

Insider

Industry Roundtable

Kickstarting trade credit

The business of supply chain financing has not escaped unscathed from recent macro-upheavals. *Dialogue* asked four industry experts to reflect on the challenges that banks and their corporate customers face in sustaining the levels of finance needed.

Q. What in your view is the most striking impact of the credit crunch on working capital requirements and the funding thereof?



■ **Pierre Veyres:**

In most markets, corporates have had to revisit their working capital management pattern, notably vis-à-vis suppliers and buyers, in order to cope with this dislocated environment.



■ **David Gustin:**

While not all companies are facing restrictive credit conditions,

the most striking impact is how quickly traditional sources of funding operations have dried up. Asset-backed commercial paper in the US market has been reduced by more than USD 500 billion from 2007 peaks in 'rolling' short term funding. Collateralised loan obligations are down by USD 450 billion during the same time period.

This removal of securitised loans is extremely problematic. Recent discussions GBI had with corporates around their receivable securitisation programmes confirm that many of these programmes can no longer survive the current climate. Where has

this funding gone? Well, no doubt trade has declined, but much of this has gone on the corporates' balance sheet. Neither scenario is welcoming.



■ **Lawrence Webb:**

International trade banks like HSBC are actively seeking to support improved working capital financing. Much of the focus has been on tools that assist in the finance of receivables.

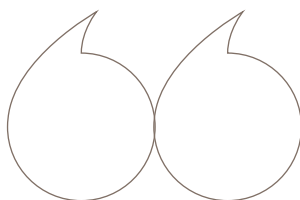
However, this largely 'post shipment' need is a relatively small part of the overall fulfillment process. We're seeing suppliers seeking working capital support upfront particularly around pre-shipment and in-transit

trade as well as a return to more traditional trade solutions such as Letters of Credit which can be used as collateral to obtain working capital finance.



■ **John Ahearn:**

Working capital has indeed become a major corporate driver today. Prior to the crisis, capital was seen as cheap and easy to come by so most companies spent little time looking internally. Now that capital is so expensive and hard to find, this has become a major focus. One of the benefits of today's environment will be that companies will be much more efficient once we come out of this.



It is my belief that all the players in the financial and physical supply chain need to work closely, in conjunction with regulators, to overcome the current situation.

Lawrence Webb, HSBC





John Ahearn

global head of supply chain finance, structured trade and export & agency finance, Citi



David Gustin

managing partner and head of international trade programmes, Global Business Intelligence



Pierre Veyres

deputy global head, Corporate and Transaction Group, BNP Paribas



Lawrence Webb

global head, trade services and supply chain, HSBC

Q. Do regulators have a constructive role to play in fixing the situation?



■ **Lawrence Webb:**

Yes they absolutely do, and we at HSBC continue to work closely with regulators in all markets. However they are not the only responsible party in this situation. It is my belief that all the players in the financial and physical supply chain need to work closely, in conjunction with regulators, to overcome the current situation. We're working with trade bodies, government task forces and ECAs to explore how more working capital can be injected into the supply chains. For example, at the recent G20 session in London, a commitment of USD 250 billion over the next two years was given to support trade finance through export credit agencies and through the multilateral banks. Further, the group committed to use flexibilities in capital adequacy

requirements for trade finance facilities. We believe that this agreement to support trade finance is a major step in the right direction. We are particularly pleased with the mandate given to regulators to use the existing flexibility in capital requirements to enable trade credit to get moving – an area of particular focus for ICC UK over the past three months.

In addition to the very sizeable sums allocated through export credit agencies and the multilateral development banks (MDBs), getting the private sector lending again is vitally important. We will continue to work with government and intergovernmental organisations to ensure this mandate is taken forward with the minimum of delay.



■ **Pierre Veyres:**

Regulators have consistently taken a positive view on capital requirements for trade finance. This was particularly true under Basel 1, some fine-tuning being necessary under Basel II so

the capital allocation further facilitates the trade equation.



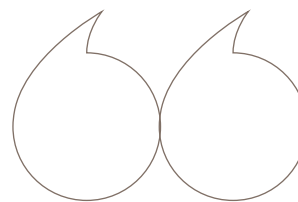
■ **David Gustin:**

Of course. The toys are broken. Absent significant short-term recapitalisation of the banking sector as well as changes in Basel II regulatory capital requirements, it is unlikely that the banking sector will return to past levels of trade credit provision any time soon. Given this, intervention by central government entities in trade credit provision would be timely and if properly constructed, would create positive stimulus and market momentum. I have to say that I do not think multilaterals providing a bank with capital to lend is a good thing, as there are limits in what they can do.



■ **John Ahearn:**

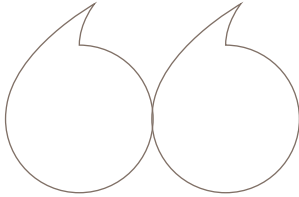
While I agree with my colleagues that Basel regulations play a role going forward, I think the current issue has to do more with capacity that is no longer available in the market. We are seeing fundamental shifts in



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Pierre Véyses, BNP Paribas



the business. Banks that were once very active in the trade finance world have retrenched into their local markets and are no longer interested in these types of assets. We are also seeing companies that at one time could go to the capital markets now frozen out. They are coming back to trade finance as a way to fill the void for capital expenditure and short term liquidity.

So when you combine the two what you have is significant demand with very little supply. This combination leads to increased pricing and an economic slow down. The main question on everyone's mind is, 'Is global trade down due to demand or due to the lack of financing?' and I think the answer is both. The question is how much is each contributing to the problem. Governments have the ability to fix the financing problem and take it off the table by creating secondary markets, similar to what the US government has done with TALF and other programmes. I believe that we should see intervention in these markets to take one of the problems off the table.

Is there a way to unblock the supply of trade credit without evidence of a sustainable economic recovery?



■ **Pierre Veyres:**

There are three ways to achieve this: review the capital requirements under Basel II; enlarge the scope of the traditional trade facilitation programs handled by multilaterals; and increase the liquidity level which has already been initiated by most central banks.



■ **David Gustin:**

There is no good scale way to access one million companies. It's done poorly right now through 8000 banks, but that's the best we have today. The issue is getting capital properly deployed. This stuff is really hard. The EDC small business programme has helped 300 companies with their SME portfolio. The US Government auto sector programme has

helped the top tier, but not the 4000 other auto suppliers.

One idea is to take a portfolio approach, whereby Government or multilaterals support purchases of trade portfolios from banks with various requirements to replenish.



■ **John Ahearn:**

I think you need to look at this in a more fundamental way. We are talking about the underlying infrastructure needed for an economic recovery. If we allow significant numbers of our suppliers to go out of business, when an economic recovery begins to take hold we will not have the people and providers available to support growth. I think the auto sector is a good example. If we allow all of the suppliers to disappear in an industry that has high barriers to entry, then once the economy recovers and demand begins to appear, will there be capacity to provide the services? I go back to the previous point. Let's find ways to support the credit and keep the players in the market, until

demand reappears. If that requires government intervention, then so be it.



■ **Lawrence Webb:**

We must nevertheless be prepared for the recovery when it arrives so that we can take advantage of it. This means making sure we have the systems and procedures in place to get trade credit flowing as a recovery begins to gain momentum.

At HSBC we are continuing to lend for trade purposes. For example, we announced a global USD 5 billion fund for the express purpose of lending to fundamentally sound SME and MMEs to supply working capital and support businesses that trade or aspire to trade internationally.

Government-backed guarantees can also help in certain trades and we are exploring ways of unlocking some liquidity from the capital markets. In the short term, we may see a slight increase in demand for product as we approach the end of the de-stocking that has taken place over the past several months.

Once we see an increase in the demand for products that would foretell a meaningful recovery, availability of trade credit will reflect that.

What, if anything, can be done by banks collectively to boost the flow of supply chain financing?



■ **David Gustin:**

A secondary market for the trade asset class has to be developed. Right now, global trade banks are migrating from an originate-and-hold model to an originate-and-distribute in a closed loop. That needs to be opened up to more players.



■ **John Ahearn:**

I agree. We need to create with various governments a secondary market that the supply chain assets can be put into in order to continue to provide financing for this sector. If we continue as is, what we will see is that deals that are well priced for good credits will get done, but anything that is slightly impaired will not get anywhere This is a major problem.



■ **Pierre Veyres:**

Similarly to the documentary business that

has for long been based on relatively secured financing, the banks should organise and standardise the open account market place by means such as the TSU.



■ **Lawrence Webb:**

Trust needs to be re-established and this will take time. We continue to work closely with our partners, despite the current challenging environment. We all also need to fundamentally understand supply chain financing and all the partners within it – from the large buyers to the smaller suppliers. Banks like HSBC, for example, often have relationships on both sides of a trade transaction globally which provides us with an understanding of the business that enables us to better weigh the risks associated with supply chain financing.

To what extent is supply chain financing a scale business and to what extent is it dependent on close relationships? What are the respective implications for large global banks versus local providers?



■ **Pierre Veyres:**

A successful supply chain business requires intimacy with the client so the banker understands and assesses the business model of his client primarily in terms of flow of goods and liquidity channels. Global players bring end-to-end approaches, whilst local providers help assess the specifics and risks in the local context.



■ **Lawrence Webb:**

I would say that supply chain financing is, by its nature, about generating scale and volumes in an efficient manner. Our ability to provide global insight combined with

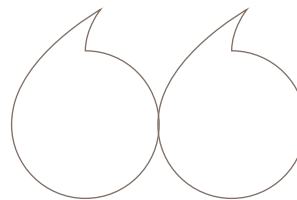
local knowledge is key to meeting the needs of our customers. Current challenges in the economic environment underscore the importance of what is sometimes overlooked when the economy is stronger, which is the importance of working with a strong provider that understands trade and the flow of trade.

That being said, as Pierre suggests, close relationships are vital. To be a successful provider of supply chain finance, a bank must have an intimate working knowledge of industries, working capital cycles, supply and demand, etc. Relationships are as fundamental today as they were when HSBC was founded more than 140 years ago.



■ **David Gustin:**

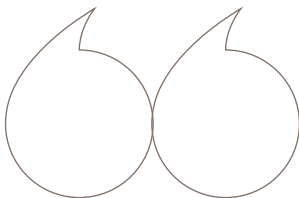
Domestically, where there are liens perfected on receivables, banks can discount 'buyer approved' invoices. With the right distribution, that can be hugely scalable. The challenge comes with international trade. One of the risks in the electronic platform for Payables Factoring is that banks take perfected interest risk. In emerging markets where they don't have UCC or Canada's PPSA (registered liens), you run the risk of suppliers double dipping. This prevents many banks from financing these receivables, especially in today's environment.



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David Gustin, Global Business Intelligence





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■ **John Ahearn:** We have seen the supply chain business as very scalable and growing rapidly. The problem has to do more with the size of deals being done. We are seeing supply chain financing deals that are in excess of USD 500 million. The lack of a secondary market is causing great concern to take on this size of deal.

How much of a burden is the production, delivery and processing of the data necessary to make appropriate credit decisions?



■ **Pierre Veyres:** The fact-finding process, although looking relatively straightforward for corporates in developed markets, requires expertise and global scale to be efficient. A lack of transparency can make the process more challenging vis-à-vis midcaps, particularly in countries where the level of disclosure is limited.



■ **John Ahearn:** While I believe that many people talk about providing financing based on the ability to analyse data, I think the reality is that most banks are still looking at the underlying balance sheet of the company. The industry will move in that direction at some point. However, given today's pressure, I think the need to do so is not there yet.



■ **David Gustin:** John's right. I mean the logistic world has had both the data about physical moves and the collateral and that data has not been used for finance except in limited cases. This is a technology and operational problem and to some extent, a partnership/revenue sharing issue with logistic players. While complex, these challenges can be overcome. The real challenge is developing a secondary market for trade distribution.



■ **Lawrence Webb:** Quality data gathering provides greater visibility and information exchange across the chain which translates into better risk management tools and

thereby stimulates more (but still prudent) lending – something which is fundamental to trade finance and banking as a whole.

What role can the TSU best play in the present environment?



■ **Lawrence Webb:** TSU is an innovative utility and its role in matching players in the industry is a potentially important one. HSBC is happy to be a member and we look forward to contributing to TSU.



■ **Pierre Veyres:** The TSU can help banks to bridge the gap between exporters and buyers in a streamlined and secured framework – a key role in today's context.



■ **David Gustin:** For TSU to be effective, they needed to think through what elements of the corporates' business lend themselves to enough standardisation that if SWIFT could provide a framework for communicating, it

would drastically alter the machine-readable nature of the business documents/data set. This would have a dramatic impact on supplier/buyer flows and the ancillary services provided from those flows (risk mitigation, financing, FX, etc.).



■ **John Ahearn:** While the TSU has the potential to play a major role in the future, I believe that it will be impacted by the current crisis. Most banks are focused on much more core activities in their business and our clients are looking at ways to mitigate risk. Until the entire structure, including the legal aspects, is worked out around the TSU, I think we will see little take up. The financing aspects of the TSU are core for this product to really take off. While the TSAG have moved greatly in the last few months to close those gaps, it still is not 100% finished. It is once that aspect is completed that I believe we will see a major take up of the product. ¹⁰

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