The last three years have seen incredible headwinds into the trade finance space for banks. The perfect storm

The continued low interest rate environment, coupled with the ongoing quantitative easing, is creating a similarly ongoing surplus of liquidity in the markets. Banks are scrambling to get performing trade finance assets onto their books that yield any meaningful returns.

Second, the new regulatory regime of Basel III is seriously impacting the cost of trade finance assets for banks. This is because most banks do require their operating units to pay a liquidity premium to their own treasury departments to ensure optimal usage of the bank’s balance sheet. As this liquidity premium is applied for any asset irrespective of tenor, short-term trade finance assets do get unduly penalised.

Third, the increased cost of compliance, in particular the new requirements for AML and sanctions management, are further eating into the banks’ net profits on their trade finance businesses.

Impact on the bank clients

As a result of all of this, large corporates and trading companies have access to cheap trade finance, while local, regional and global banks are running after the same type of assets and are in intense competition with each other.

However, there is still a major trade finance gap out there for SME clients in the developing world – for whom it continues to be very challenging to get access to bank trade financing. In the bank-to-bank space, AML risk, relationship cost and profitability considerations have all had a huge impact on the portfolio of various western banks and forced them to review – and in some cases close – many client relationships where the throughput did not pay for the actual cost of maintenance.

The dilemma for banks

As indicated above, the regulatory regime of Basel III plus the other contributors have created a perfect storm, and are eating deeply into the banks’ net profits from the trade finance business. Two areas of focus are emerging:

- the actual cost of maintaining a client relationship with the increased AML compliance requirements; and
- the actual balance sheet return of the trade finance assets that can be originated.

The outcome of all of this is that in the bank-to-bank space, the new AML criteria and knock-on costs lead to much more scrutiny of whether the client relationship is likely to be profitable or not.

However, the more difficult choices the banks have to make lie in the second area where the perfect storm hampers the profitability of maintaining their corporate trade finance clients – be it for traditional trade finance or for the supply chain or export finance portfolios. Low spreads mean lower returns and, on a stand-alone basis, many transactions are generating very low returns or, in some cases, even a negative return, as capital and liquidity costs exceed the spread that can be achieved on certain transactions.

With such low-performing portfolios, programmatic distribution in form of either securitisation or other investor-friendly joint venture structures become very difficult.
to set up as the economies are simply not there. Banks, whose main business priority is return, have already reduced or are in the process of reducing their trade finance activity and are very selective about which new transactions they will consider. Often, they are only willing to provide trade finance lending where there is a profitable overall multi-product client relationship in place or they have an agreement with the client for compensating business to enhance overall return on lending.

Return
Another area of differentiation is the calculation models that are being used in the banks to calculate the return on equity (ROE), their risk weighted assets (RWA), and the return on risk-weighted assets (RoRWA). These pricing or return models have become more and more sophisticated over the recent years with lots of variables loaded into them as a result of the new financial regulations and each banks’ own view on how returns should be calculated. There is no “one size fits all model” being used across the industry. Items such as liquidity premium, overhead cost, ROE margin and cost of credit vary greatly from organisation to organisation and, on top of that, there are local levies imposed in various jurisdictions that either apply for local bookings only or also apply for off-shore bookings.

There are banks that have reduced their return requirements and are happy to add trade finance assets to their books at single digit returns and increase their market share rapidly. Mostly these banks are regional or local banks, whose balance sheet structure allows them to build large asset portfolios at single digit returns and hence they are becoming more aggressive in supporting their corporate clients internationally. At the same time they are also building out their correspondent banking activities to capture additional flows.

Efficiency
No matter what the strategy, all banks are challenged to increase the efficiency of their trade finance business. There are three areas of particular focus that are relevant:

- leverage technology and data management;
- set up an integrated implementation and delivery framework; and
- deploy value pricing.

Let’s look at these three areas in more detail.

Technology and data
Despite the fact that trade finance is a lending business and the main driver is credit and the lending aspects as outlined before, technology plays a key role for any bank to excel in trade finance and to increase its efficiency. Only the large banks have the investment appetite to build their own systems and most banks depend on external vendors to support their solutions sets. There are some good systems available and it can be tough to choose the right provider. In any case, the key challenge is always to build the interfaces and to ensure that the systems can support the bank-specific solution sets. In addition, data management has become a key competitive differentiator and banks who can equip their front office staff with real time client data globally will have an advantage.

Implementation and delivery
Equally important is to set up an integrated client delivery framework to ensure that the client experience is at a high level and that the bank actually delivers quality service throughout. Two areas come to my mind.

First, the supply chain finance space, where implementation project teams become part of the sales process, and having a fully functional, trained and aligned implementation team can be a key competitive advantage. The second area is the conduct regulation space where a bank needs to have a framework of controls, escalation points and rapid decision making process for resolution in place to maintain the client service that clients expect. It is crucially important that AML KYC and sanctions decisions can be taken rapidly to ensure they don’t hold off the commercial arrangements of the clients and are in line with the time sensitivities of settling the underlying commercial contract and movement of goods or services.

Value pricing
Finally, the third area of the efficiency topic is the introduction of ‘value pricing’. It is important that all stakeholders and, in particular the front office staff understand and can articulate the value proposition and client benefits of each solution set to increase the efficiency of the sales process and to maximise the return that a bank can achieve from its trade finance business.

Meat and poison
One man’s meat becomes the other man’s poison. While the international trade flows are shifting east and south-south trade is growing much faster, regional and local banks covering those markets can build up their portfolios and their market share pretty quickly – but the traditional large banks have a tougher time to keep their market share. However, this is a generalisation. Each bank is adapting its own strategies to the new market realities, and further behaviour changes are being expected to transpire over the next few months – and during next year – as the parameters of the perfect storm are here to stay and the economic cycle change is shaping up to be a very slow change in the making. Already, now we see signs of trade finance team reductions, and other cost saving measures. And, in the case of GE Capital or RBS, there has been partial or total withdrawal from the market.

Choices
Keeping or growing market share comes at the price of accepting lower returns over a longer period, which have to be absorbed within the client relationships. It’s best to stay close to your clients and to defend market share as much as possible. When the economic cycle changes and liquidity tightens and spreads go up, one can then benefit from the client loyalty, and the resulting spread increases should transform the trade finance portfolios into more attractive assets. Another positive impact of increasing spreads and returns would be that programmatic asset distribution would become more attractive, and more institutional investor funds could be used to finance international trade.

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