Trade Finance: Re-Intermediation through Supply Chain Solutions

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- Trade finance is a core value proposition of leading banks, and uses long-established products and solutions to meet the needs of clients across the globe.
- The historical approach to trade finance is no longer sufficient given evolving technology, international commerce and client expectations.
- Leading trade bankers have identified a promising opportunity to add value through supply chain finance.
- The right trade banker is a key business partner – and a competitive advantage – in the successful conduct of international trade.

The business of international trade finance uses instruments and processes, such as the much-maligned and undervalued documentary letter of credit, which date back hundreds of years, and have evolved only incrementally over most of that period of time. In comparison, whole industries and industrial models have come and gone, or have fundamentally reinvented themselves over that same period, and trading patterns have been reshaped numerous times across the globe.

Acknowledging the effectiveness and adaptability of traditional trade finance mechanisms, and their enduring contribution to the conduct of international trade, it remains fair to say that the provision of trade finance services – especially at the short-term end of the market – has taken place in a fairly static, uniform and "commoditised" environment. As a client, you might have been tied to a primary bank due to credit line requirements on the import side, or relationship-maintenance considerations on the export side.

Either way, in most cases it was a factor other than the nature of a bank's unique or innovative product offering in trade finance that kept you coming back. A letter of credit from one credible bank was often as good as one from the equally solid bank across the street.

Recent developments in international trade and trade finance, however, threaten (or promise, depending upon your point of view!) to irrevocably alter this reality, in what is probably the most dynamic time for the business of trade finance since the early 1970s.

Technological, commercial and competitive forces have obliged trade financiers to look for new ways to add value for their clients, or face the prospect of becoming marginal contributors to the ever-increasing, profitable flow of global trade. Internet-based trade payment systems, the entry of hedge funds and other non-bank providers into trade finance, and the changing needs of international commerce in all parts of the world have combined to motivate – even demand – new offerings from trade finance.

The banks' and trade financiers' efforts at product, service and solution innovation are succeeding gradually, despite slow initial uptake from the market. It is not surprising to note that some of the most leading-edge thinking on the subject, and some of the first steps in shifting from theory to practice, are taking place in Asia, from China to India, Singapore to Japan and beyond.

A business based in, or operating in, the Asia-Pacific region has excellent opportunities to receive or derive value – traditional and leading-edge – from trade financiers and trade bankers today.

China, India and other de facto and emerging economic powers in Asia Pacific have taken centre stage on both the demand and the supply side in the equation of global trade – including key areas such as energy, natural resources and commodities of all types, as well as manufactured goods and service sector trade.

Asia has become, as was long expected, a major power in responding to demand across the globe, and has become part of company supply chains all over the world. Sourcing practices today are increasingly a combination of pure import, export of a finished product, and import for the purposes of further production.

Whether we consider a small business in Brazil or Canada looking to source products or inputs from China, or a global multinational in India seeking products from neighbouring markets, it is equally true to note that imports, exports and foreign investment may contribute, in combination, to the international activities of each of these companies. Even traditional re-exporters such as Dubai and Hong Kong are adapting to developments in global supply chain management and finance.

Trade Finance Shifts to Open Account

The fundamental shift from traditional trade finance instruments to the increasingly common use of open account terms – basically electronic (bank-enabled) transfers of funds between importer and exporter – without the traditional risk mitigation and financing options offered by the banks, is a direct consequence of the re-shaping of global sourcing patterns and supply chains.

Even as the business environment has become more complex, businesses have demanded a shift to a fundamentally simpler (though less secure) mode of settlement for international payment obligations. Leading trade finance banks have been working for years to develop new business solutions to ensure continued effectiveness as trade business partners. Meanwhile, the less visionary and imaginative cling to the notion that the trade finance landscape remains largely unchanged.

The shift in the model of trade finance has been driven by changing patterns of global sourcing, but equally importantly, by evolving technology that has become a transformational tool that permits the conception, development and marketing of new solutions and trade finance business models.

That same evolution in technology has also provided the basis for trade financiers – banks as well as the increasingly large group of non-bank providers – to offer some high-value business solutions in a creative and cost-effective manner to a broad segment of trade finance clients.

Transaction, or Business Solution?

Certain trade banks are questioning the sustainability and ultimate practical impact of the global shift from traditional products to open account, supply chain and other settlement and financing modes.

Some of those same banks and financial institutions continue to see trade finance as a purely transactional business, and fail to see a more holistic and relationship-based vision for this critical line of business, which supports one of the great engines powering the global economy: international trade.

While the exact definition of “supply chain finance” is still evolving, and varies between banks, there is definitely a higher level of interest in and dialogue about this topic – with one top global bank engaging their group chairman in supply chain discussions with top-tier clients across the world.

A relationship approach to trade finance offers the opportunity to devise tailored business solutions, and of deriving a competitive advantage through optimised trade finance, risk mitigation and payment facilitation.

Is there really a practical difference between a transactional and a relationship approach to trade finance?

If your business is to develop and construct great or uniquely designed structures and buildings, you will undoubtedly need a banker at some point in the conduct of business, and the choice you make will be a critical one – which could conceivably save your business, or sink it at the first sign of a windstorm at the construction site.

Does your trade banker supply a few bricks, then disappear until you need a few more, or does that financial specialist share your vision for the final structure, imagine with you the views from the top-floor penthouse, and work with you to provide the suite of business solutions that will enable, empower and sustain your business?

Does your banker attempt to force “proven” products and techniques that fit poorly in your market, or does that service provider understand local nuances – such as the flexible, camouflaged power of bamboo and its ubiquitous use at construction sites across Asia?

The finance of international trade can be about the bricks: simple solutions, many very similar to each other, which can be difficult to differentiate, and which deliver finite value, or it can be about the vision and the final structure: relationship-based, high value and highly tailored to your needs – providing effective commercial solutions and a competitive advantage.

Trade and Supply Chain Finance

It was once true that business people and academics across Asia looked to the Americas – primarily the US – to identify, learn from and adapt best practices related to business, finance and perhaps somewhat ironically, trade finance.

The hegemony of the US has been challenged on several levels over recent years, including in areas related to business and commercial best practices. This may be especially true in the context of cross-border business, where commercial sense alone is not sufficient for success, and where relationships and a long-term view are vital.

As one senior Hong Kong-based retired bank executive noted recently, "the only reason we look to the US these days, is to see if any of their actions are such that they will adversely affect us on this side of the globe.…"

The July-August 2008 issue of Singapore-based *Asia Inc* explores several dimensions of this emerging reality, in a feature piece entitled "A Long Goodbye: US and Global Growth Slowly Decouple". Recognising the still formidable impact of the US economy on global business, as well as the influence of the European Union, the article nonetheless opines that significant changes are in the making, noting that "In the 18th century India and China together accounted for half of global gross domestic product, according to Organisation for Economic Co-Operation and Development figures. If free trade and economic liberalisation continue apace, these two countries are on the way there once again."

This is a profound shift with consequences yet to be fathomed, and it applies equally well to the financing of international trade.

While some of the product and solution developments proposed by US and European service providers have been quite innovative – as companies such as TradeCard and TradeBeam illustrate – some of the more widely accepted "solutions" can best be described as conservative, iterative advances on traditional product offerings, even some that arise from the integration of long-standing products such as trade finance and cash management.

Many trade financiers continue to focus on the "bricks" rather than the "building", while leading financial institutions in Asia, including several that are headquartered elsewhere, have embraced both the risk and the opportunity represented by shifts in global sourcing and related developments in open account based trade, as well as the potential in new business models around global supply chains.

Trade bankers who share this view tend to speak also in terms of relationship-based approaches to business, and these ideas lead directly to the creation of supply chain financing solutions that look at the existing relationships as a series of proven commercial relationships, where the total value is greater than the sum of that of the individual relationships.

While most traditional trade finance products tend to approach business as a series of transactions, a supply chain-based solution tends to be driven by and tailored to the broader commercial objective – the building, not the bricks. In fact, leaders in the area of supply chain finance have engaged former logistics and supply chain executives in their trade banking teams, to devise, market and deliver effective supply chain finance solutions.

Certain trade financiers are looking to develop end-to-end solutions, with options to finance a client and/or key members of the client's supply chain – following the full series of procurement-related relationships, upstream into the most fundamental element of the client's supply chain.

Even further along in terms of evolving solutions in supply chain finance, is the view that extends to both the procurement and the distribution supply chains for a given client – effectively covering the acquisition of components, the assembly of a product, and the distribution and sale of the final output. Both the procurement and the distribution segments of the supply chain will have cross-border reach and involve international trade.

In the end, financing the full supply chain based on specific activities or selected points in the lifecycle of a transaction – referred to as “event-triggered financing” – works best if a client has that significant level of trust to make their business fully visible to a trade financier.

That transparency allows the bank to provide the most effective, tailored business solution for a client, shifts the dynamic completely to a relationship approach, and positions the bank as a strategic business partner: a privilege that many have lost by holding on to a transaction-based approach, and by refusing to respond to the changing realities – and requirements – of global trade.

Supply chain finance is a reality in international commerce. It presents opportunity for tailored delivery, and holds out the promise of a competitive advantage. The critical choice for an international trader is in the selection of a trade finance provider: will you be discussing bricks, or sharing the building of an edifice? Choose carefully. A trade financier can be a highly compensated order-taker, or an important strategic business partner.