



## The Bank of New York Mellon Innovations In Trade Services

### Increased Risk and Global Trade

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Economic uncertainty and widespread risk-aversion continues to impede international Trade. Global trading partners are seeking support from their banks and other service providers for their efforts to keep goods and services moving. Many of these partners are re-positioning the way they manage Trade, in part by reverting to bank financing mechanisms that give them greater security and allow them to mitigate as much of their cross-border risk as possible. Hence the trend over the past few months toward increased use of traditional trade instruments such as letters of credit.

At the same time global banks are facing their own risk-management issues and are re-examining their ability to absorb the exposures they are being asked to take. Trade credit is no exception, and there has been a contraction in the global availability of Trade and working capital facilities, as banks endeavour to deal with their own portfolio concerns. All of this is happening just as demand for these exposures is growing.

Re-establishment of global stability requires continued fluid movement of goods and services. This, in turn requires that adequate risk-taking capacity be made available by the market. The key questions that are being asked around these issues are:

1. **What risks are banks being asked to provide in support of their importing and exporting clients?**
2. **What volumes of risk-taking can the banks absorb?**
3. **What capacity do non-bank entities have to provide this support?**
4. **What expanded role can export credit agencies (ECAs) and multilaterals play in support of Trade?**

Over the past 6 months, risk has increased at every stage of the Trade process, so there has been a commensurate increase in demand for reliable risk mitigation mechanisms by many parties engaged in Trade. Trading parties who had once accepted the low cost, reliability, and efficiency of non-traditional solutions such as Open Account are now thinking once again about more traditional products and services that enable them to pass their risks to banks, and other market players. Indeed, LCs and other traditional trade instruments are now increasingly being sought and used by trading parties to cover payment and other risks from developed and developing market counterparties, alike.

These risk-mitigation tools are being sought in an environment where many banks are as reluctant to take increased risk as the clients who are asking them to do so. While the time-tested quality of Trade exposures is well-established, this distinction is being blurred in the current market and many banks are finding it difficult to absorb new risks of any kind.

So, what are trading partners and their banks to do? Let's first examine some of the many issues they are facing:

1. **Credit and Risk Appetite:** There is now deep reluctance across the market to incur increases in risk. Buyers are less willing to extend pre-export funding to their vendors, vendors are reluctant to extend financing terms to their buyers, banks are cutting back on exposures, and are raising the cost of the risk they do provide. Third party purchasers of market risk, who have heretofore played a crucial role in disseminating market risk, have also severely curtailed their activities. The core function of Trade finance as an optimizer of working capital flows is damaged and needs to be fixed.
2. **Changing Profile of Service Providers:** Many traditional Trade banks have curtailed their risk-taking activities; others are hampered in this regard by mergers, bailouts, or by the effort to restructure their balance sheets. Yet others have ceased to offer these services entirely for a lack of liquidity. Likewise, non-bank providers of Trade support have seen their businesses shrink as funding becomes scarcer and more expensive, costs rise, and demand evaporates. The availability of fewer sources of risk-taking, during a time when demands for such services is growing, is clearly problematic.
3. **Liquidity and Funding:** Much of the world's Trade activity had shifted to open account because players could reduce processing costs while still being assured of having access to needed liquidity. With access to liquidity in all forms now severely constrained, parties are forced to seek alternative sources of support. One of these is certainly the traditional Letter of Credit, provided the bank or banks involved are prepared to extend the credit facilities required.
4. **Capital Adequacy:** As mentioned, many banks have curtailed their risk-taking activities while they engage in the process of right-sizing their balance sheets. Much of this is driven by the current crisis, but much was already



underway as part of Basel II. Banks in markets where Basel II has been adopted have been forced to amend all credit pricing (including Trade) to meet minimum return requirements. The quest for capital adequacy for many banks has (for now) replaced client service and risk-taking, even for “safer” asset categories like Trade.

5. **Multilateral and ECA Support:** In the absence of a properly functioning Trade market, what expectation do we have that multilateral agencies and ECAs may step in with expanded support to re-establish market “normalcy”? The traditional “lender of last resort” role played by these entities is one that can contribute to re-establishing trust in the market and is being actively discussed. Once this underlying trust is re-established, it should follow that credit and Trade will become more free-flowing. But we do not yet know what kind of expanded support multilaterals and ECAs will be willing to provide, how much risk they will have the capacity to take, and in what form such support might come.

Clearly these factors, if unaddressed, pose the danger of deepening the current logjam in global Trade. This logjam threatens to prevent Trade flows from serving as one of the largest drivers of an eventual global recovery, and steps to avoid it must be taken by all who are able to do so.

This process can begin with economic recovery or with programs established by multilaterals and ECAs, which may give the market the confidence it needs to operate more “normally.” Many believe that normalcy will begin to return when there is an increase in interbank lending, which should lead to expanded Trade and other lending activities.

But are there steps that market participants can take in the interim that would assist in the effort to maintain fluid Trade flows? We believe there are.

#### Some examples:

1. **Buyers of Trade services who are looking to their banks for support need to recognize that Trade services in today’s market will cost more than what many are used to paying.** Risk premiums, required returns on exposures, and processing costs are all rising, and these may be features of the market for some time. If parties want banks to absorb the risks of these transactions, they will need to ensure that the risk takers are adequately compensated for doing so.
2. **Importers and exporters should identify those banks from whom needed support could come, and ensure that they are seen by these banks as “relationship” clients, to whom scarce risk resources are more likely to be allocated.** Ideally, the banks identified would be global players, like The Bank of New York Mellon, who can provide all needed services within their own global network of offices and branches, thereby reducing their reliance on, and exposure to, other financial institutions.
3. **Importers and exporters should explore automating as much of their Trade activity as possible.** This can offset some of the increased transactional costs that the current environment will impose. Such automation may come about from entering into outsourcing arrangements that permit a bank to shift fixed costs to an outsourcing partner. Such arrangements allow Trade players to enhance the profitability of their Trade business and offset some or much of the increased cost they experience presently. They should also understand that automation need not be prohibitively expensive: most of the global banking Trade players, such as The Bank of New York Mellon, already have state-of-the-art processing systems that can be delivered to clients quickly, and often at much lower cost than with a software vendor.
4. **Likewise, banks can take steps to manage their exposures through increased transactional scrutiny, correct and frequent KYC and other protective measures, and by ensuring that operational processing standards are thorough and training standards high.** Most global banks have already taken such steps. Banks should point to these high standards as selling points for clients who are looking to direct their Trade business to them.

For Trade market participants, the regulators who oversee them, and the investors who buy their securities, Trade risk is no longer assumed to be “safer” than other risks being taken. This blurring of risks and loss of perspective means that Trade exposures will be more closely scrutinized and judiciously rationed. The cost of obtaining such credit facilities has already risen and may continue to rise, and the terms and conditions under which Trade credit is approved and extended will be more restrictive.

Importers and exporters, for whom this credit is crucial, will need to re-assess how they work with their banks, the cost of these relationships, and which banks they can work with. Similarly, banks need to consider – in addition to who will receive allocations of their scarce Trade credit – who in the market they may need to team up with to successfully process client transactions, what risks these relationships bring with them, and whether these risks are acceptable.

All of this points to the value of taking a collaborative and partnership approach to Trade, ensuring that all available technology is brought to bear in facilitating and lowering the costs of Trade processing, and ensuring, to the degree possible, that Trade market participants have access to the greatest allowable amount of Trade credit.

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