Cover Story

Trade finance tomorrow: evolving or devolving?

Alexander Malaket examines the state of the trade finance sector and puts forward ideas as to how the industry will look and operate five years from now.

Trade finance in 2015: will this business look much the same as it does today – combining long-established instruments with slowly evolving, incrementally innovative solutions evolved largely as a defensive measure? And will it still be a small part of business for the vast majority of financial institutions, and an interesting line of activity for niche providers – a critical element in the complex equation of global commerce, largely operating 'under the radar', except in times of crisis?

Will trade finance, perhaps, evolved from the global crisis of 2008/2009, start to take a more prominent, visible position among the components which sustain and enable international commerce, help drive international development and shape economic influence and prosperity across the globe?

Of course, this is extremely difficult to say.

It may well be that our business remains largely unchanged in the next five years or longer: that efforts to innovate fail miserably due to lack of uptake in the market, and that nervousness in financial sectors and among business and political leaders continues to dampen enthusiasm for international business. But this is an uninteresting and uninspiring scenario.

Far more compelling is a thesis suggesting that trade finance emerges from a game-changer such as the global crisis, as a far more visible, valued and powerful business – an activity recognised for its fundamental contributions to international prosperity and its thus far under-appreciated success in devising practices, instruments and capabilities uniquely effective across every environment and jurisdiction on the globe.

Trade finance can and will evolve significantly in the coming years, to respond to the needs of two historically underserved client groups: emerging economies (and their banks), together with small- and medium-sized businesses.

The scope of trade finance

Trade touches every critical dimension of cross-border interaction between people, companies and nations, from the movement of resources and foodstuffs, to the exchange of goods and services that enhance quality of life – for both importer and exporter. Trade moves every variation of product or service that crosses borders, and trade finance has evolved solutions and features meant to facilitate the secure flow of related financial obligations.

The activities commonly understood to comprise international commerce – whatever they are, and whatever combination of counterparties they may involve, are supported and enabled at levels of 80%-90% by trade finance. That support has been convincingly demonstrated to be critical to both the sustainability of healthy trade flows, and the recovery of economies of all types, in times of deep crisis.

Trade will, over the coming years, exhibit growth rates commensurate with the demands and requirements of massive emerging economies, evolving far beyond the simple model of 'Triangle Trade' to a complex web of 'Network Trade', crossing (perhaps criss-crossing) multiple borders both in the 'real' world and in the world of virtual commerce. Its shape and evolution will necessarily be influenced by a larger number of stakeholders with a wider range of interests, seeking more effective, innovative financing solutions to meet a wider range of requirements.

Trade finance is likely to grow and evolve in several directions and dimensions over the coming years:

- Extend across a transaction beyond traditional scope – become relevant earlier in a trade transaction, remain relevant and useful beyond the traditional 'end point'
- Extend into new/emerging sectors and realms of activity – biotechnology, environment, services sector
- Expand and increase activity in growing or underserved sectors/markets such as small businesses and developing/emerging markets
- Expand the availability of solutions in target activities, such as international development
- Devise solutions linked to online international commerce.

Over the past 10 years or so, trade finance has extended its realm of activity and value linearly. What once applied in a transaction somewhere between a signed sales contract and final settlement of a transaction, has now extended its reach, initiated earlier in a transaction, long before a sales contract is signed, and remaining relevant, partly by virtue of a focus on global supply chains, long past settlement.

This linear 'extension' of the role and applicability of trade finance has been the focus of growth and innovation to date, motivating the creation of full-service Global Trade Management solutions which have gained some traction, but not yet fulfilled their promise.

Extending trade finance

Trade finance can grow and evolve on a second dimension: the number and variety of transactions and industry/business sectors which it can support and enable, through combinations of generic and/or tailored solutions. The application of finance solutions related to aircraft sales is perhaps illustrative of the concept, even though some will argue that this specialised form of financing is not trade finance in the traditional, short-term sense.

The ability of trade finance to respond to emerging needs in the environmental sector, biotechnology, or other specialised realms of activity, perhaps including fast-growing service sector trade, will present oppor-➤

➤tunities for growth and evolution. Similarly, solutions aimed at supporting large-dollar transactions online will eventually become part of the fabric of trade finance, just as virtual commerce has become a core element of the fabric of business.

Trade finance can and will evolve significantly in the coming years, to respond to the needs of two historically underserved client groups: emerging economies (and their banks), together with small- and medium-sized businesses (SME's).

While many organisations – banks as well as public sector entities – have spoken energetically about the importance of small business, as a client segment and as a political constituency, this group remains underserved. Recent focus on global supply chains has motivated trade financiers to look at opportunities in the SME segment: senior bankers are noting that servicing small business, particularly in emerging economies, is profitable, and adds value to relationships with the large anchor clients in the supply chains being reviewed for financing.

A global supply chain view of the universe of trade finance opportunities will almost inevitably lead to greater focus on developing and emerging economies, where trade finance has tended to focus on the upper tier of the market – an approach that will not fully address the needs of increasingly integrated supply chains. The further into a supply chain a trade financier looks, beyond the anchor entity, the further into developing and emerging markets that financier will be called upon to venture.

In addition to providing interesting returns, such an extension of activity will tend to bring trade finance providers closer to the connection between international trade and international development – and by extension, to the role that trade finance can play in facilitating commerce linked to development efforts.

While a number of banks participate in development-related trade finance through letter of credit confirmations backed by guarantee programmes sponsored by various international financial institutions, this engagement is primarily at the level of financial institutions, through correspondent relationships, or through participation in IFI-supported programmes.

Supply chain-based models will involve a trade financier directly with small businesses in developing and emerging economies, either based upon the financial robustness of the anchor entity in the supply chain, or based upon a combination of revised risk tolerances and bespoke mitigation solutions, adapted to the conditions in developing markets.

Certain (public sector) export credit agencies have worked to extend their mandates beyond supporting exports with a pre-defined percentage of domestic content, to undertake equity investments in foreign companies with the expectation of generating benefits for the home country. In similar fashion, trade financiers can look at their business with new eyes, to identify opportunities which respond to the unique needs of the day.

Trade and developing economies will become increasingly closely connected over the coming five to 10 years.

The positive connection between trade and international development has been well and convincingly demonstrated, even in the context of a less-than balanced trading system. 'Aid for Trade' initiatives linked to the World Trade Organisation and other international entities have been working at various levels, from trade policy and capacity development efforts to specific initiatives in-market or at the level of target industry sectors.

The ability to engage private sector participants remains a challenge, across every developing jurisdic-

tion on the globe – and one key requirement in support of that engagement, is the absence of adequate financing. This is a reality from the Caribbean to the South Pacific, from the Horn of Africa to the (slowly) emerging entrepreneurial class in Botswana.

Trade finance can evolve its value proposition – with continued attention to commercial viability of transactions – by engaging more actively in the space around international development. A pre-requisite of such engagement is likely to involve better understanding and leverage of the various guarantee and financing schemes offered by public sector entities, international institutions and others.

Just as organisations gain long-term relationships by remaining engaged in markets experiencing crisis (Mexico, Brazil and others illustrate), trade financiers active at the developing stages of a market, will be well-remembered as that market evolves to sustained growth and profitability.

Just as trade finance has evolved into open account and supply chain activities – extending its activities in the realm of finance, the business can also evolve on the trade side – covering a wider variety of trade flows, or new modes or areas of trade, including trade for development. Several trade finance specialists, engaged with top-tier global institutions as well as with leading regional players, have described their focus on trade 'corridors' – highlighting the opportunity to develop viable business, on the basis of solid knowledge of markets at each end of the corridor, and specialist focus on the nature of trade flows in a given corridor.

Similarly, as financial institutions and specialist lines of business such as trade finance better appreciate the value of their expertise, leading providers of trade finance have demonstrated some success in developing and leveraging advisory capabilities, both at the commercial level and at the level of correspondent banks, advising both customer groups on various dimensions of trade finance.

It is well-known that trade finance is a business which exhibits high levels of concentration among perhaps five major providers today, and yet, mid-tier providers across the globe continue to stay engaged in the business because the value of the trade finance solution is understood.

A way forward?

Some financial institutions, including some in the mid-tier of providers, have determined that a product-agnostic, solutions-based approach is the way forward. There are certainly strong arguments in favour of such a model, particularly for mid-tier institutions. The removal of organisational silos, and a shift in orientation from bank-centric to client-centric, are certainly compelling steps in the shaping of trade finance over the coming years.

A cautionary note: the risk of having trade finance melt into broader transaction banking units, or perhaps more widely into commercial banking groups, with limited distinction or differentiation, may appear to respond to the needs of clients coming out of the 2008 global crisis. It will not, however, respond effectively to the larger needs of international commerce, economic growth, development and prosperity.

Trade finance needs to focus on and respond to the evolving needs of international business, global sourcing and cross-border trade, in ways that evolve with changing patterns of business, and become increasingly inclusive over time.

The expertise and capabilities developed among trade finance providers cannot be lost, otherwise, the market will find ways to fill a gap – much as it began to do in the early stages of open account trade, when the main providers of trade finance – the banks – were very nearly dis-intermediated.

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The degree to which this issue is critical, and the continuing evolution and relevance of trade finance is important, can be illustrated by the notion of 'Engagement through Trade' – the idea that the most complex and divergent political views (and their consequences) can and ought to be resolved through active dialogue and engagement, particularly on the commercial front. This concept is widely supported among a variety of political and business leaders, and its effectiveness is believed to extend to resolution of the most challenging circumstances.

Nations that trade together, goes the thought process, do not go to war.

If indeed the power of trade is such that it can forestall war, and raise nations out of poverty, then it stands to reason that the institutions, mechanisms and processes which support and enable trade, must be preserved and enhanced.

The business of financing international trade will involve additional providers and stakeholders – just as it has now re-validated the importance of export credit agencies and international institutions – and it will do so across a wider range of cross-border commerce and a broader set of financing mechanisms than was the case pre-2008. More importantly, trade finance will expand its value proposition to meet the inevitably growing needs of international commerce.

One question for some of the readers of *Trade Finance* Magazine: Are you a banker who happens to work in trade finance, or a trade financier who happens to work in a bank? ■