



Trade Finance Holds its Own

Amidst the Credit Crunch

But risk is being re-priced and deals more selective as customers feel the pinch. BY RICHARD BAROVICK

For the trade finance fraternity, the Export-Import Bank's annual Washington conference is a welcome networking opportunity, a rare chance for over a thousand professionals to catch up, swap yarns, share market intelligence.

At the April 2008 gathering, Ex-Im's own news was limited. But, this year more than ever, participants listened intently to the luncheon speaker: Lawrence Lindsey, an economist and former White House official, prognosticated on the course of the mounting credit crunch.

His forecast: the end was probably in sight for the crisis in mortgage lending, but others would follow, in auto loans and credit cards.

And that led to a buzz around the room: how would trade finance fare in this increasingly hazardous financial environment? The consensus, readily gathered, was clear: so far, so good, no serious problems had yet emerged.

Since then, however, a growing perception is that the enduring crunch has been joined by a rising arc of oil prices, along with other raw materials costs. It's now, therefore, seen as a double whammy: exporters and importers—or many of them—are living with both a

squeeze on their financial liquidity and mounting costs of doing business.

What, then, has been the impact on trade finance? Two answers can be found out there: the short version and the long version.

The short version

The short version is that trade finance has weathered the storm without substantial damage, but has not escaped it. Lenders and credit insurers have revised their perception of risk, and, accordingly, have increased the price of their services, while becoming more selective in approvals. Exporters and importers, meanwhile, are tugging at one another to negotiate favorable payment terms and bolster liquidity. Some foreign buyers are pushing for longer payment periods, or just plain paying slowly.

The more damaging side is that several sectors—residential building, construction materials, automotive, plastics-based production—have lost some or a lot of their access to financing in the U.S. and abroad. And, some smaller exporters have experienced a loss of access they had earlier enjoyed. The bottom line: there's been

some pain, but it has been contained within specific parts of the trading economy.

The long version is to ask, and answer, why trade finance has managed to avoid (so far) the severe dislocation that began with mortgages and migrated to other sectors, damaging financial institutions and squeezing their customers.

The quick answer: trade transactions are mostly short-term, and are largely self-liquidating arrangements; lenders and insurers have become highly sophisticated in managing trade finance risks, including the use of massive Internet-based information platforms, while the resources available have grown dramatically, as many more lenders and insurers have entered the field.

Let's look first at what's been happening so far.

For starters, lenders and insurers, as expected, have become more cautious and raised the price of their services. Many of the pros in the field, when asked, respond with similar points, but express them in contrasting ways.

"Financial institutions have pared down their level of exposure," says Bruce Proctor, Managing Director of JPMorgan's Global Trade Services unit in New York. "They are somewhat less open and less aggressive in responding to opportunities."

At Atradius Trade Credit Insurance in Baltimore, Brett Halsey, CEO, counts several corrective actions to reflect the new risk profile. First, the company has cut back involvement in specific sectors, among them construction, building materials, plastic resins, specialty retailer operations, textiles, and paper.

Second, with insolvencies-bankruptcies and claims back to normal levels from a more benign environment over several years, Atradius is now more selective in choosing customers, taking a closer look at customer experience and loss ratios. And while the average premium rate has seen a slight increase, the credit committee's careful scrutiny of each country's risk profile has helped keep prices under tight control.

In Houston, Tom Wells, managing director of Vinmar Finance, a specialty trade finance company (part of global plastics marketer Vinmar Group), stresses the double whammy angle: higher costs are raising working capital needs of exporters and importers, at a time when lenders and insurers are more cautious. "There's no lack of credit, but borrowers need more to do the same volume of business, and the lender limits they face are tightening."

Gary Mendell, president of Meridian Finance Group in Santa Monica, California, a credit insurance broker and financial arranger, stresses that buyers are pushing suppliers to offer longer payment terms, but are also paying their invoices slowly. "That is creating more demand for credit insurance, and premiums are rising a bit."

Until recently, insurers have been limited in hiking rates because of the intense competition they face, but, Mendell

added: "If six insurers look at a deal, and only one is willing to do it, that insurer can write its price." And, he reports, exporters with existing policies can usually continue to cover the same buyers, but, "if a company does not have a policy, it can be harder to place the coverage."

Carey Fiertz, head of Export Risk Management (Salisbury, Connecticut), a credit insurance specialty broker, finds banks now more selective in the medium-term equipment deals they take on, while charging more. Lender "spreads" (the amount over and above the standard base rate) can be

significantly higher. "On a \$5 million deal, the interest rate recently was often 1 to 1.5 percent over LIBOR (the London inter-bank standard), but lately it's been 2 to 2.5 percent. And "some sectors are tough; banks can be reluctant to finance them, sometimes even with insurance coverage."

At the same time, smaller exporters appear to be facing a squeeze in their access to credit, perhaps inevitably, since they are typically more reliant on outside financing.

In Miami, Stephen Fancher, who runs the Florida Export Finance Corporation, a state government unit, reports that, "it is definitely hitting some of the smaller people that we deal with. These firms are facing trouble in accessing finance and in dealing with slow payments by foreign buyers."

Meanwhile, the credit crunch also opens opportunities for institutions that have escaped the crunch, to expand their trade finance operations. Bruce Proctor at JPMorgan emphasizes it's a good time to re-invest in the sector. "We are pursuing growth in key markets for trade services, accelerating product development, adding people and expanding our technology base." In buoyant places like the Middle East, for example, "we are shown quite a few deals, especially in infrastructure projects."

In New York, at First Capital, a diversified finance company, Anthony (Tony) Brown, International Managing Director, smiles: "We have been boring consistently on trade finance. We have money to lend, and have not been distracted. We are reaching out to companies that are not getting finance from their lenders, or are facing restrictions."

And at Atradius in Baltimore, Brett Halsey calls the recession "an opportunity to reach new clients who are realizing the value of trade credit insurance."

The long version

The long version of what's happening, why trade finance has escaped the dislocation that is striking other financial sectors, reflects developments that go back about twenty years.

In the 1980s, the Latin American debt crisis brought losses, though most involved sovereign debt. The credits were syndicated loans or bonds, with dozens of U.S. banks going along for the ride, buying into a piece of the action. The outcome was a sobering change in attitude, managing

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risk became an elevated and serious priority, and quite a few lenders pulled back sharply from trade finance.

Meanwhile, today's weak dollar and competitive U.S. exports have created a more buoyant prospect, with a more benign risk profile even with the credit crunch. Keith Leggett, senior economist with the American Bankers Association, notes that trade contrasts sharply with housing, automotive, and other currently shakier sectors.

"Trade finance is easier to engage, while a lot of private equity is moving into the field, a sign of acceptable risk," he says. And, a lot of banks enjoy the risk enhancement of the Export-Import Bank.

Moreover, most trade transactions involve tangible products like oil or grain, with short, say six-month, payment maturities and self-liquidating structures, says JPMorgan's Bruce Proctor. That manageable risk is now attracting potential new investors, including investment funds, hedge funds, insurance companies, and private capital, he remarked.

Then too, the mountains of electronic information now streaming through global databases and Internet platforms have squeezed much of the risk out of buyer and seller performance in trade activities. The admonition to "know your customer" is a lot easier to achieve.

An important segment of the information now is being furnished by three large European-based credit insurers—Atradius, Euler Hermes, and Coface—that have built a sizable U.S. presence. Each has a database covering some 40-50 million firms that American exporters and importers can use as a tool of insurance coverage, or by itself.

Meanwhile, the other segment, the Internet platforms, developed and maintained by large banks and independent information technology services (such as TradeCard and TradeBeam), which has enhanced visibility substantially across the supply chain, continues to squeeze a lot of risk out of the trade world.

And, while risk has been reduced, trade finance has been hugely enhanced by an inflow of capital and an expansion in the number and variety of institutions that deliver credit and take risk.

In the banking arena, a recent and significant example was the late-2007 purchase of Miami-based Total Bank, a 30-year-old community lender, by Spain's Grupo

Popular Espanol (assets: \$190 billion). The revamped Miami institution decided in early 2008 to move into trade finance and international banking, in April it created a brand-new group headed by Miami trade finance veteran Emy Ruiz.

The ranks of finance companies hit a watershed in 2003 when half a dozen set up shop to specialize in Export-Import Bank medium-term equipment deals, thus filling a gap that followed the withdrawal of some banks from that market niche. Most were launched by ex-bankers, trade finance veterans, among them: Brett Silvers (who established WorldBusiness Capital), Gustavo Rosas (created New Continent Finance), and Peter Swain and George Wood (opened Chancery Export Finance). Most work closely with the Private Export Funding Corporation in New York, an Ex-Im strategic partner, which provides a secondary market, buying the trade finance obligations these groups have created.

In credit insurance, as many as eleven global underwriting groups now serve U.S. exporters and importers (World Trade, April 2008). With home bases in the U.S., Europe, Australia, and Bermuda (plus Lloyd's of London), they have brought a huge expansion in risk-taking capacity, alternative underwriting styles, and dissemination of product knowledge.

Meanwhile, the emergence of private equity groups and institutional investors means that trade finance has "arrived." Trade obligations are now seen as an attractive, strong performing "asset class," says Fritz vom Scheidt, a principal at Toronto-based Tricon Group, which has managed several trade finance funds.

In New York, Finacity Corporation is financing \$15 billion a year in short-term trade receivables, with two-thirds of its revenues from outside the U.S. Principal partners-investors include ABN Amro Bank, Bank of America, and Euler Hermes ACI (credit insurance). And New York-based Rosemount Global Trade Finance Fund, whose backers include Merrill Lynch and Massachusetts Mutual Life, invests in, trades and syndicates trade debt from borrowers in key emerging markets.

Finally, IT groups that provide the electronic platforms to support trade finance have also been a magnet for deep pockets. Warburg Pincus, a private equity group, has invested in both TradeCard (New York) and GT Nexus (California). Orbian Corp. (Connecticut) is owned by hedge fund Ritchie Capital and venture capitalist Benchmark Capital. TradeBeam (California) boasts partial backing from private equity firm Carlyle Group.

Here, then, is the bottom line: trade finance enjoys a preferred underlying risk profile, while its managers have become increasingly sophisticated and their jobs made easier by advanced IT. And, the capacity to lend and cope with risk has seen dramatic expansion in banking, finance companies, insurers, and deep pocket investors.

If that terrifying global meltdown ever comes to pass, when the dominoes start to fall, trade finance looks likely to be among the last ivory pieces standing. **WT**

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Trade Finance Case Study

Another way to source overseas.

BY JOSEPH INGRASSIA AND JOHN RICE

Whaling Manufacturing, Inc. has been in the outerwear business for nearly forty years operating from a 120,000 square-foot manufacturing and warehouse facility in Falls River, Massachusetts. During its apogee, Whaling employed 400 workers manufacturing private label raincoats and outerwear for the leading department stores of the era, as well as labels such as Bill Blass.

By the mid-1990s many of Whaling's competitors began outsourcing their manufacturing to lower cost emerging market economies in Asia, but owner Jim Pavao continued to believe that producing a higher quality garment was more important than offering lower priced imported goods to his customers.

What Mr. Pavao failed to recognize at that time was the significant shift occurring in U.S. retail as consumers (and the retailers catering to them) became more interested in lower price rather than higher

quality (at higher price points).

In August of 2005, after having expended all of its equity trying to compete as a domestic manufacturer against imports, Whaling needed to revise its business strategy and funding. Through a financial intermediary, Whaling was directed to Capstone Business Credit, LLC, a New York City-based venture merchant bank.

"We're experienced in a broad range of situations that require a business strategy makeover from off-shore manufacturing to new distribution channels and overall management support," says founding partner Joe Ingrassia. "In terms of the international business environment, the current credit crisis is forcing the market to look at viable, alternative financing and business options that not only provide funding, but strategic business advice enabling companies to improve their operations on an international basis and grow in a sustainable manner," continues co-founding partner John Rice.

Prior to working with Capstone, Whaling relied on a factoring relationship that provided a small inventory advance. "Our system is different in that we will finance pre-sold goods," explains Rice. "Under our scenario, Whaling was able to increase its sales because they could purchase sufficient goods to satisfy demand created by their sales people. In addition to purchasing the pre-sold goods, the firm provided a factoring facility."

Capstone began working with Whaling to structure and fund its offshore manufacturing. Whaling was in a situation not uncommon with being late to offshore manufacturing and forced to pay a premium for goods. For example, when a borrower is perceived to be an uncertain risk, the foreign supplier increases the cost of goods to take into account his cost of capital, the length of time he feels it will take to get paid by the offshore buyer and a risk premium based on historical payments.

When Capstone entered the picture, the borrower instantly becomes a cash buyer, enabling the client to renegotiate the cost of goods sold to strip out the risk premium, cost of capital and the time value of money.

Whaling's portfolio of outerwear includes uniforms for various law enforcement agencies throughout the U.S., including the NYPD, NYFD, Houston Fire Department, Chicago PD, U.S. Border Patrol, U.S. Forest Service, and U.S. Coast Guard.



The next stage in re-defining the buyer-vendor relationship concerns volume. “Our clients grow between 10 percent and 15 percent per annum and as a result, their purchase volume with their suppliers increases accordingly,” adds Rice. That growth typically results in further price reductions as the manufacturer gets economies of scale due to the increase in volume.

**International advisory:
sourcing expertise managed**

Typically a borrower travels to the foreign manufacturer’s location to make a determination for themselves as to the efficiency of the manufacturer. In the Capstone model, the VP of Sourcing will travel and meet with the supplier to make the onsite determination.

Meanwhile, Whaling initially began operating in Korea. Capstone has since transitioned Whaling from Korea to other Asian countries where the labor rate is lower and the quality is as good or better.

Through the issuance of letters of credit and strict quality control, Whaling is now able to compete effectively in the U.S. market.

The current business climate is forcing companies to **re-evaluate their funding, sourcing, and operating strategies.**

**Relationships:
interfacing
internationally**

In terms of overall manufacturing relationships, the borrower’s goods are reverse engineered in some instances. Capstone’s sourcing professional can determine what the best fit would be from a factory perspective. The finished product is then presented to the potential manufacturer and advised of the cost. A comparison is made between the historical cost data, the cost of the new factory and the existing factory. If the sourcing department approves the old factory, as well as the new factory, then both of the



factories are provided the chance to bid on the manufacture of the goods.

A key component to the success of this process is direct interfaces between Capstone's clients and their overseas sources. "If we can locate a better factory and get the cost of goods down that is a home run," says Ingrassia. "If we keep the same factory at a lower cost of goods sold that is a success, as well."

Ninety-five percent of Whaling's manufacturing is now offshore in China, Cambodia, Vietnam and Thailand. The firm maintains a small domestic manufacturing presence.

Objective set of eyes: sourcing and inspection

As part of Capstone's performance risk mitigation strategy, a sourcing and inspection service has been developed in China. These two aspects of the program work hand in hand with the funding of the offshore manufacturers. Through our sourcing department, we are able to determine whether or not the factory selected by our borrower is adequate and can maintain the output required to meet the demand of its customers. Once this is determined, Capstone insures that the pricing of the goods on a cost of goods sold level is appropriate.

Many times there are daisy chains of intermediar-

ies know as agents who add unnecessary costs onto the cost of goods sold thereby reducing our borrowers' gross margin. Specifically, our sourcing department actually assists in reducing borrower costs at the cost of goods sold level, thereby increasing the gross margin and covering our finance charges in most cases. Higher gross margins for our borrowers translate into less risk for us. The inspection group is intended to be an objective set of eyes for our borrower. They insure that the goods are being manufactured to the standards set between our borrower and the ultimate buyer.

Through the use of the Internet, we can get daily inspection reports from the producer of the raw materials all the way through the entire production process when goods are being loaded into a container for shipment to the U.S. Once the variables of whether or not the factory can produce or the quality of the product are known, we then work out a supplier credit facility of some kind whether that is a letter of credit, a letter of guarantee or a partial or full cash payment against documents etc.

Joseph Ingrassia and John Rice are managing members of Capstone Business Credit, a New York City-based venture merchant banking firm that provides innovative financing for growing businesses within the consumer finished goods and import/export industries.



The Hidden Cost of Open Account

Often times the internal administration efforts outweigh the perceived benefits. BY DAVID GUSTIN

When I completed my 2006 Biannual Import Payment and Finance study, 62% of financial firms surveyed indicated anyone can use Open Account.

I started wondering if anyone really has thought this through. I also started to wonder if banks are their own worst enemies, not educating their clients as to the true costs of open account. It's kind of like when we fill up our gas tank for \$75 and think that is high, but don't realize that oil is priced well below its true cost if we added the military costs associated with protecting supplies, as pointed out by the Rocky Mountain Institute.

Coincidentally, I have had a few recent discussions with investment grade companies that have moved significant payment volume from Letter of Credit (L/C) to Open Account, only to say the internal administration effort was more than they planned. And, most of these companies were not paying for their L/Cs, given their investment grade status.

While companies did not explicitly state this, the push to open account is recognition, right or wrong, that the substitution of a bank's capital in the payment process is not inherently necessary. Thus, credit lines once devoted to issuing L/Cs are now freed up to do other things.

There may be a misperception here, as banks will think very carefully before replacing a trade credit line with a working capital line or project finance facility that is not as safe as a trade line.

In addition, while many treasurers do not understand Basel II implications (or even know what Basel II means) the upcoming Basel II charges for operating risk and corporate capital based on risk rating grade will continue to impact finance costs.

Again, like the gasoline that actually costs a lot more at the pump than what we pay the oil companies, open account has its own hidden costs. I will examine a few areas that treasurers need to consider:

Credit management costs

When selling, exporters need to manage country risk, establish buyers' credit lines, and manage the drawdown process—all of this can be an expensive process.

Certainly OECD sellers must factor this cost into their financial supply chain. Take the example of how a company would measure and integrate country risk into a customer risk assessment, to be able to justify the need of a guarantee when customer financials may not be acceptable? That takes having a country risk capability (even if outsourced to Fitch, etc.), customer risk

assessment software, algorithms for setting buyer credit lines, a line management process and an understanding of bank regulations and payment/FX restrictions.

Think countries like Venezuela, Pakistan, and Turkey as examples of where this would be necessary. These activities are not typically done by low-cost labor either.

Finance costs

A Small- or Medium-sized Enterprise (SME) pays a premium for debt, struggles to raise equity, and lacks the leverage to extend payment terms. SMEs should give a hard thought before going on open account with an overseas buyer (assuming their buy/sell relationship is not measured in years.)

The real reason for payment terms was to give the buyer time to ensure the proper amount was being paid, not as a way for the large and creditworthy buyer to 'borrow' from the smaller and less creditworthy supplier.

It has become a common practice to try and create a post-shipment funding source for suppliers who are trading on open account. While once a Letter of Credit took care of the financing, be it along the supply chain from pre-shipment line to procure materials to a post-shipment finance negotiation structure, now sellers have an option to finance post-shipment receivables, hopefully at a rate substantially lower than previously.

In moving to open account finance structures, buyers must consider:

How their Vendors must use technology – As one SCF vendor put it to me, “Suppliers really get pushed in the middle. They are so confused about all the different ways to get financing. Everyone is promising low-cost, non-recourse, off balance sheet financing. All these technologies and banks converging on them to say, ‘use this service, it will help you out.’ All this actually ends up doing for them is creating more work for the suppliers. One supplier told us they have 40 applications to log into, accept orders, and process invoices for all their customers.”

Very few pre-shipment finance models exist – Our 2006 study confirmed that buyers don't normally care about their vendors' pre-shipment financing needs; nor are banks especially interested in financing suppliers they don't know in places like China or India without some insurance.

Factories go bankrupt in China, India, Vietnam, etc. and there are cases of banks writing off pre-shipment loans to suppliers when the buyer was totally unaware.

Additional insurance costs

Sellers typically don't need insurance on a Letter of Credit. Sure, they could confirm the issuing bank's standing and country risk, and that information is very accessible. But open account? Have you ever tried to secure receivable insurance as a middle market seller?



“The quest for indemnification from the buyer...is the Holy Grail of the open account chase.”

And few insurers will look at it from a transactional basis. They want a premium based on some holistic package (typically selling you a BMW when all you need is a Volkswagen).

As to buyers providing payment indemnities to enable purchase order financing, the model for the underwriting of pre-shipment finance and what form the indemnity takes is unclear. It is not clear, for example, what form of enhancement the buyer's bank will be comfortable in providing,

what the seller's bank is most comfortable in receiving and who will pay for this payment indemnity. A global trade banker recently commented, “The quest for indemnification from the buyer, which will facilitate the credit extension to the seller, is the Holy Grail of the open account chase. Buyers who grant these indemnifications, under US GAAP, may face a situation where the former trade obligation needs to be re-classified as bank debt.”

Custom and financial documentation costs

Trade Services is difficult to automate given its paper intensity, leading to high semi-fixed staff costs for all involved (banks, forwarders, agents, corporations). Moving vendors to open account generally does not lessen the financial or customs documentation requirements. Custom requirements drive paperwork. What moving to open account does is enable importers to

streamline documentation that is absolutely necessary to approve payment. It does nothing to streamline customs clearance.

When companies do not use Letters of Credit as a payment method with their suppliers, the connection to the bank is lost. They are no longer outsourcing documentation management to banks. This is where it can become an internal administrative burden for corporates with hundreds, if not thousands, of suppliers.

Moving to open account from L/C involves replicat-

ing features inherent in the L/C, including:

- How to dispute invoices that don't reconcile?
- How to ensure proper documentation for customs?
- Who to conduct financial conditions management?
- How to reconcile vendor payments?

Costs involved in complying with government regulations

From my discussions with Treasurers, there continues to be a lack of awareness around their risk exposure and the necessary controls required to be in compliance with regulatory requirements when dealing with not only overseas suppliers, but the myriad of agents that are involved in the process. For example, when commissions are paid to third parties, they need to track the money flow to those parties.

Compliance and risk requires an increased involvement of the treasurer.

Companies must recognize that they need to incorporate U.S. rules globally. Not being adequately aware of risk exposure, not establishing necessary controls and procedures, or overlooking regulatory requirements, can expose the enterprise to potential fines and penalties.

Compliance involves both technology and people.

In our work, we found training is recognized as the biggest investment required, particularly of sales staff. As to technology, most companies should do restricted party screening at the time the customer does a Request for Quote (RFQ). The important thing is to be able to follow the order from RFQ to shipment. If an export license is required on an order, smart companies will not build or accept an order until they start processing an export license.

In summary, it is important to understand how a company forms their policy around payment terms, who oversees it and how often it is reviewed and is there a formal process to review it. It is these questions that provide a foundation for best practices around treasury and credit management policies. **WT**

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