Stepping back to move forward?

Alexander R. Malaket explores how the global financial crisis has impacted on the development and use of supply chain finance (SCF).

Kah Chye Tan, at Standard Chartered in Singapore

The global financial and economic crisis has, indisputably, had a powerful impact on trade finance, and by extension, on trade itself.

Most regions report that the changing risk environment has motivated a return to traditional trade financing instruments, particularly documentary letters of credit, which are enjoying a new level of appreciation for their risk mitigation capabilities.

Will the crisis and its fallout reverse a rare momentum of innovation in the business of trade finance? Have the demands for security on both sides of a trade deal, derailed developments in supply chain finance?

Crisis & innovation: complement or contradiction?

Trade finance has seen an unprecedented level of innovation, both at the product level and at the level of the technology associated with the transaction side of the business – from processing to reporting, compliance and beyond.

That is, until the global financial (now economic) crisis hit like a runaway locomotive.

The redrawing of the map of global risk, which absorbed previously blue-chip countries, banks and corporates, and raised to positive prominence markets like Canada and parts of the Middle East, drove a rush back to more traditional – and proven – instruments of trade finance. The documentary letter of credit (LC) quickly became *de rigeur* in the business of international trade. A complicated and labour-intensive, error-prone mechanism, which nonetheless has offered balanced comfort to buyers and sellers, has returned to the centre of the stage in trade finance. At least, that is the reality that is often described anecdotally by a variety of sources.

The crisis-driven return of the LC was predicted by several commentators over the last number of years; even as the ultimate demise of this instrument has been predicted for nearly three decades, some sensed that the letter of credit had not seen its final moments as an enabler of international trade. The current crisis has proven this view to be prescient.

The letter of credit is unpopular, unwieldy and expensive, yet its stronger supporters now argue that innovation in terms of new products is an unnecessary exercise in the repackaging of a familiar set of banking products. For this group, supply chain finance is little more than an attempt by bankers to maintain a presence in a lucrative business, in what was the new reality of open account global trade.

The LC, some argue, provides almost all that is needed to efficiently facilitate trade. The imperfections of the instrument, from the painstaking attention to document preparation, to the issues of workflow and high rates of discrepancy, can be resolved through appropriate application of technology, and a more conscientious attention to the optimal structuring and processing of a transaction by all parties involved.

In short, the LC is not obsolete, but rather, misunderstood, and its effective risk mitigation features, coupled with the wide acceptance of the ICC rules which guide its use, are more important than ever.

Innovation retreat

These arguments have found new voice and some level of support in the context of the global crisis. Is the new model based upon supply chain finance doomed to fail as a result of the crisis, and has the crisis effectively stamped out the spark of innovation in an industry that has used letters of credit for hundreds of years? Hardly.

Dominic Broom, managing director, market development, treasury services EMEA at the Bank of New York Mellon, in London, observes: "The financial crisis has had the effect of raising the level of dialogue among corporates and banks alike, in terms of the value proposition around supply chain finance. The discus-

Andrew Betts, at RBS in London

Richard Brown, Bank of New York Mellon in Hong Kong

sion has evolved beyond the basics of open account, to take on a more holistic and encompassing flavour which we refer to as an 'integrated treasury solution'. As a service provider to banks, we note a related progression in the nature of financial service partnerships, increasingly combining to deliver local relationships with global reach and capability. Vision and collaboration will chart the evolution of integrated solutions in international business."

While a number of trade finance providers have been hesitant in adopting a supply chain finance (SCF) offering, or have faltered in the design of their programme or solution, others are firmly convinced that the market requires such an option, and that the global crisis has done nothing if not illustrate this need.

Kah Chye Tan, global head of trade finance at Standard Chartered in Singapore notes: "The much-reported shift back to traditional instruments such as documentary credits is probably overstated. Objective metrics do not support this view definitively, and while the global crisis may have slowed down the pace of decline of letters of credit, it certainly has not halted the evolution of supply chain finance models. In any event, for us, supply chain finance involves an ecosystem view – SCF is a holistic solution which can be tailored to meet the needs of a specific client, combining a variety of products, solutions and advisory support as appropriate. In that sense, supply chain finance is product-agnostic.

"While some providers will tend to cherry-pick which companies they will agree to finance within a supply chain, our approach is very much all-encompassing: we like concentration risk in the context of SCF, and take the ecosystem view to its natural scope and breadth. We are quite happy to support an ecosystem where the anchor client is a buyer or a seller, and our programs operate internationally as well as domestically."

Indeed, several discussions have validated our expectation that the global crisis has identified a gap in most SCF programmes – and has brought into focus, the importance of a risk-mitigating capability in any solution that purports to enable cross-border business.

The SCF continuum

Supply chain finance is still very much in its infancy as a programme or as a holistic offering. While one could argue that the elements of an SCF programme are made up of familiar financing mechanisms such as factoring and others, the broader definition of SCF is still evolving. Some providers are very focused on a narrow set of solutions targeted at buyer or seller, while others are developing a vision which is more encompassing, and ironically, brings back some familiar language in trade finance – language we heard in the 1990's about providing services 'end-to-end' in a trade deal, or enhancing efficiency through technology and the elusive STP, or straight-through-processing.

As SCF models are being developed, many of the same aspirations and objectives of trade financiers are re-appearing in the new context. Just as there were once niche players in traditional trade finance, and just as there were global providers arguing energetically in favour of global footprints, many of those arguments are being revived in relation to SCF, and being magnified in their importance by the global crisis.

Several providers have woven together the ongoing integration of transaction banking solutions (trade, cash, foreign exchange and others) with traditional trade finance products, to propose far-reaching solution sets under the banner of SCF.

Markus Wohlgeschaffen, head of global trade finance and services at HypoVereinsbank/UniCredit Group in Munich notes: "The definition of supply chain finance continues to evolve, just as the vision around its value proposition is expanding – in part, as a direct result of the global crisis. At UniCredit Group, we take a broad and holistic view which includes both 'active' elements – products that are asset-based such as LC confirmations and any kind of transactional liquidity providing – and 'service-related' elements that include cash, e-banking and processing. We no longer limit our view to the single product or transaction. Indeed, we are convinced that the days of bilateral bank/corporate relationships are over, and that the future is in taking a community view, along global supply chains."

In those advanced models, financiers target the full range of activities, covering both the payables and the receivables sides of the transaction: procure-to-pay and order-to-cash, pointing to the increased focus of corporates on internal efficiency and best practices in financial and treasury management. The crisis has provided a compelling reason to carefully, but actively, seek ways to extract value and efficiency from current processes.

Jean-Paul Riolacci, global head of GTS at BNP Paribas in Paris, notes: "Supply chain finance has generated significant interest over the course of the crisis; our clients have succeeded in optimizing the physical flow of product and the efficient management of inventory, to the point that further improvements are relatively marginal. On the other hand, companies are increasingly aware of the opportunities linked to optimization of the financial supply chain, with benefits on balance sheet treatment and working capital needs.

"Even in the emerging world of SCF, we perceive that a global footprint is of critical importance for global companies with subsidiaries everywhere. Our approach to supply chain finance is very much holistic and global, and we are prepared to support both the payables and the receivables side of the equation as needed by our clients. [In addition] we developed a strong offer for inventories, even more directly linked to physical and commercial supply chain. Contrary to perception in some parts of the market, we do not have issues with capacity – particularly given that trade involves an underlying asset, and a structured solution is often available for this type of financing."

As the value proposition around SCF evolves, and as bankers become better at articulating the nature of supply chain finance, with inevitable points of differentiation between service providers, commercial customers will have more flexible trade financing options through the crisis and beyond.

In addition to the renewed focus on risk mitigation, the crisis has also engendered a two-way risk assessment process. Just as banks have always assessed the risk➤

Keith Karako at Citi in New York

Bill Nowicki at HSBC in New York

➤and credit standing of their clients, the crisis has motivated – forced – corporates to assess the credit standing of their bankers in a way that has perhaps never been seen.

This new tendency, which is leading importers and exporters to find ways to diversify their banking relationships, is also influencing both the development of SCF, and the evolution of related technology solutions.

Olivier Berthier, solutions director, transaction banking at Misys, notes: "While we have seen traditional trade finance instruments returning to favour in many markets, and deployment of supply chain finance solutions has slowed somewhat as a result of the global crisis, our visioning and advisory discussions with banks have matured in the area of supply chain finance. The line between traditional and evolving products is getting thinner, as the crisis has motivated greater attention to risk mitigation features in open account and supply chain solutions. Perhaps more importantly in the long term, we are seeing banks exercise care in assessing corporates, but now, it is equally true that corporates are assessing risk related to their banking relationships, and are increasingly interested in multi-bank capabilities. "

Clearly, the pace of evolution in SCF is different across regions, but the pace of development seems to be continuing across the globe, even in markets traditionally well-disposed to (or even restricted to) the familiar mechanisms of trade finance.

Lok Nath Mishra, head of commercial banking at ICICI Bank in Mumbai states: "There is movement in the area of supply chain finance, or what we refer to more commonly as 'channel finance'; while the large government-led banks in India are in a mode of 'business-as-usual', the influence of foreign-based financial institutions is discernable in the development of channel finance programs here. The focus at the moment however, is primarily on lower-value, receivables-based bilateral deals where counterparty risk is not a concern, and therefore the current iteration of channel finance is sufficient to meet the needs of commercial customers."

The driving forces of India and China

The evolution and rate of adoption of SCF in emerging economic powers such as India and China will certainly be of critical importance.

At Bank of China in Beijing, Wang Guosheng, general manager, global trade services, comments: "Supply chain finance is a kind of systematic financing arrangement towards all the member enterprises on the supply chains with credit sale as the major settlement method [with] one another. Against the international financial crisis, many enterprises have chosen [to use] LCs again with relatively small risk, but high cost to make settlement for the purpose of preventing defaulted payment and bankruptcy of foreign buyers and political risk of counterparty countries. Take Bank of China for example. One of our feature products of supply chain finance is 'Rongxinda', where our bank can provide enterprises with financing after the enterprises secure credit insurance from the insurance companies and show our bank their trade documentation and insurance documents. As to 'Ronghuoda' (goods-pledged finance), a third-party logistics regulatory body is introduced, to supervise the customer goods pledged to our bank, thereby mitigating risk related to the loss of goods."

One recurring reality in SCF which is familiar in other aspects of banking, is the risk of under-serving the SME sector. While many economies vaunt the importance of their small and medium-sized businesses in terms of value-creation and contribution to elevated standards of living, small businesses consistently cite access to financing – including trade finance – as a major challenge.

The challenge of 'on-boarding' of suppliers to buyer-driven SCF programmes has been identified as one of the early obstacles to wide-spread adoption of SCF models, from Frankfurt and London to New York, Hong Kong, Dubai and beyond. At the same time however, such 'community' models of financing may prove to be helpful to SME's in accessing consistent and reasonably-priced financing: another lesson drawn from the global crisis.

Andrew Betts, global head, trade finance and supply chain, global transaction services, RBS, remarks: "We do believe that the standard proposition related to supply chain finance has reached a level of acceptance in the market. However, enormous opportunities remain to increase the penetration globally into the buyer community – both among larger multinationals as well as SMEs. That will continue to be the main focus in the space over the short term. However, a combination of internal innovation and requests from buyers means that the model itself is reasonably dynamic, and corporates have reacted well to that.

"Supplier on-boarding is obviously the critical component to a successful SCF programme. RBS has in place a well defined supplier on-boarding strategy that has been successful across a number of markets within our vast country network. Additionally, we have partnered with third party market participants where it makes sense to leverage our capabilities to maximize on-boarding. Components of supplier on-boarding such as electronic delivery of documents and "click through" acceptance continue to evolve. Regardless of the method of on-boarding, the bank must still retain its protection, which requires that the assignment of receivables be valid and our rights be enforceable in the specific market."

In addition to the product and programme-level evolution of trade finance driven by the crisis, some argue that the very nature of bank-to-bank relationships – the traditional correspondent banking model – faces some degree of 'redesign'. Numerous trade finance providers are touting the advantages of SCF models built upon partnerships between local banks and global financial institutions.

This global-local partnership is not new to trade finance (think outsourcing of trade back offices over the past fifteen years or more), and yet, the current crisis has affected the playing field on which banks build their partnerships.

Richard Brown, head of treasury services, Asia at BNY Mellon in Hong Kong observes: "A disturbing reality at the moment is the lack of availability of supply chain and trade financing for SMEs. Stimulus efforts in

Cristian Mandachescu at Scotiabank in Toronto

Markus Wohlgeschaffen at HVB-UniCredit Group in Munich

China have been quick and significant, but targeted primarily at corporates and state-owned enterprises to date. The retreat of large international banks from China is a significant factor, since those institutions targeted the SME sector over the last decade, and the actions of certain providers have tended to exacerbate the volatility around SME financing. Our approach is to partner with local banks who know the market and the client base, have an enduring commitment to their customers, and can benefit from the capabilities and footprint of BNY Mellon. The concept is proving itself, as we have succeeded in increasing our business in the region despite the reality that trade volumes are down."

Rising like the Phoenix...

In the end, the global financial and economic crisis has put unprecedented focus on trade finance. While most agree there has been a shift back to traditional product offerings as a reaction to crisis, the post-crisis reality is likely to be (with some discipline from the industry) an integrated offering which improves both the SCF model, and the traditional product offerings, which will be absorbed as elements of broader SCF programmes.

William Nowicki, executive vice-president and head of trade and supply chain for North America at HSBC declares: "Dramatic changes in the economic climate have compelled some businesses to return, on what we believe will be a temporary basis, to more traditional trade solutions. That being said, for our customers who are already trading on open account terms with vendors with whom they have established relationships we see a continuation of business as usual. Depending on the statistics you look at, more than 80% of trade is conducted on open account terms and in the long term, we don't believe that that will change.

"Perhaps the one thing that the changing economy has done is to make buyers and suppliers more aware of the importance of knowing their trading partners and establishing strong relationships. For some, this may mean re-evaluating the number of buyers/sellers they work with so that they can maintain closer contact with them. For some importers it was deemed to be inappropriate to move into open account terms during the height of economic volatility although we will continue to work with them to identify the right timing for a move. For others, open account trading was business as usual and for yet others it was appropriate to continue to add trading partners to their existing portfolio."

For some, the next iteration – linking treasury and trade finance with operational elements such as procurement – is already an area of preoccupation and focus.

As early signs of recovery start to show, it is clear that trade finance has been transformed by the global crisis, and that a forward momentum will be sustained through and beyond the crisis. The final product is likely to be enhanced by the lessons of the global crisis.

It is worth keeping in mind, however, that the roots of history are clearly present in the new branches of innovation in the business of trade finance. Put another way, even if SCF appears to be a major innovation, there is a view that this is a natural, reasonable progression – far from a sea-change in the business model.

Cristian Mandachescu, vice president, trade services and financial institutions at Scotiabank in Toronto observes: "Evolution is taking place in an upward cycle; understanding that institutional memory covers, on average, ten years, we can certainly look back into the history of trade finance to identify similarities with the current dialogue and activity around supply chain finance. In some respects, advanced models of SCF are about corporates outsourcing their payables and/or receivables functions, and about financial firms repackaging traditional products while applying advanced technologies as a delivery platform."

The good news is that the development of SCF models, including the nuanced differentiators offered by providers will certainly survive the global crisis, and thrive as another option available to importers and exporters in the post-crisis environment. The need to integrate more effective risk mitigation within SCF programmes will serve as a bridge between traditional products and emerging solutions; the banks will have succeeded in re-intermediating themselves into the business of financing trade, and, in the end, importers and exporters will be better served.

While perceptions and opinions about the position of traditional versus emerging solutions in trade finance can vary, sometimes significantly, there are some consistent massages and take-aways: in the end, trade finance has had its profile raised immensely over the course of the crisis. Equally importantly, the evolving demands of buyers and sellers, coupled with the continued desire of many banks to remain engaged in trade finance, will ensure that the industry will find an appropriate balance between – or combination of – traditional plus emerging products, in the overall value proposition around trade finance.

Keith Karako, global head of structured trade at Citi in New York states: "The crisis has accelerated interest in and development of the value proposition around supply chain finance. Not only are our clients paying closer attention to increasing the efficiency of their financial supply chain, but among the leaders in this area, we are seeing operational units, such as procurement groups, assessed on improvements to working capital objectives — as opposed to the more traditional 'cost of goods sold' targets.

"While some argue that the crisis has resulted in a return to LCs due to their presumed effectiveness in risk mitigation, many will point out that the high rates of discrepancy in these instruments negate that risk mitigation. Nonetheless, LCs still have, and will continue to have, a prominent role in the supplier finance market. In the context of SCF programmes, however, these structures often include robust risk mitigation. And, an important next step in the further development of the SCF model will be the creation of a set of industry standards, covering process and documentation, and leading to consistent, equitable treatment of SCF under regulatory and financial reporting regimes."

Effective trade and supply chain finance is a necessity – not a luxury – and it will indeed rise from the ashes of the crisis, better-positioned to serve the needs of importers and exporters across the globe. ■