Hidden gem or fool's gold?

Do trade operations present a revenue opportunity, or is it time to acknowledge that operational capabilities in trade finance should simply be viewed as a sunk cost? The question of profit and loss visibility in trade finance is perennial – what are the implications of the acknowledged shift to open account business? As transactions shift from LCs to open account, what will the net contribution of operations look like? Alexander R. Malaket explores some of the market-leading thought and trends in this area.

A question of visibility

The business of trade finance is seen, and managed, very differently across financial institutions, and its potential as a bank line of business, in the context of a bank's portfolio of offerings, is given a range of priorities, depending on the perceptions of its potential. At one extreme, the view is that trade finance can be an interesting loss-leader, or must be maintained as part of a portfolio of commercial and corporate banking solutions. The other end of the spectrum views trade finance as a compelling, highly profitable business with an attractive regulatory capital profile, particularly in certain niches and markets, perhaps with some attention to the structured side of the business.

The recurring challenge has been, and for many (most?) trade finance businesses, continues to be, achieving a level of convincing and verifiable clarity about the contribution of the operations side of trade finance.

Anecdotal views are widely circulated, and for many years, the conventional view has been that trade operations are generally money-losing propositions. Even the much-vaunted 'factory models' of trade processing, which sought to minimize cost by driving volume through their vast an expensive capabilities, were challenged in understanding the final contribution of their large, often global capabilities.

Trade finance operations are the source of transaction processing costs, product contributions to revenue – in fact, product-level profit and loss (P&L) – yet for many banks, the challenge of capturing those metrics appropriately is one recurring complication. In the event that the metrics should show a favourable net contribution to the bank's bottom line, it does not always follow that the source of that contribution is recognized as a trade finance operation or capability.

Trade services operations lack visibility in the context of most banks' international divisions, and are often little more than an afterthought in the context of a bank's full set of product and service offerings, and the supporting capabilities associated with those other offerings.

The solution starts with you

If a trade bank's operations group is to be properly assessed, measured and valued within a bank's portfolio, and if the optimal strategy for a given bank's trade business and operations is to be devised, P&L clarity must be achieved at the line of business level first. Additionally, any related value contributed by the operational capability should be reflected in the message crafted by trade executives, about the overall contribution of trade operations.

The option to outsource trade processing is a very real option today, supported and enabled by numerous providers with extensive capabilities, and offering a far clearer and more easily demonstrable value propositions than was the case even a few short years ago.➤

➤For certain banks (and that number is probably growing by the day), the outsourcing option is not only logical, it is almost unavoidable. Others are at a crossroads, facing decisions about whether it makes sense to preserve an internal processing capability, and several of the more global banks – including the insourcers – perceive a real opportunity in maintaining, investing in and growing their processing power plants.

Regardless of the position of a given bank on this spectrum, P&L and 'value' clarity relative to the trade operations business is fundamental, yet woefully lacking, and in many trade banks, strikingly low on the list of priorities. This will only be remedied if senior trade bankers make it an imperative to understand the fundamentals of this business, and to communicate the value with integrity and conviction within their respective financial institutions.

Bruce Proctor, head of global trade services at JPMorgan Chase, observes: "There is a very interesting case to be made for the resurgence of the trade finance business; we see profitability in the traditional product areas as well as in open account and supply chain management business. The key for us is to focus on creativity: a solution-orientation that shifts away from providing trade finance as a commodity product."

An academic discussion?

Is this shaping up to be an academic discussion, or are we exploring a legitimate business issue and a real challenge faced by trade bankers, trade operations executives and other stakeholders?

Consider the case of a consultancy engagement that took place some time ago (and has probably been mirrored many times, before and since). A team of consultants, including trade finance and operations subject matter experts, were engaged to assist a major trade bank in considering options related to it operations, business model and technology, with some attention to various outsourcing options.

Bruce Proctor, head of global trade services at JPMorgan Chase in New York

One key challenge for the bank, and for the consulting team, related to the lack of clarity around the P&L, including such fundamentals as product-level revenues and profitability, as well as basic questions about the aggregate contribution of the business, to the bank's bottom line.

Many banks make a conscious choice, driven by the need to respond to the urgent at the expense of the important, to devise complex global strategies, make transformational decisions about the business of trade finance in their institutions, and otherwise chart the future of trade operations, without benefit of clarity around value and around P&L.

The question of value and profitability of trade finance and trade operations is far from academic: it is at the nucleus of the dynamics which will shape the future of our industry, and its importance is being underestimated in many institutions. The need to understand and properly communicate value in trade finance is nudged aside in favour of a host of projects, innovations and activities which, while they might be more attractive or interesting, are not nearly as foundational.

Without clarity on value and P&L, innovations are built on weak foundations (or are deemed not viable, as the strength of the foundation is underestimated), investments are made with distorted views of payback and returns, outsourcing arrangements are arrived at using notional numbers...the consequences are very real, and the issues demand attention of executive leadership, not the cursory academic glance too frequently reserved for this issue.

The consulting team we introduced earlier, together with the bank project team, was directed to identify options, recommend a go-forward strategy that could transform the trade operations organization and the broader trade finance business – all without benefit of truly validated P&L insight, and with questionable understanding of the overall value of the business within the context of the bank.

This bank is not alone in facing the challenge of P&L, and is far from alone in having put 'the cart before the horse'; banks across North America, Europe and Asia are facing the reality of this challenge – some recognize its critical nature, others hope to manage as they have until now – perhaps failing to see that this is no longer a purely internal question, but one with implications which extend outside the offices of the bank. While some executives still wrestle with the concept of fully-loaded costs, others are working to put science behind the metrics, and to secure ownership across their organizations.

P&L takes centre stage

There are senior executives in trade finance – including trade operations – who recognize the importance of this question of value, P&L and clarity, and have internalized it to the point of moving beyond discussion, to action.

Decisions made about the viability of maintaining in-house processing capabilities versus outsourcing, choices made about whether to invest in the business of trade finance, or not, basic choices about product offerings and niche markets – can all be usefully informed by clarity around value and P&L.

The recognized global shift to open account business makes this question even more critical, given that the industry is moving to a product which is even more commoditized than its traditional offerings, and will therefore exhibit thinner margins and increasing margin compression as the shift accelerates. As product margins tighten (perhaps until new value propositions are developed), the 'margin' for error in terms of P&L will be much smaller, and the value of accuracy and robust financial metrics will increase.

Adnan Ghani, global head of trade finance at ABN Amro observes: "The challenge we see is in being able to compellingly differentiate a commodity product such as trade finance. We seek to deliver value to our customers at the lowest possible cost, and are taking a classical product management approach, where P&L is understood at the product level. ABN is combining this with a client segmentation discipline that enables our various trade-related offerings to be attractive and profitable."

Product management with the expectation of understanding product-level P&L is standard practice in some industry sectors, yet, as another senior banker observed, the financial services industry – and trade finance is very much included – has demonstrated a lack of focus and discipline in this area, and is lagging, with the exception of a few leaders.

One institution indicates that its approach includes investing significantly in MIS, incenting sales and relationship managers using a shadow accounting system which helps provide clarity and visibility on the P&L picture, and complementing regional reporting lines with product-level ownership, in a matrix structure that strikes an effective balance.

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Leading global banks have executed highly focused projects, with the intent of acquiring a thorough understanding of costing and price-points on a fully-loaded basis, and at granular levels within transactions, to the point that the cost and revenue profiles of elements of a transaction are measured. Profitability may be found in a 'piece' of a trade transaction – such as negotiation of documents under an LC, as opposed to the issuance of an import credit.

Banks in general are managing trade operations and trade finance as a fixed-cost business; leading organizations have been able, through creative staffing models, some element of outsourcing and other emerging practices, to recast trade finance as a variable cost business – enhancing the viability of the business and its ability to adapt to cyclicality.

One view was that the industry would experience greater consolidation if clarity in value and P&L were truly achieved across a large number of trade finance banks; leaders in this area of analysis appear to be confirming some long-held views about the need to invest in technology, the advantages of labour arbitrage, and the value of focusing on increasing STP, or straight-through processing in trade operations. Mid-level banks are experiencing flat to declining revenues, and the global liquidity in the market continues to compress margins, in some markets, reducing the returns by a factor of ten.

New trails for trade finance

John Ahearn, managing director, head of trade services and financial institutions, global transaction services at Citi, notes: "We have taken a very rigorous approach to understanding our costs on a fully-loaded basis at very granular levels. Globally, most banks manage trade as a fixed-cost business, whereas the leading institutions have shifted to a variable cost model. We will focus on increasing efficiency and straight-through processing, but are also looking at securitization, which we believe will make a tremendous difference in the financials related to trade banking."

Leaders in trade finance are optimistic about the prospects of the trade finance business; there are very positive expectations among several leading banks about the value of the open account business, particularly in the provision of financing solutions, with the most optimistic views looking very much forward to having open account revenues surpass those generated by the traditional portfolio of trade banking products.

Trade bankers in the top-tier institutions are very much aware of the high client retention opportunities that come from being engaged as a solution provider on the supply chain side of a client's business, and are investing significant time and effort to develop and communicate value propositions in this area. Concurrently, certain banks perceive that the opportunity for trade services is not necessarily in labour arbitrage, but rather in concentrating on a solutions view, and taking more of a 'middle office' approach to the delivery of trade finance services – promoting expertise as opposed to focusing on transaction processing costs.

The focus on – and increasing expertise in – the supply chain side of trade, allows banks to offer net-new value propositions, and in the case of a few leaders, to take financial transparency to a new level. Some banks are succeeding in earning attractive returns by leveraging their global reach to cover client supply chains. In so doing, they also provide supply chain partners with transparency about trade banking fees and charges, further cementing the buyer/seller relationships as well as increasing client retention rates for the bank, and engaging customers in ensuring the bank earns an adequate target return on a deal.

Ian Wright, SVP GTB and trade services at HSBC, notes: "Trade is in our DNA; we look at the trade➤

➤business on a global basis and take advantage of our footprint to provide full transparency to our clients about the total cost of a trade deal. That allows us to compete very effectively on service and on price, doing so on a consistent basis across the globe."

The supply chain expertise and solution set have evolved, and continue to do so, very quickly. Leading banks have devised solutions around working capital optimization – DSO (sales) DPO (payables) and now DIO (inventory) – becoming increasingly active beyond the traditional range of bank activities, and moving well into the supply chain, looking at such solutions as event-triggered financing across the life of a transaction.

Trade bankers are now drilling into details such as provisions in free trade agreements, to assist clients in minimizing 'landed cost' through appropriate customs classification of goods: the more the range of expertise broadens beyond traditional offerings, the more critical P&L clarity will become.

New value propositions in this area, together with a market segmentation approach and clarity on value and P&L will allow banks to charge in line with the value perceived by the market, and will ensure that trade financiers direct resources, financial and otherwise, to areas where the returns are highest. The idea of a profit 'architecture' in trade conveys the purposeful, structured and knowledge-driven approach to managing the business of trade finance – defined in its ever-broadening sense – that is being taken by global leaders.

The increasingly critical importance of understanding P&L, and value, in managing a trade finance business, may perhaps be well illustrated by the entry of hedge funds and investment banks into the business of trade finance, as well as by the re-emerging interest in securitization of trade-related assets. Each of these realities will push the market to take a more rigorous approach to understanding, managing and communicating value and P&L, both internally and beyond the walls of the trade bank.

John Ahearn, managing director, head of trade services and financial institutions, global transaction services at Citi in New York

For banks that can get the value propositions right, around open account and supply chain, and can do so while properly measuring and tracking to a solid P&L, the future seems to be promising. Add to that the flexibility, additional revenue streams, lower origination costs – and accounting advantages – of securitization, and the promise is amplified.

All this, however, will depend heavily on clarity and effective metrics around value and the P&L – taking an 'architecture' approach to building up the components of profitability of the trade finance business.

The perennial question echoes: is trade finance a sustainable business? Do trade services operations contribute to the bottom line, or can they? The answer is, it depends... ■