and ensuing downturn.

A number of leading financial institutions envisioned and implemented an integration of lines of business such as trade finance, cash management and correspondent banking – some taking it further into payments businesses or global transaction groups.

While investment bankers in Wall Street and elsewhere struggle in the midst of an industry-wide bloodletting, trade finance banks for whom the business is strategic, perceive an opportunity to secure high-quality specialist resources as other banks retreat from certain markets.

Internal structures and integrated organization now offer a wider variety of career options, and more channels through which (and from which) to develop trade finance skills. International business may be in the DNA of some, or an acquired taste for others. For many (most?) trade finance specialists, it is to conventional banking what fine wine might be to grape juice.

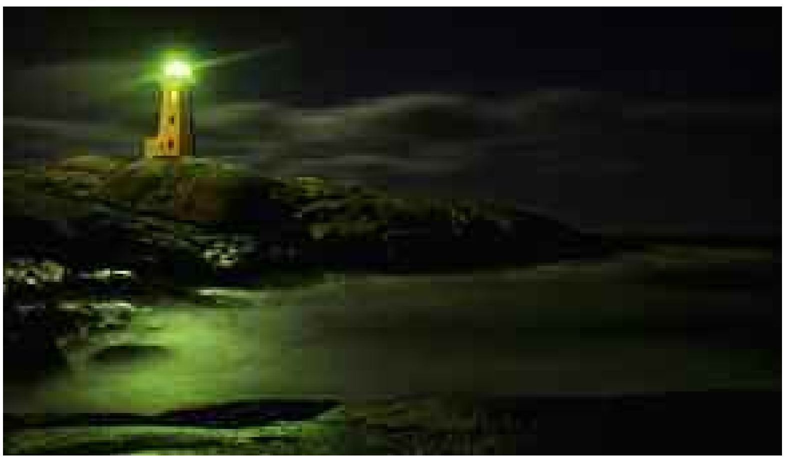
Those looking cautiously beyond the end of the tunnel envision a future where expertise in, commitment to, and a passion for trade finance is not only conceivable, but imperative.

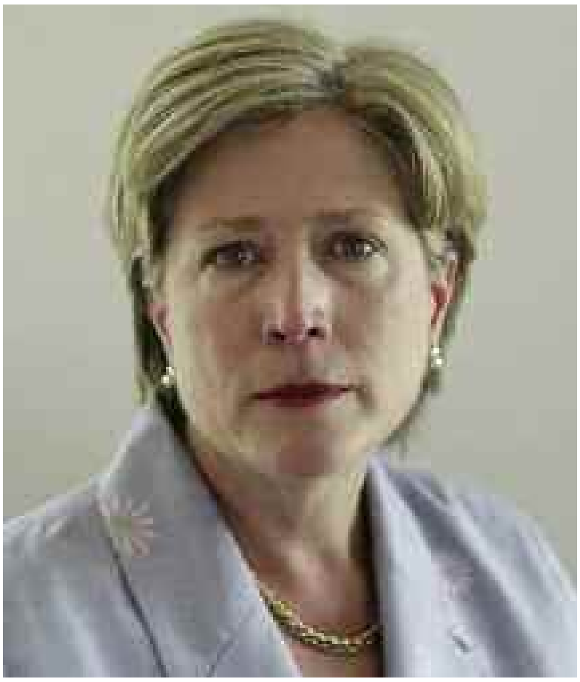
Top-flight trade finance specialists will be invaluable in the current circumstances, as well as in the next phase, because skilled, committed specialists are critical to one other dimension of the business: taking a relationship approach with clients.

Take care of the relationships

Several executives over the past months have expressed the importance for them, of taking a long-term, relationship focused approach, which entails 'being there' for key clients and in key markets, and helping those clients to do the same for their business partners.

The relationship approach requires the discipline not to take an opportunistic, transactional approach with non-clients whose motivations are shaped by crisis, and whose profile would not otherwise fit with a financial institution's client base.





Marilyn Spearing at Deutsche Bank in London and Frankfurt

Yes, it has been possible to earn 'fast money' through inflated returns, liquidity premia and net-new client transactions – to the point that there are anecdotes in the market about trade finance businesses closing their books early, having exceeded all targets and hit credit line ceilings.

There are trade financiers who have remained focused on core clients, intentionally steered away from extraordinary, one-off business transactions and wilfully kept pricing under control, preferring to forego the return in exchange for goodwill and its longer-term payoffs.

Bruce Proctor, managing director, global trade services at JPMorgan, in New York summarises the situation as follows: "We believe it is critically important, both during this downturn and as the situation starts to normalise slowly, to continue to take a long-term view. At JPMorgan, we continue to see trade and trade finance as a core business, and we will focus our efforts on client relationships – corporates and banks – all the while maintaining our commitment to innovation and the delivery of better products and services to our customers. We certainly see changes in the market as result of the crisis – such as the greater engagement of governments and international financial institutions – but fundamentally, trade continues, and we are staying the course through this cycle."

Our discussions with trade financiers across the globe, including those whose insights enrich this article, are a reminder that in most cases, a crisis is less important in determining long-term survival and success, than the manner in which one reacts to that crisis.

There is light at the end of this tunnel, and we can now suggest with some confidence that it is not a freight train coming at us, but rather, the glimmer of a lighthouse showing us the way back to port, so that we may continue the work of financing global commerce. ■