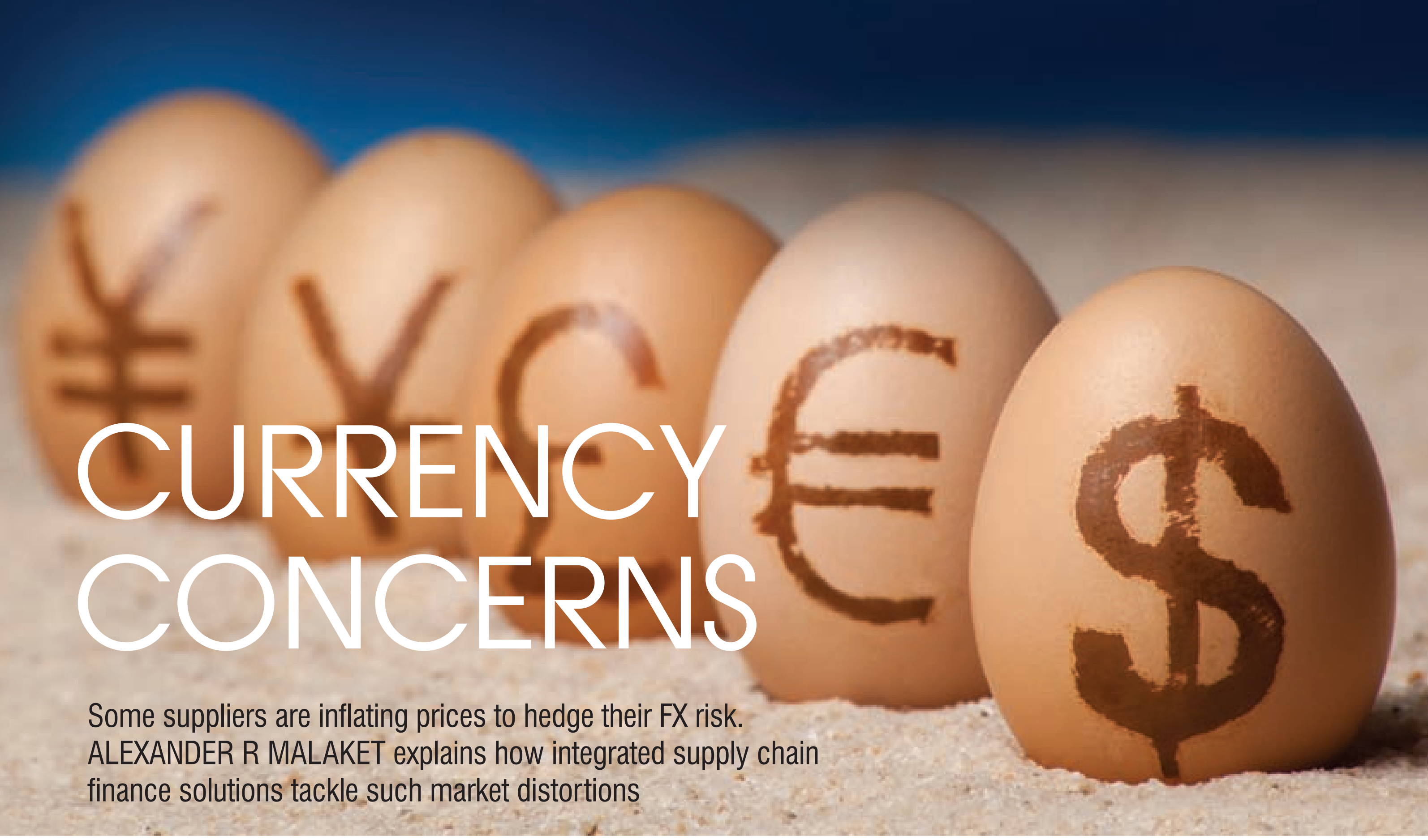

CURRENCY CONCERNS

Some suppliers are inflating prices to hedge their FX risk. ALEXANDER R MALAKET explains how integrated supply chain finance solutions tackle such market distortions

Thomas Kuhn, a noted philosopher of science, is said to have observed that interesting insights and discoveries are often made at the 'intersection' of two or more disciplines.[1] The current circumstances surrounding the finance of international commerce may be an effective illustration of this notion in the context of business and finance.

Rise of the euro and RMB

Supply chain finance is very much in a state of development as an integrated, holistic solution to the needs of importers and exporters, and their supply chain ecosystems; likewise, the global foreign exchange landscape is undergoing a phase of inexorable transformation. The US dollar is clearly losing ground to the euro and the renminbi (RMB), reportedly dropping from the currency of choice in up to 80% of international trade transactions, to perhaps 65% today, with the majority of the market share loss occurring in the last five years. A multicurrency system of cross-border commerce appears increasingly inevitable, and the impact of such an evolution is generally seen as positive for the international system.

Suman Chaki, head of trade and cash solutioning Asia Pacific, global transaction banking at Deutsche Bank in Singapore, observes: "Supply chain finance is being rediscovered and is becoming increasingly strategic in the minds of C-level executives, as the development and deployment of such programmes is becoming more international – even global – in nature."

He adds: "Principal or anchor clients with distributed manufacturing facilities need their suppliers to ship to multiple locations, as far-flung as south east Asia, Latin America and Eastern Europe, and while the majority of transactions are still denominated in US dollars, there is a shift in certain trading relationships, where some suppliers are less prepared to accept foreign currency risk."

Cash and trade integration

In addition to the dynamics around trade finance and foreign exchange, the ongoing integration of cash management and trade finance, in pursuit of client-centric transaction banking solutions, continues apace. Some senior trade financiers have indicated that the integration is already complete, while others quietly reverse course and seek to decouple their trade and cash activities.

Those institutions pursuing an integrated offering in transaction banking are seeing current conditions drive a requirement for foreign exchange (FX) to become the third focal point of integration, joining trade and cash in a combined solution that is particularly attractive to corporates engaged in international business and trade.

The imperative to organise cash and trade under a transaction banking umbrella internally may have been based, historically, on several motivators, including some useful organisational objectives, and a view among certain banks that there are synergies to be extracted from such a model – in sales, operations and in revenue aggregation.

Current drivers, however, appear to originate from the requirements and expectations of corporate customers, not banks. Clients are increasingly expressing their requirements based on their own transactional processes and activities, and less on the basis of bank-defined product silos.[2] Supply chain finance, together with the various needs now being expressed by importers and exporters, provides a clear, client-focused rationale for the design and development of integrated offerings; even in banks, where the businesses and their supporting organisations remain distinct.

Ashutosh Kumar, global head of corporate cash and trade at Standard Chartered Bank, observes: "We are seeing a notable increase in demand for supply chain finance solutions among our clients, driven by the desire of large buyers, for example, to better support their supply chains by managing upstream and downstream liquidity, mitigating risk and improving overall supply chain management practices. Our customers are looking for a holistic discussion covering trade and supply chain finance, cash management optimisation, and options related to appropriate management of foreign currency exposure."

The Singapore-based UK bank has been busy evolving its offerings in response to these developments. "We are now able to facilitate payments and settlement in over 130 currencies through an automated process, and can offer large buyer clients a single solution to pay a large group of suppliers, with or without financing, and with the option to address FX requirements. These developments will continue as companies adopt increasingly strategic views of supply chain finance and management, and will be accelerated as the global system moves, inevitably, to a multi-currency environment," adds Kumar.

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Corporates in the driving seat

Trade bankers were reporting two or three years ago, that their initiative of inviting discussions around supply chain finance often resulted in first meetings between finance, operations, logistics and other areas within a corporate client. It can be argued that today, there is a certain degree of role reversal, with corporate clients accelerating the development of integrated solutions by trade bankers. This development, evolving from corporates' focus on supply chain management, working capital and various forms of risk, including supplier concentration risk and foreign currency exposure, is gaining momentum, and doing so in the context of a highly dynamic global currency environment.

A senior trade finance executive for a major European automotive group comments: "Certain markets tend to prefer to transact on the basis of certain currencies – for example, many countries in Europe and North Africa tend to favour the euro, while some others in the Far East and in the Middle East, for example, favour transactions denominated in the US dollar. There is certainly some arbitrage in the market at the moment between the US dollar and the euro, though for exporters, the primary focus is on commercial matters and adequate risk assessment."

Concerns about some European market risks have increased in the light of recent economic developments. The executive continues: "Although it was once possible to conduct business in Europe and in OECD markets with confidence, exporters now seek appropriate risk mitigation solutions such as letter of credit confirmations or bank guarantees where necessary. Some markets are deemed, at the moment, to have reverted to quasi-emerging market status, and this change impacts the approach from exporters to trade and supply chain finance. Some exporters have noted a reduction of activity in export finance among French banks, at least in part due to ongoing challenges with US dollar liquidity, and, although some may see developments in terms of the internationalisation of the RMB, this activity remains marginal, at least for flows with Europe."

Currency exposure and price distortions

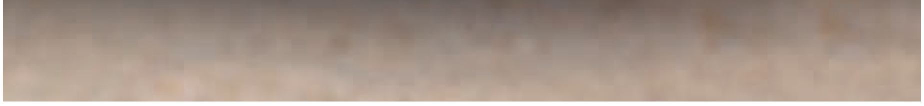
Suppliers today are less prepared to accept the risk of foreign currency exposure, and are increasingly vocal in seeking settlement of invoices and receivables in their local currency. At the same time, large buyers have become conscious of the adverse impact on costs and margins, when suppliers inflate prices in an attempt to offset expected FX losses when being paid in foreign currency.

In addition to placing greater focus on secure access to strategic suppliers, global buyers are looking at the overall robustness and sustainability of supply chains, and recognising the importance of adequate liquidity across the supply chain ecosystem, to their own success and profitability.

Chaki at Deutsche Bank notes: "Suppliers in certain markets of Asia are looking for financing and settlement to be effected in their local currency. This is the case in China with the RMB, aligning with the country's efforts to advance the internationalisation of the RMB and its positioning as a currency of international commerce. We anticipate that a portion of our supply chain finance portfolio will be denominated in RMB in the next 12-18 months, and are looking at ways to offer our supply chain finance clients a bundled solution that will allow the booking of a payment and an FX rate at the same time leveraging our FX4Cash solution."

Changes in the dynamics and relationships between buyers and sellers are fundamentally affecting the way in which banks are approaching their trade clients. Supply chains can include financially solid suppliers that require nothing more than timely payment in their domestic currency, or suppliers that face working capital challenges and need financing; buyers face a variety of combinations of trade, cash and FX requirements from their supplier community, and seek bankers with the business acumen and the technology and product offering that can address the full universe of requirements – including, of course, those of the buyer as well.

Paul Johnson, senior product manager, global trade and supply chain solutions, at Bank of America Merrill Lynch (BoAML), says: "There is a clear trend in global markets to diversifying away from reliance on the US dollar in the settlement of trade transactions, and this tendency has accelerated in the last five years, with the euro and the RMB picking up the majority of the business. In the context of trade and supply chain finance, we have seen a shift where multinational buyers are realising that small suppliers are adding significant margin to their products to help offset FX risk. As a result, the buyers are increasingly disposed to take on the currency risk – and hedge it themselves – in order to remove the pricing distortion created by the supplier communities. We are seeing scenarios where the supplier side of a trade transaction, or a supply chain, is settled in local currency,



"There is certainly some arbitrage in the market at the moment between the US dollar and the euro, though for exporters, the primary focus is on commercial matters and adequate risk assessment"

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while the buyer side remains denominated in US dollars or euros. But increasingly, we observe transactions and relationships that are non-US dollar – end-to-end."

Operational issues

There are some pedestrian, yet practical challenges in the US and elsewhere, related to the ability of corporates to transact business in multiple currencies, from the purchase order systems to the accounting systems and beyond: many legacy technologies were designed to operate entirely on the basis of a single currency. While product evolutions do allow for multi-currency solutions – and, therefore, additional flexibility in addressing the various needs of a supply chain ecosystem – certain systems and process constraints impact what can be delivered to corporate clients in practice.

Johnson explains: "BofAML has devised solutions where we bundle trade, supply chain and foreign exchange capabilities to help clients and their suppliers address the currency risk, either by offering spot-based conversion at time of settlement, or providing bundled forward contracts for later hedging. The exchange rates are very attractive, and the bundling proposition is well received in the market. These propositions are evolving, however, there is a challenge in implementing multi-currency solutions in response to the changing global market realities, which is that corporates are not always able to receive documentation, such as purchase orders, denominated in foreign currency, or even establish and manage multiple bank accounts in a variety of currencies. Legacy systems, including single-currency accounting systems, are a hindrance to full deployment of advanced supply chain and foreign exchange solutions, yet the changes are inevitable, and we are working with clients to advance this process."

At the highest levels of the supply chain/FX discussion, there is a certain absence of clarity as a direct result of recent developments and evolution in both the trade finance and foreign exchange arenas. "Nomenclature," said one executive in reference to the state of supply chain finance, "is half the problem." In other words, the lack of common terms and definitions of transaction elements creates challenges when interpreting how the industry communicates, articulates and markets the SCF solutions.

Similarly, as several currencies actively seek to preserve or acquire market share in global financial transactions, and the currencies of other high-growth and increasingly influential jurisdictions observe and learn, there is an additional layer of complexity in managing international transactions and global supply chains, as well as the financing that supports such transactions and commercial relationships.

Business development opportunities

These transformational developments, taking place at the intersection of trade, cash management and foreign exchange, offer excellent opportunities for corporate treasurers and financiers to shape the value propositions of their banks, and for trade and transaction bankers to demonstrate a comprehensive understanding of their clients' businesses. Leading trade bankers will seek to respond with effective, differentiated solutions, based on significantly more than a static set of products, or a transactional view of one bilateral trading relationship.

Supply chain finance may indeed be the umbrella under which an integrated trade, cash and FX proposition is finally deployed into the market, and may prove to be both a motivator and a beneficiary of the multi-currency environment to come. TFR

References:

1. Thomas S Kuhn, *The Structure of Scientific Revolutions,* 1962
2. See also *TFR*'s round table discussion on this: 'Marriage in heaven? Cash and trade convergence at the altar': www.tfreview.com/node/7891

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