Trade & Supply Chain Finance 2011

GLOBAL FINANCE

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Weathering The Storm

Following the 2008 financial crisis, trade finance was a term often uttered in the upper echelons of global political circles. Treasury secretaries bandied the term around at G20 meetings, stressing the importance of keeping the wheels of world trade well oiled and lubricated. The IFC established its Global Trade Liquidity Program, a joint private and public sector initiative designed to ensure banks in emerging markets had access to liquidity to help finance trade in their countries.

In 2010 there was a global recovery in trade, with volumes reaching record levels. But then 2011 began with global disasters and political upheaval. The Japanese earthquake and tsunami caused major disruptions in global supply chains, and trade to North Africa and the Middle East continues to be affected by the aftershocks of spring uprisings in the region.

Despite various bailouts, the sovereign debt crisis continues to hold sway across Europe, and banks are worried about the implications regulatory capital requirements under Basel III could have on traditional forms of trade finance—such as letters of credit and trade guarantees. Under the new rules, these instruments could attract a high leverage ratio similar other off balance sheet items. It is not just banks that are concerned about Basel III. Export Credit Agencies are also likely to be affected by the proposals, which could see loans they back no longer zero risk weighted. In this special report we explore the impact these global market events will have on trade.

We also look at how all of this is affecting global trade for corporates—buyers and suppliers that have historically relied on bank credit to finance trade. Few markets are now expecting an export-led economic recovery. Between this, tighter credit conditions and the reduction in global trade finance capacity from banks, companies are turning to alternative sources of liquidity. Trade securitization is regaining its lustre as a cheaper form of liquidity. And centuries-old trade finance tools, such as forfaiting, are getting a facelift as part of larger supply chain finance programs.

Companies are also getting smarter about how they source goods. By ensuring strategic suppliers in their supply chain are economically sound, efficient, and use green sourcing, companies are hoping to build more sustainable supply chains that can weather any economic storm—and build their brand reputaion at the same time.

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Rebuilding Confidence

Global trade was affected over the course of 2011 by major disruptions such as the US sovereign rating downgrade, the Japanese earthquake and political upheaval in the Middle East and North Africa. Not only are companies managing the impact of these events on their supply chain, but they are also looking for new alternatives as existing trade finance capacity tightens. By Anita Hawser

When the US sovereign long-term debt was downgraded by Standard & Poor's in early August, global trade was already contending with the Japanese earthquake and tsunami in May and the ongoing political and social unrest throughout North Africa and the Middle East, which continues to simmer in countries such as Libya, Egypt and Syria. The downgrade, along with the ongoing European debt crisis, added extra friction to already-slowing global trade volumes.

In response to the uprisings in North Africa overall trade and trade finance volumes declined, says Michael Burkie, market development manager, treasury services, EMEA, BNY Mellon. However, he adds that it was not a "global trade event crisis." The most recent major global trade setback was in 2009 when exports worldwide fell by 12%. The secondary market in trade also disappeared as banks' confidence in one another nosedived and a number of monoline export credit insurers became more risk averse.

After the 2008–2009 financial crisis, joint public and private sector initiatives pumped significant amounts of liquidity into global trade and financial markets. In 2010, the World Trade Organization reported that world trade grew by a record-breaking 14.5%. But in April this year, the WTO warned that global trade was not out of the woods yet and that it would grow more modestly in 2011, at 6.5%. The WTO stated: "The short-term outlook was clouded by a number of significant risks factors, including rising food prices and unrest in major oil exporting countries. Adverse developments in any of these areas could potentially set back the economic recovery and limit the expansion of trade in the coming year."

On the brink

A number of market events have occurred since the WTO published those comments. In early August, financial markets watched in disbelief as gridlock in the US Congress between Republicans and Democrats over spending cuts pushed the US to the brink of defaulting on its debt obligations. Both sides eventually ceded ground to reach

Ahearn, Citi: Costlier trade to come

agreement, but should no accord have been forthcoming global trade could have come to a standstill.

"The US economy is still one of the largest import economies on the planet," says Burkie of BNY Mellon. And with US government spending cuts on the horizon, he says trade could still be impacted. "Early next year there is an opportunity to revisit the cuts. It hasn't given the 100% top-to-bottom assurances that America typically would have given the marketplace."

The export credit insurance market was not directly affected by the US sovereign downgrade, but Charles Berry of BPL Global, which provides political risk and trade credit insurance, says the insurance market is vulnerable to any economic events. "If the world enters a double dip recession, that would impact trade insurance and political risk," he commented. "The number of claims would go up, as it always does in a recession." He says monoline export credit insurers are not yet tightening their underwriting as much as they did in 2008 during the crisis. "But if it happens, monoline credit insurers are in a better position today than they were in 2008."

European Debt Overhang

Concerns remain, however, about the impact of the debt overhang in the eurozone. John Ahearn, global head of trade finance, Citi Global Transaction Services, says banks are cutting back on their exposure to other banks in the eurozone. "One of the things we should be thinking about is how bad it is going to get," says Ahearn. "We should be starting to lay some groundwork now if we need to inject capital into these specific markets."

Ahearn says the issue of sovereign risk presents a more complex scenario than what trade banks faced in 2008. "The good news is that whatever is happening, it is happening at a slower pace, which gives us a chance to react. But I don't think the financial community is reacting quickly enough."

One issue that must be addressed, says Ahearn, is that European banks often deal in trade and commodities denominated in US dollars. "European banks are clambering for US dollar liquidity. However, the way the swaps market is working today, it is very expensive for them to swap euros to dollars."

Improving Working Capital

With bank credit still scarce, particularly for smaller-to-mid-sized companies, corporates are focusing on how they can best utilize their working capital on a global basis. "Having learned during the 2008 recession how critical it is to ensure the health of their trading partners, many buyers and suppliers are collaborating around supply chain financing," says Drew Hoffler, senior manager of financial solutions at system vendor Ariba. "More and more companies see supply chain financing as a new tool they have in their arsenal that can help them."

In the past 12 months, Hoffler says the number of buyers using its cloud-based Ariba Discount Professional, which is a dynamic discounting solution that enables buyers to fund suppliers earlier in the trade cycle, increased 60%. Dynamic discounting is the practice of changing payment terms to speed up payment on a sliding scale: the earlier payment is made, the greater the discount given.

Companies that are not already doing so may be forced to improve their trade finance processes as a result of regulation, according to Rakesh Bhatia, global head of trade and supply chain, HSBC. He notes that in the bank's biannual Trade Confidence Index traders have consistently highlighted that government and trade regulations remain a barrier to growth. For example, the impact of Basel III on global trade is still unclear.

Regulatory Squeeze

For the past 12 months, banks have argued that if capital requirements for trade finance are restrictive under Basel III, it may no longer be an attractive business. Trade banks and the International Chamber of Commerce in Paris have presented statistics to the Basel Committee to argue their case that trade is short-term and has a low rate of default, so should not be considered a high-risk activity—and therefore should not be subject to higher capital requirements. Those close to the discussions say that they appear to be moving in the right direction—toward lower capital requirements—but the outcome is still uncertain.

Bhatia says HSBC supports the rationale behind the need for banks to hold more capital, but under the new regulatory regime trade finance should be treated in a way that reflects its "true risk profile."

Ahearn of Citi believes that Basel III will undoubtedly make trade more expensive. "Some of our clients are beginning to realize this and are asking us to take legal clauses out of documents that allow us to pass along regulatory price increases." However, trying to model the impact Basel III will have on the business is somewhat of a guessing game right now, says Ahearn. "Banks don't understand how much capital they need to apply to the business, how much of the balance sheet they will use and what the ramifications are of using that balance sheet."

He says banks will need to find ways to make the trade business "capital light", which means the model of booking a trade and then holding it on the bank's balance sheet is unlikely to be sustainable. Export Credit Agencies are also concerned about the impact Basel III could have on them, as ECA-backed loans will no longer be zero risk weighted in terms of capital requirements.

Berry of BPL Global says if some banks' capacity is constrained as a result of Basel III, trade could be financed by different sources of capital. According to Berry, "Other sources of capital, such as hedge funds and specialist private equity funds, continue to find opportunities in trade finance."

"If the world enters a double dip recession, that would impact trade insurance and political risk"

"The number of claims would go up" —*Charles Berry, BPL Global*

In With The Old

Thanks to new technology that improves information flow, traditional trade finance tools such as forfaiting are now being used more frequently as part of a broader supply chain finance program. By Paula L. Green

The age-old mechanism of forfaiting is regaining its shine as new technologies make it more alluring and tighter credit conditions demand a broader suite of tools for financing global trade.

Forfaiting is the sale of receivables at a discount on a non-recourse basis. It is usually used by exporters for longer-term receivables—for products such as heavy machinery or other goods paid for in installments over long periods of time. It offers exporters the security of immediate payment—albeit at a discount—for deferred payment receivables.

As web-based technologies allow information to move more efficiently through complex supply chains around the globe, it is making it easier to revisit and increase efficiency of tools such as forfaiting—allowing it to be used more broadly within larger supply chain finance programs.

Paolo Provera, chairman of the International Forfaiting Association in Zurich, says any company in any industry carrying out transactions of all sizes can benefit from its use.

"We see an increase of deferred payments instruments on corporate risk, and forfaiting gives suppliers a competitive tool to better negotiate their contracts abroad by offering better conditions," says Provera, who is also general manager of the Milan branch of Arab Banking Corp of Bahrain. Forfaiting allows a seller to reduce its days sales outstanding while providing their buyers with the longer payment terms that they are demanding.

Eugenio Cavenaghi, head of global trade and supply chain finance products development and facilitation at UniCredit, says new web technologies and automation hasvemade the exchange and processing of large volumes of information much more efficient than in the past.

The resulting simplification and increased efficiency has helped expand its use beyond traditional long-term receivables and eased minimum dollar value limits of transactions. "Forfaiting can now be applied to the 'flow' business, the day-to-day open account business activity consisting of many small-ticket transactions in small amounts," says Cavenaghi.

Enrico Camerinelli, senior analyst for Europe, Middle East and Africa at consultancy Aite Group, agrees that forfaiting is benefiting from the greater use of technology. "One of the trends in trade finance is the acceleration of electronic transactions to remove paperwork," he adds.

Tighter Credit Conditions

Credit conditions are tightening in many markets. With traditional working capital more difficult to come by, it could spark corporate treasurers' interest in forfaiting.

Michael Quinn, managing director, product development, global trade, at J.P. Morgan Treasury Services, says that this, combined with the greater capital requirements of Basel III—which may further restrict traditional trade finance capacity—could make forfaiting a more useful trade finance mechanism because it is done on a non-recourse basis.

The without-recourse nature of forfaiting gives exporters the opportunity to sell the obligor risk to a forfaiter and gain immediate liquidity.

Plus it allows them to shift transactions off their balance sheet. It can be used for promissory notes or bills of exchange, and now is also commonly used for discounting deferred payment letters of credit and receivables financing.

Cavenaghi of UniCredit says the Basel III regulations could encourage banks to use forfaiting more frequently as a means to improve the management of their risk-weighted assets. "And forfaiting in the secondary market is definitely a most efficient tool for the portfolio management of a bank," he adds.

But, according to Quinn a bank must maintain a book of business in forfaiting and be engaged for the long haul to make it financially viable.

New Rules May Increase Appeal

The International Forfaiting Association is working with the International Chamber of Commerce to develop informal rules that would make forfaiting more appealing to banks and companies by standardizing processes.

Don Smith, principal of US consulting firm Global Trade Advisory, says the creation of a set of uniform rules should reduce the effort involved and lower the accompanying costs.

Today, most forfaiting transactions are "heavily lawyered," which adds time and expenditure to the transactions, says Smith, who chairs a chamber group that is drafting the new rules. Standardization should reduce the amount of time and legal involvement in deal structuring—and thus reduce costs. Smith says he hopes the rules will be completed in about three years.

Cavenaghi believes that forfaiting can help corporate executives manage their supply chain by reducing days sales outstanding and freeing sellers from their buyers' credit risk.

"This allows the seller also to access markets where clients are demanding tough payment terms or it lets them expand their business without incurring working capital bottle-necks," he adds.

While trade banks are increasingly interested in adding forfaiting solutions to their suite of supply chain finance products, that does not necessarily mean that traditional forfaiters should be moving into SCF, notes Provera.

He says that supply chain financing transactions tend to be short-term, high-volume, highly tailored structures. These transactions also frequently involve large investments in technical booking systems to support the business.

"I believe there is pressure for forfaiters to develop their product offerings, but I do not necessarily think that supply chain structures are the most obvious move," adds Provera. "I do not think that [SCF] is necessarily a natural area for forfaiters to move into."

Forfaiting adds another layer of transactional complexity to trade finance even as it lets exporters pass on risk to a third party or a central corporate treasury, notes Patrick Coleman, general manager of the United Kingdom and Ireland, Benelux, France, the Middle East and Africa at IT2 Treasury Management Solutions. He says that treasurers have shown interest in the tool.

Yet even with the expanded array of technology and information that corporate treasury hubs have to help them navigate the complexity of supply chain finance, forfaiting is still a secondary tool that will be useful to some, but not all, companies in managing their global trade.

Camerinelli, Aite Group: Electronic transactions are growing in use

"The seller [can] access markets where clients are demanding tough payment terms"

"Forfaiting can now be applied to the...day-to-day open account business... of many small ticket transactions" —*Eugenio Cavenaghi, UniCredit*