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Trade finance: The landscape is changing—are you?

High performance. Delivered.

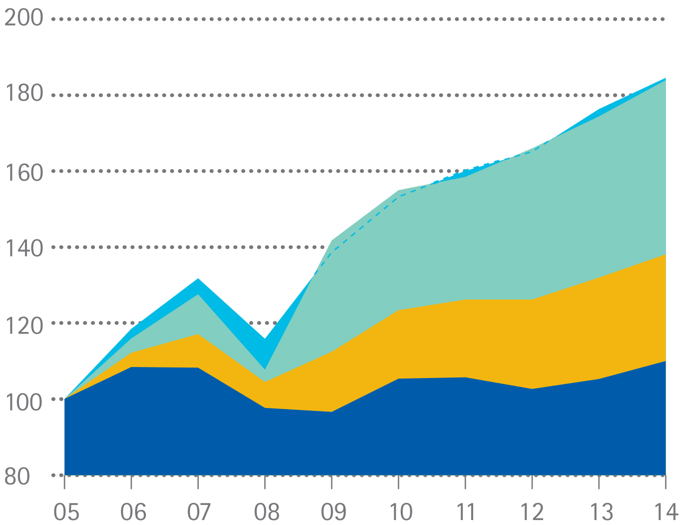
Doing business means taking risks. Doing business cross-border increases those risks: Will my buyer pay me, and pay me on time? Will the goods I ordered be delivered as agreed? What are the chances of future limitations on foreign currency conversion or transfer limitations? Is there a risk of political instability disrupting the trade relations? How will I finance these transactions and avoid liquidity risks and cash flow shortages?

Bank-intermediated trade finance has been the preferred instrument to offset these risks for years, hence making trade finance an important catalyst of cross-border trade and a solid source of revenues for banks. However, technological innovation, switches in corporate behavior, regulatory changes and increasing market competition are fundamentally changing the rules of the game.

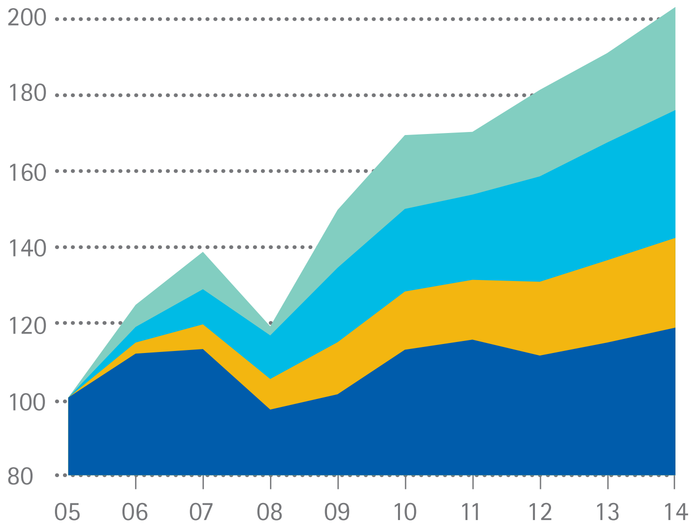
Trade finance – an attractive business

Global trade of goods has been growing at double-digit rates since the early 2000s, outpacing the growth in nominal world Gross Domestic Product. The only time when trade volumes declined was in 2008 at the beginning of the financial crisis.[1]

Global imports growth by region



Global exports growth by region



Source: CPB, Accenture

This growth is even stronger in emerging markets, particularly in Asia. In 2013, Emerging Asia represented around one-fourth of the value of global exports.[2] And according to the Asian Development Bank, this area's role in global trade will continue to grow with a 40 percent share of total exports forecasted by 2030.[3]

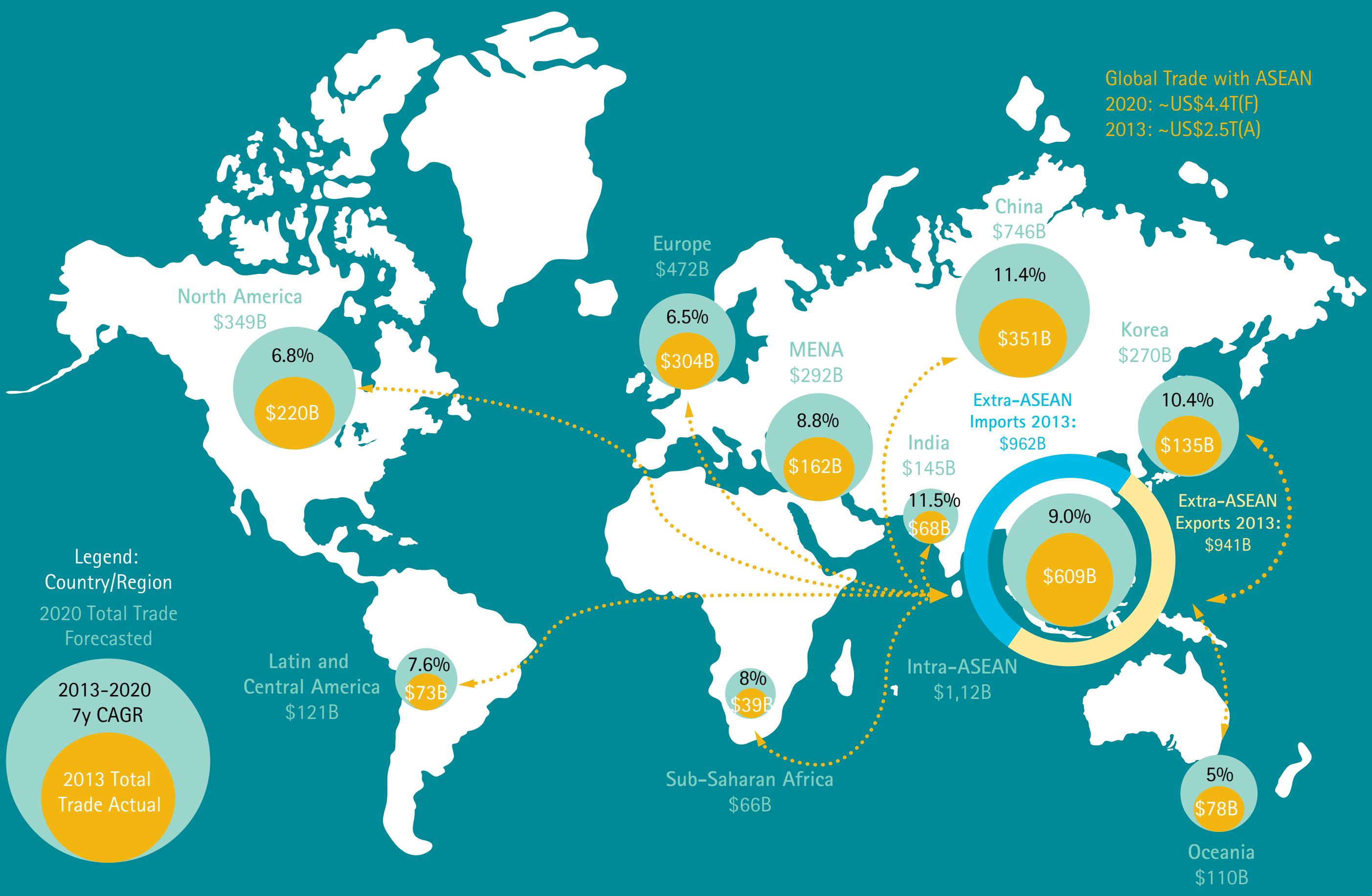
Banks play a fundamental role in the enablement of these cross-border trade flows through the payment execution, risk mitigation and financing.

They discovered long ago the attractiveness of trade finance as a recurrent and interest rate independent source of revenues, with the added benefit of default rates which have proven to be up to 10 times lower than for traditional corporate lending.

More recent evidence highlights the extensive cross-selling potential of trade finance by providing corporates with a complete and integrated transaction banking offering: $1 in trade finance fees can bring additional $1.70 in FX and cross border payment fees, and another $2.25 in other transactional banking revenue.[4]

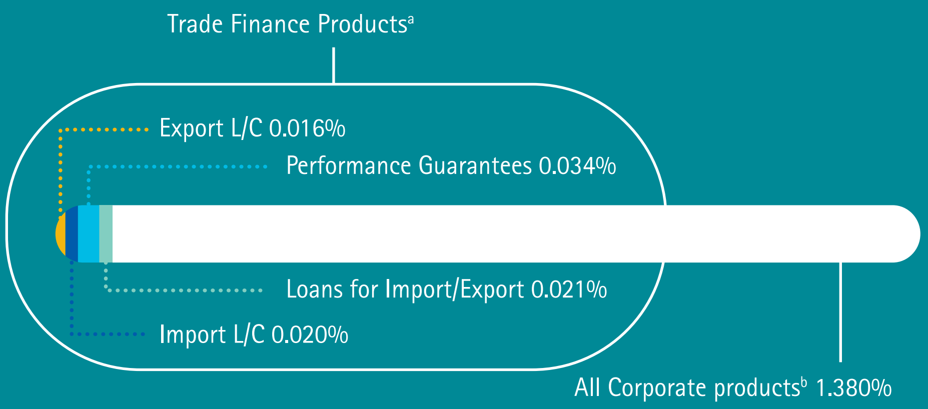
The importance of trade finance for banks in building lasting and profitable relationships with their corporate clients is undeniable.

Forecast growth in trade flows between ASEAN and its major trading partners



Source: Trade data from ASEAN stats as of December 2014; Accenture Estimates

Trade finance transaction default rates by product



Source: ICC "Rethinking Trade & Finance 2014"

[a]Default rates in the Trade Register (2013 report)

[b]Default rates for all corporate products in 2012 from Moody's

The world is changing rapidly

Technological innovation in the form of digitization of channels and products, switches in corporate behavior and expectations, regulatory changes and increasing market competition are today fundamentally changing the trade finance market space.

Switches in corporate behavior and expectations

With corporates gaining maturity in cross-border trade and getting more familiar with their trading partners and the countries they are located in, the need for risk hedging is decreasing. Corporates are getting more selective in the use of trade finance instruments due to the relatively high fees of trade finance instruments and the complexity and time delays connected to their reliance on paper documents.

This switch in corporate buying behavior is reflected in the growing importance of open account transactions, where the exporter delivers goods and the importer pays on reception or under agreed payment conditions. It is estimated that open account currently represents around 80 percent of trade transactions by volume and 35-45 percent of the value of all traded goods,[5] percentages which are expected to grow further in the coming years.

This move away from bank intermediated trade finance instruments is posing a real threat to the trade finance revenues of banks, while at the same time leaving corporates with reduced access to financing options.

The growing maturity of cross-border trade is not only luring corporates away from bank intermediated trade finance products, it is also leading to a further globalization and hence lengthening of the trade cycles, raising the need for working capital of the different players in the supply chain. The financial crisis has demonstrated the vulnerability of global supply chains to smaller corporates who often face difficulties in accessing bank financing, with supply chain failures as ultimate consequence.

Large corporates are therefore shifting their focus from meeting their own financing needs to ensuring the health of the entire supply chain. As a result, corporates are in search of new financial products that address their supply chain finance and payment needs in an open account set-up, and span across the company, its suppliers and its buyers, creating a clear challenge and opportunity for banks who want to continue to play a role in the trade finance space.

Digitization

Corporates increasingly rely on electronic channels to interact with their banks. This is also the case for trade finance. Those corporates are expecting electronic channels to become more and more sophisticated, not only providing basic transaction services, but also providing them with access to advanced reporting, forecasting and simulation services for trade finance, even more so integrated with different transaction banking products like payments, foreign exchange, liquidity and cash management.

Meeting the increased expectations of online channel sophistication is still done by a lot of banks through proprietary solutions. However bank independent platforms – portals and many-to-many host-to-host connections – offered by software vendors are gaining importance. These solutions are increasing the ease of use and transparency for corporate clients while fueling competition between banks.

An even more fundamental change is coming with the emergence of market standards for the electronic exchange of open account transaction data between banks and between corporates and their banks.

SWIFT, as one of the driving forces behind these data protocols, has launched the Trade Services Utility (TSU), a centralized matching and workflow engine which provides the timely and accurate comparison of data taken from underlying corporate purchase agreements and related documents, such as commercial invoices, transport and insurance documents.[6]

By replacing paper document flows with digital data flows, this trend provides banks with the fundamentals to radically reduce the cost and time needed to handle traditional trade finance products. Digital data flows also allow banks to develop new value added services like purchase order and invoice matching, liquidity analysis and forecasting.

Possible key benefits of supply chain products:

For the anchor or principal:

increased supply chain stability, better predictability of financial flows, greater visibility and control across the financial supply chain and payment process.

For the up and downstream participants:

improved payment terms, easier access to credit at better conditions, reduced complexity of following up payments.

Increasing competition

Given the cross-border nature of trade finance, the need for solid content expertise and the required balance sheet strength, large global banks continue to play an important role, accounting for a quarter to a third of global bank-intermediated trade finance.

There is evidence that European banks, which lost ground in 2011 and 2012 because of stricter regulations and dry global funding markets, are making a comeback. Together with American banks, they are looking at emerging markets for growth by following the global expansion of their clients.

However, local and regional banks in those emerging markets continue to stand strong. They are defending their historical majority market shares by leveraging their deep local relationships and their understanding of local markets, while investing in getting their offerings up to global standards.

While non-bank players only take a modest part of the total market, recent years have shown the emergence and success of logistics companies, supplier networks and specialized niche trade finance companies focusing on commodity trade finance or SME trade finance. Alibaba is already picking up on this trend, entering into a partnership with two UK start-ups to provide financing to small British businesses looking to buy from Chinese suppliers.[7]

It is likely that the nimble start-ups will be the first to leverage blockchain technology for trade finance, further adding to the threat for traditional banks.

Regulation

One of the most important regulatory responses to the financial crisis was Basel III, which triggered the deleveraging of banking balance sheets and constrained the availability of credit. Since then the apparent adverse economic effects of the new regulations have led to the relaxation of capital requirements for trade finance assets. This is paving the way for a renewed interest in trade finance, especially in those regions with high Basel III compliance.

What to do to stay in the game?

Extending the traditional trade finance products with sophisticated, online access and with supply chain offerings will be key for banks to safeguard their position and continue to drive growth.

Building a supply chain offering

Innovating trade finance products and channels by enabling sophisticated, online access, replacing paper document flows by data flows and building a supply chain offering will be key for banks to safeguard their position and continue to drive growth.

The supply chain offering spans a vast range of financing, payment and liquidity management services, and is still in full development with product characteristics varying between banks and geographies.

However, a number of generic trends in the development of product characteristics can be highlighted:

Anchor centered

Programs are typically set up with a large, often multi-national anchor or principal, building on its credit rating to finance players up and down stream in the supply chain; often SMEs with little access to traditional bank financing.

Multiple participants

Deals cover a set of transactions or a cluster of supply chain participants, with numbers ranging from a couple of hundred to a hundred thousand.

Web-enabled

The cross-border character and sheer size of some of the programs in terms of participants make online channels an indispensable part of the offering.

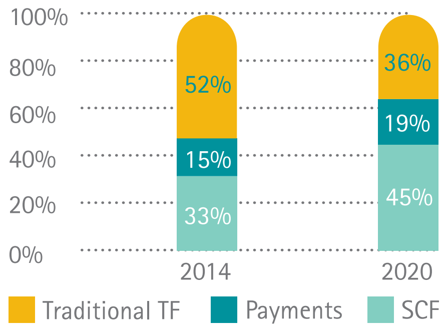
Customization

Given the recent emergence of these products, standardization is still low, with large corporate anchors expecting the bank to be flexible to tailor to their needs.

Syndication and securitization

Deals are often too large for one single bank and banks are hence turning more and more to syndications and securitization.

Trade-related revenues for banks



Source: CEB TowerGroup analysis, Accenture estimates

Digitizing traditional trade finance products

Bank Payment Obligation (BPO) is the other new kid on the block. It represents an irrevocable undertaking on the part of an importer's bank to pay (or incur a deferred payment obligation) at maturity a specified amount to an exporter's bank. Although the BPO product is not different from traditional trade finance products in its intent to mitigate the risks of international trade, it does so in a fully digital way, thus offering significant advantages in speed, flexibility and reduced complexity.

Bank Payment Obligation

Benefits for the importer

- Better payment terms and conditions
- Mitigation of goods delivery risk
- Increased convenience and reduced cost

Benefits for the exporter

- Assurance of payment
- Access to flexible pre- and post-shipment finance
- FX risk elimination by BPO in home country currency

Benefits for the bank

- Automated, low cost, high accuracy solution
- Upfront definition of matching rules eliminates subjectivity
- New value-added services opportunities

Source: International Chamber of Commerce "Bank Payment Obligation."

The race for efficiency and scale in traditional products

While new products and channels are emerging, traditional trade finance is becoming more and more commoditized, leading to growing pressure on the need for efficiency in delivery. Banks are therefore modernizing their trade finance platforms, opting for field tested technology solutions and maximum simplification and automation of processes. Outsourcing and offshoring strategies are imminent as the next step in the pursuit of cost savings.

A broad range of mature trade finance software solutions is available on the market. These solutions differ in product and functional scope as well as regional focus because of remaining local market specificities:

- Trade finance-focused packages: in most cases combining front- and back-end solutions with deep functional coverage
- Transaction banking packages with trade finance functionality: covering all transaction banking products, including trade finance, enabling a full and integrated transaction banking offering
- Universal banking packages with trade finance functionality: universal banking solutions with often somewhat more basic trade finance functionalities

Conclusion

Trade finance is an attractive business for banks. Global trade continues to be on the rise and banks play an important role in facilitating the financing, payment execution and risk mitigation through the sales of trade finance instruments. The significant cross-sell potential, ability to build lasting and sticky client relations and the low loss ratios of the instruments make for an attractive business for banks.

However, the trade finance market is changing drastically. Digitization is one of the key drivers: interaction between corporates and their banks happens more and more through online channels, and technical solutions to fundamentally replace paper document flows by electronic data flows are becoming readily available.

At the same time, large corporates are changing their expectations on the trade finance solutions provided by their banks. They are looking for the means to play an active role in the stabilization of the supply chains to which they belong, while at the same time being able to benefit from the advantages of open account transactions where possible.

Banks need to step up their game. They need to innovate their trade finance client offerings to include supply chain solutions, apparent adverse economic Bank Payment Obligation products and sophisticated online channels to access traditional and new products. At the same time, they need to invest in the efficiency of their process and technology capabilities to ensure an offering that is competitive both in terms of price and quality.

And they need to do it fast, since competition from global and local player is getting fierce.

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