



TreasuryPulse

Passion to Perform

Next Generation Innovations in Trade Finance



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Recent trade finance developments, particularly in the wake of the global financial crisis, benefit corporates in developed markets and those based in burgeoning growth areas such as export-driven Latin America.

Global trade was once predominantly conducted on letter of credit (LC) terms. LCs, though expensive and comprising a largely inefficient, paper-based process, were favored because of the security and bank credit support they offer.

Times have changed. The march of globalization, the rise of the emerging markets and the pre-crisis free-flowing of liquidity led to a shift away from the LC toward open account (OA) trade. OA offers more efficiency through lower fees and less paperwork, making it an attractive way for trusted counterparties to conduct business, provided they can get comfortable with the issues around higher counterparty risk and reduced access to finance.

While on a global level LCs have lost significant ground to OA trade, they remain the option of choice for riskier markets and certain sectors — such as commodities — in which sustained high transaction volumes continue to drive demand for risk-mitigating instruments. LCs also made something of a comeback in the wake of the global economic downturn. As trade entities found once open bank-supplied credit lines and capital markets to be restricted (or prohibitively expensive), and became increasingly conscious of counterparty risk, appreciation for the risk-mitigating properties of the LC returned.

This was not the only trend that stemmed from the credit crisis. As abundant liquidity was no longer available to keep supply chains flowing, companies had little choice but to focus on internal working capital management practices to ensure business continuity and underpin the strength and security of their supply chains. In response to this change in corporate focus, banks — particularly the major international trade banks — developed financial supply chain products designed to combine the risk-mitigating features of the LC with improved access to liquidity and increased processing efficiency.

Financial Supply Chain Solutions

Financial supply chain (FSC) solutions are — at least at a fundamental level — a fairly well-established trade finance tool, but sophistication levels are rising. This comes as a result of corporates, particularly larger US-based trade entities that have tended to drive innovation in the trade arena, increasingly turning to FSC programs to meet their working capital needs.

To do this, many companies are extending the working capital cycle — by increasing days payable outstanding — and standardizing payment terms. Buyers might have 60 days rather than 45, for example, in which to pay their suppliers, leading to notable improvements in working capital and cash flow management. Managing working capital in this way has become a key strategic activity for many large US companies.

Yet, FSC solutions don't only benefit larger corporates in more advanced markets. In exchange for such extended and standardized payment terms, smaller suppliers can leverage the creditworthiness of their larger trading partners (known as "anchor" corporates) to obtain more favorable credit terms than they could in a bilateral situation. The benefits here are numerous. Not only can such financial arbitrage opportunities improve buyer-supplier relationships — vital in an age in which strong counterparty relationships are essential — but they also increase the financial stability of individual trade entities and boost the overall strength and security of supply chains.

As a result, FSC solutions can benefit both large and small corporates and meet the needs of developed and emerging economies. Most importantly, they can complement the more traditional trade finance instruments, which tend to dominate trade finance in many developing economies.

Trade Finance Developments in Latin America

Latin America's flourishing export markets are a key driver of trade finance in the region. Despite the opening up of key markets such as Brazil — the region's largest economy — conventional tools remain the trade method of choice. This may be explained by the special regulations many Latin American countries have for trade finance instruments that sometimes grant them benefits under tax and insolvency laws. Certainly, the rapidly changing regional taxation and regulatory environment makes tax a chief consideration for domestic trade entities, which is reflected by the predominant use of tools covered by the regulations.

One such tool is the standby LC, which can effectively mitigate risk without being as labor-intensive as commercial LCs. The downside of this option, however, is that credit constraints have largely reduced the size of corporates' revolving credit facilities, meaning that contingency funds reserved for standby LCs can be used up by daily cash management needs.

To overcome this, some banks are extending bilateral facilities dedicated to corporates' standby LCs. This can free up working capital and allow companies to consolidate their total exposure with one bank — as well as provide a single point of entry for the submission of all standby LC business.

As regional trade activity grows, markets that still have a strong appetite for traditional trade finance — such as Brazil, Argentina, Venezuela and Colombia — are expected to eventually adopt a similar dynamic to countries such as Mexico that are closely interlinked with the US market, in which corporates are using more sophisticated FSC solutions. Evidence of this is found in Brazil, which has a sophisticated trade finance market although still has huge potential for FSC solutions to evolve.

The Future of Trade Finance

While the LC was once the trade tool of choice for corporates worldwide, changes in the global economic and regulatory landscape have led companies to consider trade finance crucial to working capital and supply chain management. This in turn has sparked innovations, such as FSC solutions and bilateral facilities for standby LCs, that serve to enhance working capital management, risk mitigation and processing efficiency.