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Paper: Thoughts on Trade Finance

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Advisory Services
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UNCTAD Global Commodities Forum

Thoughts on Trade Finance

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I. CONTEXT

The landscape of international commerce and trade has been evolving significantly over the last several years, with the momentum of innovation related to trade finance arguably peaking just before the disastrous arrival of the global financial crisis, followed very shortly by a worldwide economic crisis from which many countries, companies and individuals continue to recover.

Global supply chains extended in distance and in the time necessary for goods – and related financial transactions – to travel from origin to destination, and a clear shift in the global order began to evolve, with so-called Emerging Markets taking a more central position on the world stage.

International commerce, including commodity trade, has, in the intervening years from late 2007 until today, demonstrated a combination of continued evolution in certain directions, and full-on reversal of direction in other respects.

The days of abundant and inexpensive credit, coupled with uninterrupted growth in trade flows, and a consumer (West)/producer (East) balancing act have been swept away as a direct outcome of the global crisis.

While liquidity is returning, sometimes cautiously, there is a discernable shift in focus among both lenders and borrowers. Financing is now far from assured in even the most established markets, transactions or relationships, and the concept of “risk” is again fundamental to serious credit adjudication. Relatedly, the importance of both regulatory oversight, and effective support of international commerce by public sector and/or international agencies is now widely – if in some circles, grudgingly – acknowledged.

In recent months, China has surpassed Japan in rankings of economic might, Europe illustrates extremes of condition, with some countries clearly in dire straits, and others such as Germany, exhibiting that export-driven growth and prosperity can be attained even by high labour cost economies.

Developing economies, including those for which international trade is an important element of a broader poverty-alleviation and economic development program, battle with realities which include nearly irresistible forces driving resource-focused investment and initiatives, together with the longer-term imperative to position further along the value chain in international trade.

While the clamour around fundamental rethinking of economic and political systems has subsided to a degree, legitimate and provocative questions remain – questions unlikely to find adequate solutions in the context of conventional

paradigms or dogmatic persistence in the support of approaches which do not adequately serve the broader constituency of stakeholders now seeking voice and influence in international affairs.

The tension between industry, political authorities and regulators as relates to financial oversight and regulation, provides a microcosmic illustration of the implications of the global crisis and its longer-term consequences.

Trade in commodities is critically important to both the demand-side, perhaps most strikingly illustrated by the voracious appetites of China, as well as the supply side, perhaps equally compellingly illustrated by Africa and its combination of resource-riches, and wrenching poverty, and potential, unfulfilled.

One natural outcome of the global economic crisis, with its roots in the financial sector, has been additional pressure to impose regulation, or at least, oversight: a reaction that is both understandable and prudent, and one against which even the most ardent advocates of free market disciplines would be hard-pressed to argue.

The impulse – and its sometimes blatantly political motivations – must be tempered by genuine efforts to ensure that measures related to regulation and oversight, are well-conceived, and appropriately, fairly and effectively applied.

At the same time, expectations related to the efficacy of regulation, be it “soft law” such as that promoted by the Bank for International Settlements (BIS), or national regulation such as that enacted by agencies like the UK Financial Services Authority (FSA), or the Canadian Office of the Superintendent of Financial Institutions (OSFI), must be reasonable.

Circumstances relative to trade and commodity finance were, for a time during the crisis, less than encouraging, and their prospects for positive evolution seemed limited at best.

In the context of regulatory evolution and development – which pre-dates the global crisis – senior leaders in trade and commodity finance were unsuccessful – arguably ineffective, in articulating the nature of their business, including its history and risk profile, to those at the BIS and elsewhere, exercising a mandate to set a regulatory framework around financing related to international commerce, and as a subset of that, commodity finance.

This reality reflects a challenge which persists for trade bankers today, though to a lesser degree: that trade finance is, for most financial services organizations, a relatively small business which commands limited attention among the most senior executives.

'Support from the Board? Well, they leave us alone, as long as we are not losing money...'

*- General Manager, Trade Finance,
North America*

Herein lies the root of a problem that saw its fullest expression at a moment of crisis – a crisis which, within it, held the opportunity which is presented to trade bankers and trade financiers today: to claim a place in the context of international commerce, which better reflects the value and importance of trade finance.

II. STATE OF THE MARKET

The evaporation of credit which flowed from lack of transparency in financial markets, about the level of exposure to toxic mortgage assets, touched every sphere of financial activity, including trade finance and international commerce.

At the peak of its negative impact, the “credit crunch” caused pre-export or pre-shipment finance to evaporate, resulting in a reduction of shipments from Asia (primarily China) to the Americas and Europe, estimated at 40% of normal volumes. The global shipping industry saw its rates plummet by 90% and the Baltic Dry Index, an esoteric metric used by professionals in trade finance and international risk analysis, was suddenly referenced in mainstream press as one way to illustrate the negative impact of the crisis on world trade flows.

Short term trade finance became significantly more expensive, with margins increasing by 500% or more, and banks actively exiting the business of trade finance, or rationalizing their client portfolios by exiting relationships that, pre-crisis, were considered perfectly acceptable to maintain and grow.

The crisis brought sharply into focus, the importance of a “return to fundamentals” such as sound credit analysis, risk assessment and mitigation, and adequate provision for loan losses. In trade finance, pre-crisis product development efforts related to trade on open account terms, and to identifying and providing solutions in the context of global supply chains – with only limited attention to risk mitigation. Where there had been serious debate about whether Export Credit Agencies and other quasi-public or international institutions were needed to support trade or trade finance, the crisis demonstrated, compellingly, that such institutions could – and did – serve a purpose of critical importance.

As leaders across the globe sought options and solutions in response to the crisis, international trade was repeatedly identified as a major driver of global recovery, and by extension, trade finance, which supports in some form or other, 80-90% of trade flows, was recognized as fundamentally important to international commerce, and therefore to the global recovery – this by the most senior political and business leaders in the world.

Mention of the importance of trade finance at G20 Meetings, and a strong mandate backed by significant financial resources for the IFC and its Global Trade Finance Program, were initial indications of the changing profile of trade finance.

In conjunction with these dynamics, a degree of pre-crisis innovation in the business of financing trade, saw bankers engage in open account transactions, develop supply chain programs and generally invest in the evolution of the business, from technology to product development and beyond. Those efforts,

slowed but unabated by the crisis, included an effort by bankers to integrate various lines of business – including trade finance – into Global Transaction Banking units, with the effect that trade banking is now part of a larger, more visible business with the necessary organizational “critical mass” to command attention internally.

The confluence of these events and dynamics creates a situation today, where businesses linked to transaction banking are understood to be relatively secure, adequately (but consistently) profitable and very much favoured in the new, post-crisis realities of the market.

‘...time for a “back-to-basics” approach. The high rates of return of investment banking come with significant risk and complexity; transaction banking is sexy again...’

*- Senior Executive, Trade Banking,
Europe*

III. TRADE, COMMODITIES & DEVELOPMENT

“Aid for Trade” and the potential for trade to contribute significantly to poverty alleviation and international development remains a core principle of numerous efforts and programs across the globe. The attention garnered by trade and trade finance over the past two years or so has included, and rightly so, specific focus on developing and emerging markets, and the need to assure adequate liquidity and healthy trade flows in those regions.

Likewise, the focus on commodities has been evident, as noted earlier, on both the demand-side and the supply-side. Trade and commodity finance is of great importance to the full spectrum of commodity-related international commerce, from the largest, multi-bank syndicated deals, to the smallest transactions involving small businesses seeking to access international markets for products produced on small community farms.

International development encompasses a complex web of relationships and activities, seeking to impact everything from public policy to economic stewardship to private sector and small business engagement.

In addition to the high-profile, large-volume and large-value commodity transactions which attract bankers and financiers from across the globe, it is worth noting that stakeholders are recognizing a reality in international development: all the good policy and effective capacity development in areas such as trade negotiations or technical assistance related to international commerce must, to generate maximum value, culminate in successful engagement of the private sector, and must include effective promotion and support of small business and entrepreneurial ventures.

Small business owners and managers consistently identify the lack of (timely and competitively priced) financing as a major obstacle to growth and long-term success. This perception holds in economies at all levels of development, and its near-universal resonance offers an important message to trade finance providers, both private and public sector, as well as those mandated to provide support programs in the context of international development:

Small business finance – which today must include financing in support of international trade – is an increasingly important area of focus for all stakeholders engaged in international development, including those involved in commodity trade and trade finance.

Trade bankers, understandably driven by motives linked to profitability, are realizing that margins in the developed economies are relatively slim, and that the opportunities are, increasingly, in developing and emerging markets. It is for

this reason that hedge funds and non-bank providers of trade finance entered the business with a clear focus on emerging markets transactions.

More recently, increasing focus on global supply chains and the logistics “hard realities” of moving goods and components across massive global supply chains led bankers to conclude that the compelling financing opportunities are at the emerging market (typically SME/supplier) end of the supply chain.

In addition to the textbook need for cashflow and working capital support among small businesses, the nature of supply chains is such that the lifecycle of a transaction in terms of days, is concentrated in emerging markets. That is to say, the sourcing-to-production (in finance parlance, procure-to-pay and order-to-cash) lifecycle of a product is significantly skewed to the supplier end of the supply chain.

The implications for financing are that the greater need for trade and supply chain finance solutions – and from the financier’s perspective, the greater potential – is in the producing emerging markets and among the SME suppliers, than it is in the destination market, with the ultimate buyer.

A parallel reality may be imagined in relation to commodity trade and trade finance; as interest shifts from consumer economies to producer economies – and several “developed” economies wrestle with the challenges of re-engaging as manufacturers and producers in the “real economy”, the influence and leverage of economies providing resources and commodities, and the importance of their businesses as a client segment to trade finance providers, will inevitably increase.

‘The future of trade finance is in emerging markets. The focus has clearly shifted to the south-east axis; as margins compress in Europe, profitability remains in financing SME’s in developing and emerging markets’

- Senior Transaction Banker,
Europe

IV. THE REGULATORY DIMENSION

Trade finance is in a unique, perhaps unprecedented position: high profile, critical organizational mass and alignment with a global “back to basics” push in financial services.

Concurrently however, the business of finance – including trade and international finance – is under scrutiny and under significant pressure to devise and implement effective regulatory and oversight programs.

As the trade finance industry finds its voice, regulators at the national level, as well as international entities such as the BIS, are under pressure to conceive and implement effective solutions in response to the crisis and the evolving environment around banking, finance and capital markets.

The tone of the dialogue has been tempered however, it is clear that there remains significant opportunity to improve both the tone, and the overall collaboration and interaction among important stakeholders.

Important initiatives by the International Chamber of Commerce, and leading industry associations such as BAFT-IFSA and the various national banking associations, are gaining traction and helping to set a more positive direction for constructive dialogue around trade and commodity finance. Similarly, a more open receptiveness to such dialogue by those with regulatory mandates, such as the BIS and various national regulators, contributes further to the change in dynamic which must be further encouraged.

In addition to those entities, the question of financial regulation – in particular, the question of capital adequacy and reserves, which is fundamentally a matter of risk management and sound stewardship, must engage informed representatives from international institutions with a development mandate, and others from the private sector – the ultimate users, or end-clients, of trade finance.

Trade finance is undeniably different from other forms of lending, both in the nature of the transactions involved (short duration, self-liquidating), and in the risk profile of the business as a whole, and specific transactions (low loan-losses, highly effective mitigation options, often favourable liability party).

Trade finance ought to be distinguished as an asset class for purposes of regulation and oversight, and organizations promulgating soft law, such as the BIS, along with regulators at the national level, which implement and enforce regulations and laws related to financial services would, in an ideal world, align in their understanding of the nuances, and in the principles – and distinctions – which underpin their activities.

The discussion of distinguishing trade finance as an asset class in financial circles relates to the basic notion that a loan (or a financing transaction) is an asset to a financial institution, whereas a deposit is a liability; trade finance is a very different asset to a bank than a commercial loan or a credit card balance. The discussion around asset class does not relate, in that context, to the nature of the asset being financed, but rather, to the nature of the loan asset on the books of a financial institution.

The engagement of end-clients may assist in assuring fair treatment and adequate alignment, in that businesses and their owners/executives can exercise political influence to help shape the direction of regulatory requirements, certainly at the level of national regulators. The motivation for doing so relates, of course, to commercial considerations: the increased cost of trade finance, resulting from incorrect imposition of higher capital reserve requirements on trade finance transactions, which have the effect of raising the cost of funding trade finance, and likely, also reducing the amount of capital (lines of credit and related facilities) which a financial institution allocates to the trade finance business.

It is worth noting also that the implementation of BIS capital adequacy rules (with whatever local refinements might apply), is taking place at different times and rates in various regions across the globe. This reality further argues for clarity and correctness in the way in which BIS regulations are devised at the outset.

At a time of continued restriction on access to capital and financing (certainly in sharp contrast with the free-flow of finance, pre-crisis), the ability of a business such as trade finance to compete effectively for limited capital is fundamental to its success, and to that of its numerous beneficiaries.

International agencies, likewise, can and ought to be engaged in the dialogue, linking trade finance not only to the successful conduct of international commerce – and an eventual recovery of the global system – but also to efforts and outcomes in international development – including linkages to commodity trade.

The BIS is required by its mandate and the nature of its activities, to carefully consider a wide range of issues related to banking, financial services, capital markets and every aspect of the global financial system that touches on an aspect of the scope of BIS's activities. While trade finance may have been a relatively minor consideration in comparison to a host of others, the current reality is that trade finance has attained a level of profile and a certain organizational and political "critical mass", that requires a re-examination of the ways in which it will be adequately and fairly regulated.

The active and well-informed engagement of all major stakeholders, combined with a genuine, solution-oriented dialogue and the acknowledgment that national regulators will ultimately translate soft law into enforced regulation – with an appropriate layer of interpretation duly inserted into the process.

“The [capital adequacy] regulations will be what they will be: we will simply be forced to react to them...”

*- Global Trade Executive,
Americas*

Even when all the dialogue and process subtleties are resolved however, the process risks failure if it remains the victim of passivity or worse, apathy among stakeholders best positioned to shape developments in trade and commodity finance.

The challenges inherent to navigating to global economic recovery, just like the challenges of poverty alleviation and international development, are too complex and encompassing, for stakeholders to be permitted the luxury of excluding contributions from any direction that advances the dialogue and enhances execution: bankers, private sector stakeholders, regulators and those expert in international development all have a perspective to offer and a contribution to make. Eventually, non-bank providers may find themselves subject to similar regulatory oversight, and can contribute usefully to current discussions.

Just as the levers of global influence are inexorably evolving in recognition of new realities, so too, the influences shaping regulation of trade finance should evolve to recognize, and represent, the full gamut of stakeholders, ensuring that all are adequately well informed.

Regulation is required.

Well-considered and thoughtful regulation ought to be the objective of all concerned, given the recognition that anything less risks creating more damage than the negative outcomes it seeks to mitigate.

Sibos 2010: Interactive Session on Basel II

Sibos, the annual conference hosted by SWIFT, and arguably the leading industry event in financial services, certainly as relates areas such as transaction banking, payments and trade finance, was hosted in Amsterdam in October, 2010.

Over 9,000 delegates, including the largest trade banking contingent in the history of Sibos, over 1,300 strong, convened to consider numerous key industry trends and issues, with financial sector regulation – including Basel II and III, figuring prominently on the agenda.

In one session, attended by this author, a neutral party facilitated an exercise wherein attendees were separated into three groups, asked to review several sample trade finance transactions with varying characteristics and risk profiles, and were asked to determine the amount of capital to be applied to each transaction from a reserve perspective, to address the requirements of capital adequacy.

A consultant and advisor at heart, this writer opted to circulate between the three groups to observe the dynamics and the approach. In the end, these groups, led by three top-level senior executives, all experts in trade finance, arrived at different (at times markedly so) assessments of the transactions under consideration. Even with energetic interventions from one experienced audience member who clearly had significant history with these issues the groups applied different levels of regulatory capital in several of the case studies. In one instance, while the same capital requirement was identified, the rationale for doing so differed between at least two of the groups.

A microcosm of the state of the industry...

Clarity would be beneficial, no doubt.

Similarly, it is clear – and understandable – that the specialists at the BIS may not fully appreciate the transactional nuances related to trade finance and its esoteric instruments and structures. A similar exercise would no doubt reveal a similar divergence of views and understanding related to trade finance, though such a detailed understanding would serve well, the appropriate development of capital adequacy requirements linked to a unique asset class such as trade finance – and by extension, commodity trade finance.