Trade Finance, quo vadis?

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Why trade?

Trade is an economic development imperative. Every economy relies on trade to earn national income and provide local employment. Every country attempts to achieve a surplus of export value over import value. Some countries, particularly in South Asia have experimented with 'import substitution' as a policy. This route has been largely discredited as it does not deliver the economic growth required over the long term. Import substitution may have worked had it only meant 'sensible self-reliance'. When import substitution combines with severe foreign exchange control, it ends up limiting cheaper essential imports, protects inefficient local production, decline in quality standards and limits incentive to invest. Import substitution could be seen as an expression of mercantilism but ends up negating the international trade theory of comparative advantage.

Asian tigers Hong Kong, Singapore and Taiwan successfully adopted the export-driven model. However for larger countries with greater, more diverse population, this works up to the point import markets are buoyant. Focussing on exports at the cost of developing local consumption also stunts economic growth. The solution lies in achieving a balance between calibrating domestic consumption to avoid wasteful expenditure, encouraging inward investment flows towards sustainable wealth-generating activities and achieving cost-competitive production.

In the South Asian neighbourhood, intra-SAARC trade has not lived up to its potential. Political and cultural divides have held back governments from exercising the political will to commit to pragmatism. In comparison, NAFTA, ASEAN and the European Common Market mechanisms though imperfect, have delivered results proving the benefits of regional multilateralism. A starting point for each South Asian country is to develop a national consensus about the need to engage with neighbours while the resolution of political disputes is placed on a separate agenda. Dubai and Singapore do more SAARC trade than the countries constituting SAARC.

The contradictions affecting trade

The trading business has traditionally been exposed to low entry barriers leading to intense competition. Consequently, they have no leeway to accommodate inefficiencies. Trading businesses have had to diversify into upstream and downstream activities related to the products they trade, creating supply chains. However supply chains thrive on the back of effective infrastructure. The standard of port facilities, their operating efficiency, connectivity with the hinterland are matters requiring improvement. Political leaders, administrators and economists tend to agree on according trade a high priority. Yet there exists a lack of synchronicity between trade-related regulations and the promotion of trading as a valuable economic activity. Perhaps, designating trade as a primary economic activity deserving the attention of a senior cabinet minister may contribute more focus and attention. Should trade occupy a higher profile, the place of trade finance within a bank would move correspondingly.

The place of trade finance in a bank

Often trade finance is lumped with other forms of business lending and therefore submits to treatment that is not entirely appropriate. Trade Finance is not just another form of lending to corporations nor should it be viewed simply as financing of working capital. While the premise in corporate banking is substantially the credit worthiness of the borrower, trade finance is a form of asset-backed lending. It gives weight to the acceptability of the underlying performance risk representing the borrower's abilities and counterparty credit and performance risks. A corollary is the attendant risks are dispersed. This is not to suggest that the borrower's creditworthiness is to be ignored.

Providers of trade finance take a transactional view of the client rather than an aggregated view offered by financial statements. It is also in the nature of trade finance for borrower's drawdown occurring for each transaction separately, the related cash and documentary flows could be isolated and followed, offering the lender a greater degree of transparency. Moreover, certain classes of trade finance exposures remain a contingent liability for a bank vis-à-vis the counterparty, till such time contractual performance occurs and the related documents are presented.

The organisation structure in banks may not be entirely suitable to promote growth of their trade financing business. In many institutions, relationship managers are tasked to identify a range of borrower's needs including trade finance. When the client's trade finance requirement is referred to risk approvers, the proposition could be viewed through the lens of the bank's general credit evaluation protocol, rather than a trade finance-specific risk evaluation protocol. In between these two parts of the bank lies the 'Trade Finance department' which essentially serves the purpose of implementing and following up on approved transactions. This suggests the 'Trade Finance department' is concerned only with the operational aspects of the trade finance transaction. Focus on trade finance business of a bank is better served when all trade finance-related activities are placed in a silo – relationship management, operations and a suitable risk approval protocol. It is this distinction separating the large international providers of trade finance from other banks offering an array of corporate & institutional banking services.

….. and now the regulators?

The same lack of distinction seems to be at play in the 'regulator' space. The Basel Committee on Banking Supervision at the Bank of International Settlements (a forum for central banks) has proposed measures commonly referred to as 'Basel III'. Basel III was announced following the disastrous consequences of the global financial crisis of 2008/2009. The areas of particular concern of the Basel Committee was to bring some order and restraint in regard to derivatives and securities transaction exposures (among other matters) undertaken by deposit-taking institutions. Using somewhat of a sledge hammer approach, Basel III can be summarized in three dimensions for the purposes of this article.

- More capital
- Less leverage
- Diversified funding

The need for banks to bolster capital is by itself not a bad idea as it equips them to absorb a larger quantum of unexpected losses. However, shareholders contributing capital will demand returns commensurate with the risks they are exposed to through the bank's activities. A trust deficit has emerged between contributors of capital and bank managements, thereby making it more difficult to attract fresh capital. This leads to risk aversion on the part of lenders, a constriction in the outward flow of credit, so all forms of lending including trade finance is affected.

The limitation on leverage displayed on the bank’s balance sheet is a matter of particular concern to the trade finance community. This is a non-risk based measure intended to rein in the size of bank balance sheets on the back of limited capital. Emerging market banks may be required to translate off-balance sheet exposures (where substantial trade finance exposures reside) into on-balance sheet liability on a 1:1 basis. This is a significant change as previously certain categories of trade finance exposures were translated at a discounted rate. This directly affects the additional capital banks will need to secure at a time when conditions to attract fresh capital are not ideal.

The events of the global financial crisis highlighted the ‘contagion’ effect whereby linkages between banks in supporting financial transactions led to wholesale, along-the-chain distress when one link collapsed. The global trade finance system relies substantially on inter-bank funding to facilitate the cash flow needs of counterparties connected through a transaction.

The bulk of trade finance exposures are extinguished within 360 days of inception, in fact mostly within 180 days. Yet, regulators may require banks to reserve 360 days funding regardless of the shorter duration of transactions. As if this is not a large enough obstacle, the Basel Committee has suggested no weight be assigned to funding provided by correspondent banks in calculating the net stable funding ratio of the lending bank. The Basel Committee prefers the banks rely more on retail customer deposits placed for long maturities as a stable source of funding. This is a case of going back to basics.

A reading of the Basel Committee’s recommendations suggests that the considerations of the trade finance community (both providers and users) were not a matter of the highest priority.

So the question ‘Trade Finance, quo vadis?’

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