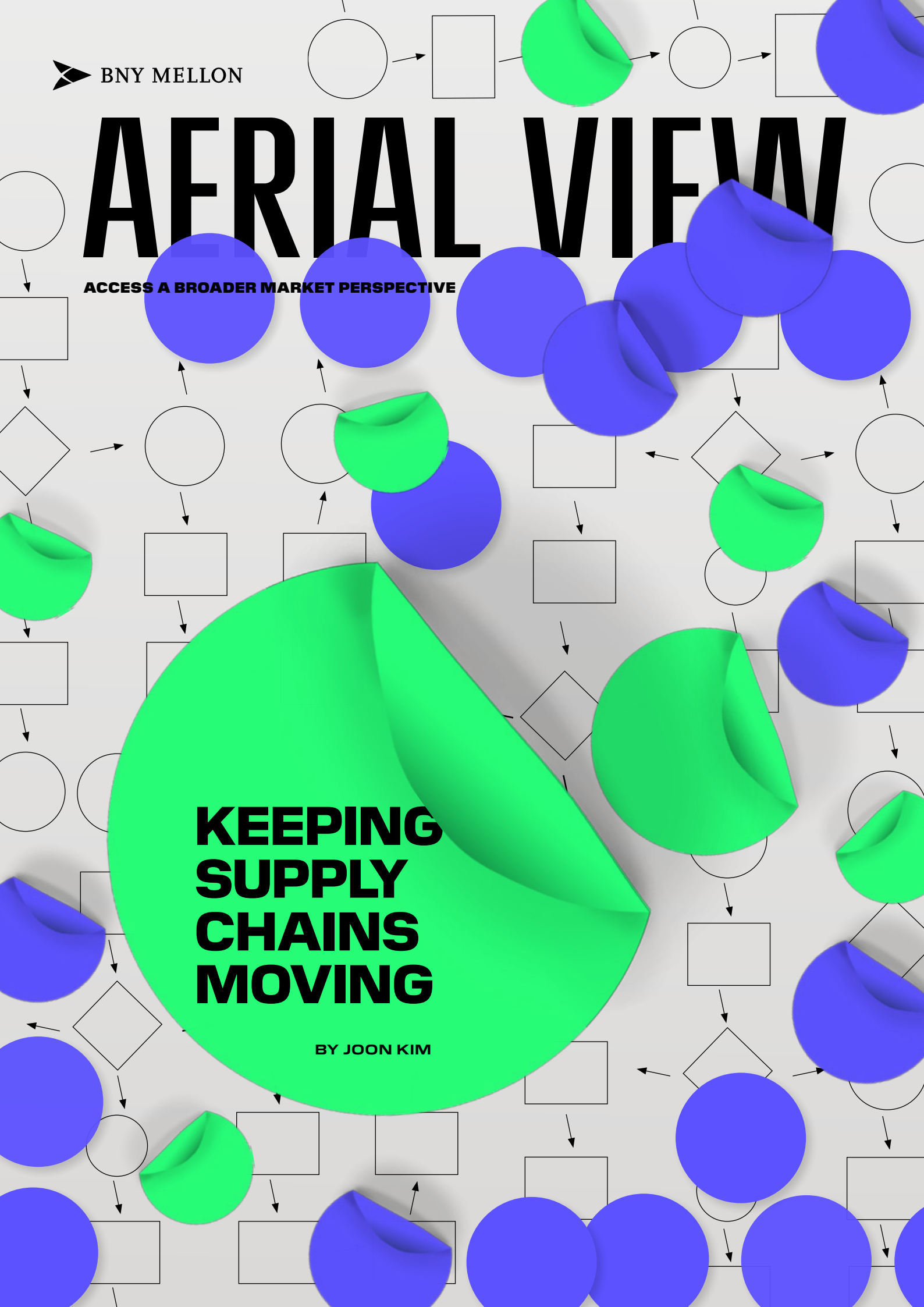


# AERIAL VIEW

ACCESS A BROADER MARKET PERSPECTIVE

## KEEPING SUPPLY CHAINS MOVING

BY JOON KIM



# BY THE NUMBERS

**350,000**

Estimate of how many jobs American companies will reshore in 2022<sup>1</sup>

**\$3.1Bn**

Amount of revenue made by the 10 largest trade-finance banks in the first half of 2022<sup>2</sup>

**\$3Tr**

Value of trade finance assets that could be sold to non-bank investors in the next five to eight years<sup>3</sup>

**\$7.5Tr**

Value of bank-intermediated trade finance deals conducted in 2018<sup>4</sup>

**6.3%**

CPI (adjusted for volatile food and energy prices)<sup>5</sup>

**3%**

Total increase in U.S. interest rates so far this year<sup>6</sup>

**\$5.5m**

Increase in U.S. non-farm employment in 12 months to August 2022<sup>7</sup>

**44%**

Increase in commodity prices over pre-pandemic levels<sup>8</sup>

## SOURCES:

1. The Reshoring Initiative, as of September 2022

2. Coalition Greenwich, as of 1H22

3. Tradeteq, as of 2020

4. Tradeteq, as of 2020

5. U.S. Bureau of Labor Statistics, as of August 2022

6. Federal Reserve, as of September 2022

7. U.S. Bureau of Labor Statistics, as of August 2022

8. Bloomberg Commodity Index, as of September 19, 2022

# IN A PERIOD OF UNCERTAINTY, SUPPLY CHAIN FINANCE IS ONCE AGAIN PROVING ITS METTLE. BUT AS BANKS' BALANCE SHEETS COME UNDER PRESSURE, WILL THEY HAVE THE FINANCING CAPACITY?

BY JOON KIM

**G**lobal supply chains—still reeling from the pandemic—are facing a series of nasty shocks.

Commodity prices are elevated, labor markets remain tight and inflation is much too high for central banks' comfort levels.

At the same time, the shrinking workforce (see Figure 1) and excess demand for scarce workers are impacting production potential. The result is a mounting inflation problem.

Tightening monetary policy is on the agenda for the rest of the year, testing the ability of central bankers to bring prices under control. But a quick return to normal is unlikely for global supply chains.

The pandemic has forced a rethink of the traditional, internationally dependent production and distribution model,

as have ongoing geopolitical and international commercial disagreements.

These economic forces are proving challenging for the corporate community. For instance, the Reshoring Initiative, which aims to bring manufacturing jobs back to the U.S., estimates that American companies will reshore 350,000 jobs in 2022—the highest number in recent history.

Rising rates, coupled with higher energy prices, have led corporates to place a stronger focus on payment risks and ensure adequate access to liquidity. As corporate buyers, they are equally wary that macroeconomic challenges present a serious obstacle to the working capital needs of their own suppliers, thereby placing supply chains in jeopardy at a time when they are already fragile (see Figure 2).

For many smaller suppliers—

especially in emerging markets—high interest rates have made borrowing directly from local banks very expensive and loans less readily available. Stringent know-your-customer (KYC) requirements are adding to the costs banks face when onboarding new customers, meaning they have to be more selective about the customers they service.

Supply chain financing (SCF) has the potential to offer some relief. And many corporates are turning to trade finance as both a cash optimization tool and a means of ensuring supply chain security.

## **SUPPLY CHAIN SECURITY**

By working with its banks to implement SCF programs, a large corporate buyer can try to standardize its payment terms to its suppliers, reducing the impact on those suppliers' working

## A DIMINISHING POOL

The ongoing pandemic is shrinking the amount of workers in the labor force.



SOURCE: OECD

FIGURE 1

capital needs. This is because through SCF programs, the buyer's bank can pay a supplier early with only a small discount—an attractive way to pull in liquidity relative to alternative funding sources.

The popularity of SCF as a working capital solution has also been fueled in recent years by the 2007–2009 global financial crisis and the ongoing movement from traditional letters of credit to open account trade. According to market intelligence provider JD Supra, open account trade now accounts for more than 80% of all trade arrangements.

In today's more difficult economic environment, corporates are looking for more—and ever larger—financing,

so much so that pre-pandemic levels of trade finance activity have already been surpassed. The greater value of trade finance transactions (see Figure 3) is being largely driven by record-high commodity prices, which have impacted the size of the trade tickets. Data provider Coalition Greenwich says the 10 largest trade finance banks in the first half of 2022 made revenue of US\$3.1bn, versus US\$2.9bn for the first half of 2021.

For many global banks, the current macroeconomic climate favors the provision of trade finance and SCF, in much the same way that the financial crisis caused banks to emphasize fee-based transaction banking services over direct lending. This is because trade finance

is often deemed less risky and has one of the lowest default rates.

According to the International Chamber of Commerce, the short-term nature of the business makes trade finance assets less likely to experience defaults than other investment types. Although trade finance default rates increased slightly during the COVID-19 pandemic, SCF default rates have remained low in comparison to other trade finance instruments.

However, in today's more difficult economic climate, many trade finance banks also have to consider how they can satisfy growing demand for trade and SCF when they themselves face constraints. Rising interest rates are impacting the

## SUPPLY CHAIN PRESSURES

Supply chain pressures peaked in late 2021 but the supply side has been easing.

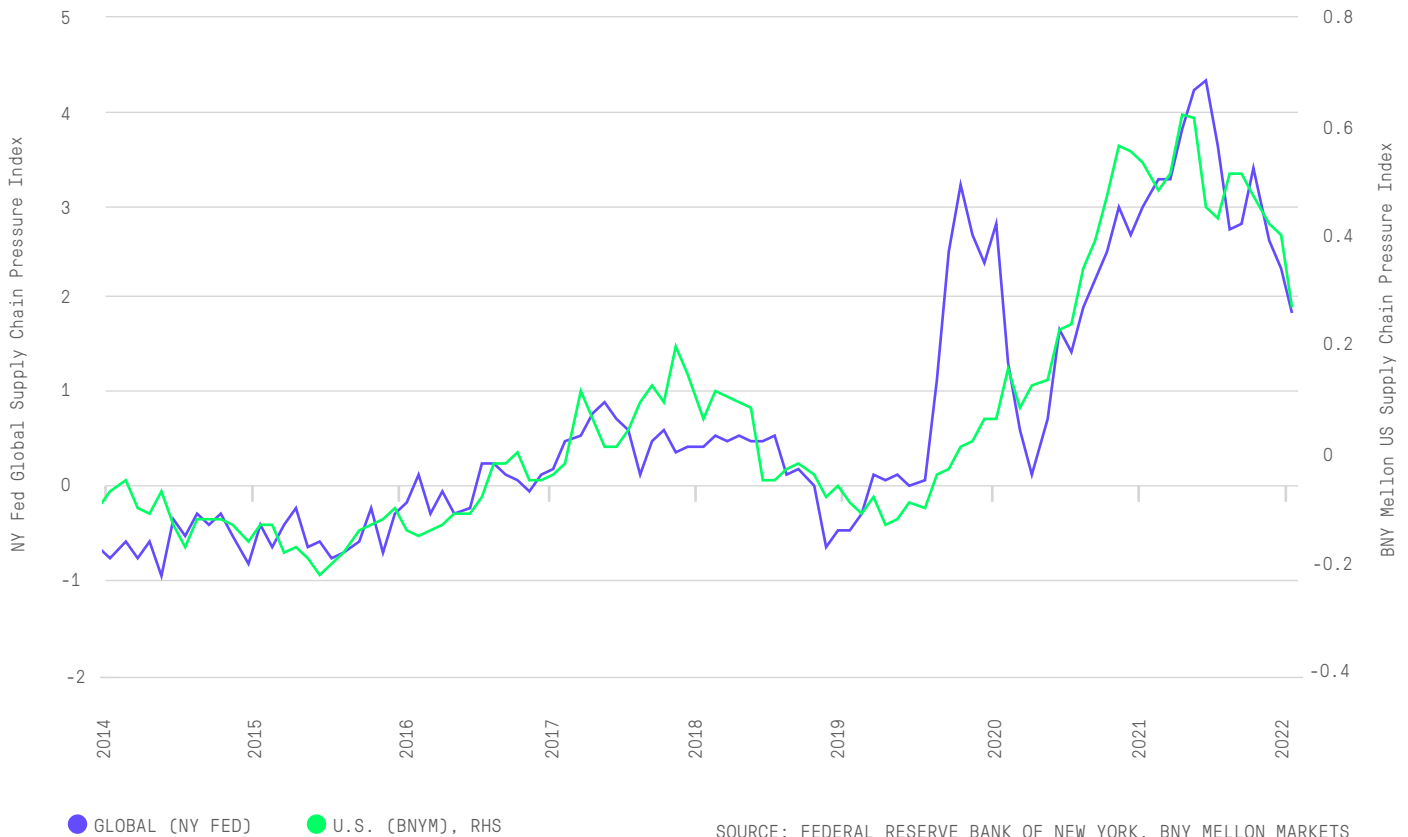


FIGURE 2

deposit side of bank balance sheets, with the greater possibility of outflows due to the availability of more attractive rates elsewhere in the market.

Basel III regulation has impacted trade finance banks' capital requirements, with many subsequently focusing on more familiar counterparties, and moving away from geographies and sectors that they deem even riskier.

The regulations, which are still being implemented, ushered in different methods for calculating capital requirements for operational risk. Banks that opted for the standardized approach of calculating capital face higher charges for the provision of trade finance than those using the advanced measured approach.

### SHARING RISK, REAPING REWARDS

In recent years, many banks have created more capacity by distributing trade finance assets to third parties. The process of trade finance distribution started as an interbank market, with banks using it as a tool to manage country, sector and buyer limits between themselves.

However, given today's pressures to support more and larger trade financings, having the additional option of selling trade finance assets to non-bank investors could help banks to remove more risks from their balance sheets, and find new avenues for growth.

Opening trade finance assets to non-bank investors also has the potential to unlock hundreds of billions of dollars of new liquidity, helping to plug the gap between trade finance capacity and demand. Investors such as pension funds, insurers and hedge funds have already invested in trade finance assets, but more investors could become interested if the attributes align with their institutional market needs.

Of the \$7.5 trillion in bank-intermediated trade finance deals conducted in 2018, some \$300–400 billion was distributed between banks. In comparison, less than \$100 billion was sold to non-banks, according to Tradeteq, a World Economic Forum member.

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# [The Marco Polo Network has] “brought groundbreaking innovation to begin a scalable move away from paper-based trade finance processes.”

— KAZUO YOSHIMURA, SMBC

Moreover, the issuance platform for illiquid credit believes that the distribution of trade finance assets to non-bank investors could grow to a \$3 trillion market in the next five to eight years.

Fintechs are also changing the game by developing platforms that can enable banks to efficiently automate the provision of trade and SCF to corporates and their suppliers, whilst also providing real-time transparency into the status of the transactions. By offering multi-channel platforms, they are playing an important role in the distribution of trade finance assets to third parties.

The Marco Polo Network (MPN), which boasts 30 of the world’s largest banks—including BNY Mellon—as members was launched in 2017 as a blockchain-based software platform for trade financing (see Figure 4), as

well as payments and working capital. The network also opens up the potential for the development of a liquid secondary market in trade finance by enabling the sale of trade assets to alternative liquidity providers that are members of the consortium.

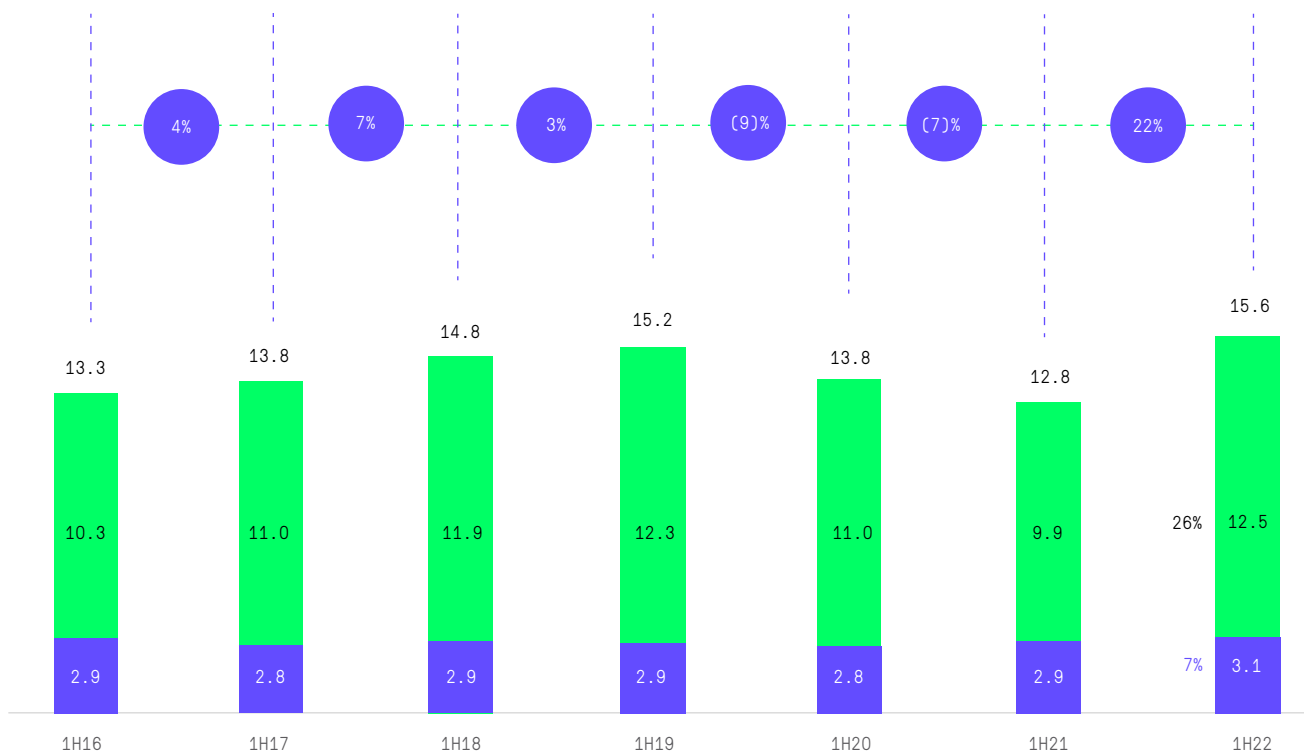
In a testimonial on its website, Kazuo Yoshimura, Global Head of Trade Finance at SMBC, says that the network has “brought groundbreaking innovation to begin a scalable move away from paper-based trade finance processes.” SMBC recently started live transactions on the Marco Polo platform in Japan with major Japanese exporters, he adds, noting, “By teaming up with Marco Polo Network, we endeavor to continue providing effective trade solutions to our customers on a global basis.”

The network also can help counterparties to monitor whether trades align with their environmental, social and governance (ESG) principles—which is becoming an increasingly important factor in supply chains. Users can get an independent view into a large number of corporations to which an ESG score is applied, helping them to determine whether a company meets their ESG values. This includes, for example, the ability to track the labor conditions for workers within the supply chain, identify whether raw materials were obtained from prohibited areas such as conflict zones, and monitor the carbon emissions of vehicles being used to ship orders.

Other trade finance providers have also entered this space with varying degrees of success. One of the early movers in DLT platforms

## TRADE WINDS

Revenues on trade finance deals originated by transaction banks have been increasing.



SOURCE: COALITION GREENWICH PROPRIETARY ANALYTICS

FIGURE 3

—we.trade—closed down in June this year, but a number of other blockchain-based platforms continue to thrive. Many leading banks have joined more than one blockchain trade finance initiative. By doing so, these banks can support their clients across multiple platforms.

### OFFERING RELIEF

Such platforms will prove their worth if financing conditions tighten further. As rising energy and food costs (see Figure 5), coupled with labor shortages, put pressure on companies' operations and capital, it could cause many of them to increase their prices and seek new and innovative ways to safeguard their businesses.

It is true that some key input and commodity prices have retreated, with core CPI (adjusted for volatile food and energy prices) remaining near 8.3% year-over-year, as of mid-September. But central bankers erred last year by presuming rising inflation would be transitory, so the response now is for them to deliver higher—and ultimately restrictive—interest rates, likely for a lengthy period. Lessons learned during the 1970s showed that it can take a long time for inflation to return to trend, and risking a mild recession to bring inflation down is preferable to ceasing tightening too early.

Borrowers will need to shore up their liquidity while ensuring the future financial viability of the

suppliers they rely on. SCF, with all its recent enhancements, represents a proven way of achieving both these goals. And banks now have a very valuable role to play in safeguarding it to keep commerce moving. ●

*Joon Kim is the global head of trade finance product and portfolio group for BNY Mellon Treasury Services.*

*Questions or Comments?*

*Write to Zoran Kanlic at Zoran.Kanlic@bnymellon.com or reach out to your usual relationship manager.*

# HOW WE GOT HERE

BY JOHN VELIS  
FX AND MACRO STRATEGIST FOR  
THE AMERICAS, BNY MELLON

Globalization was in retreat, it was claimed, and “reshoring”, “nearshoring” and “friendshoring” were the growing trends in trade. Frictions between major trade partners encouraged the search for alternative sources of supply and distribution.

Nevertheless, supply conditions have been gradually improving. Indicators like container shipping prices are well off their peaks and commodity prices are broadly coming off as well. The Federal Reserve Bank of New York’s Global Supply Chain Pressure Index, which incorporates data on transportation costs and business surveys, peaked in December 2021 and has been cooling off ever since, suggesting some relief across global supply chains this year.

The COVID-19 pandemic snarled global supply chains, creating shortages of materials, crucial inputs and components. Logistics networks became entangled and bottlenecks throughout the economy developed. The pandemic itself shifted consumption and spending behavior, practically eliminating demand for some types of industries, and generating explosive demand for others.

This re-allocation across the global economy during COVID-19 exacerbated supply chain difficulties. Even though demand in the economy initially collapsed and took nearly a year to recover, the supply side of the economy was so impinged that inflation began to accelerate, and by June 2021, the annual rate of increase in the U.S. Consumer Price Index, or CPI, had topped 5%. It is now 8.5%.

Demand began to recover sooner than supply chains did. The price of copper, which has often acted as a proxy for global activity, had already recovered to pre-pandemic levels by the end of 2020, anticipating a resumption in activity and economic reopening. But the supply side remained under great strain. The minutes from the July 2021 Fed rate-setting committee meeting mentioned “bottlenecks” or “supply” 32 times in a 15-page document. Rising demand was meeting still-limited supply, generating growing inflationary pressures. By December 2021, the CPI was up 7% over the year prior.

Just as demand globally was recovering, war erupted in Ukraine. This was an additional blow to the supply side. In particular, energy (especially natural gas) and grain prices were affected. The IMF’s Global Price Index of All Commodities reached an all-time high in March 2022, as did the FAO’s Food Price Index.

Finally, events in China have become central to the global supply-side situation. Large swathes of the economy have been taken offline and come back online again as Beijing persists with its zero-COVID policy. Also confronting a property market crisis, the Chinese economy has become a source of great uncertainty for the global outlook, including its crucial role in the global supply chain. At the end of July, the IMF downgraded its forecast for China’s economic growth to just 1.1% in 2022 and 1.3% in 2023. Data from the widely cited CPB Netherlands Bureau for Economic Policy Analysis shows that exports from China have been flat since the beginning of 2022.



## NETWORK EFFECT

The blockchain-based\* Marco Polo Network automates how invoices are paid.

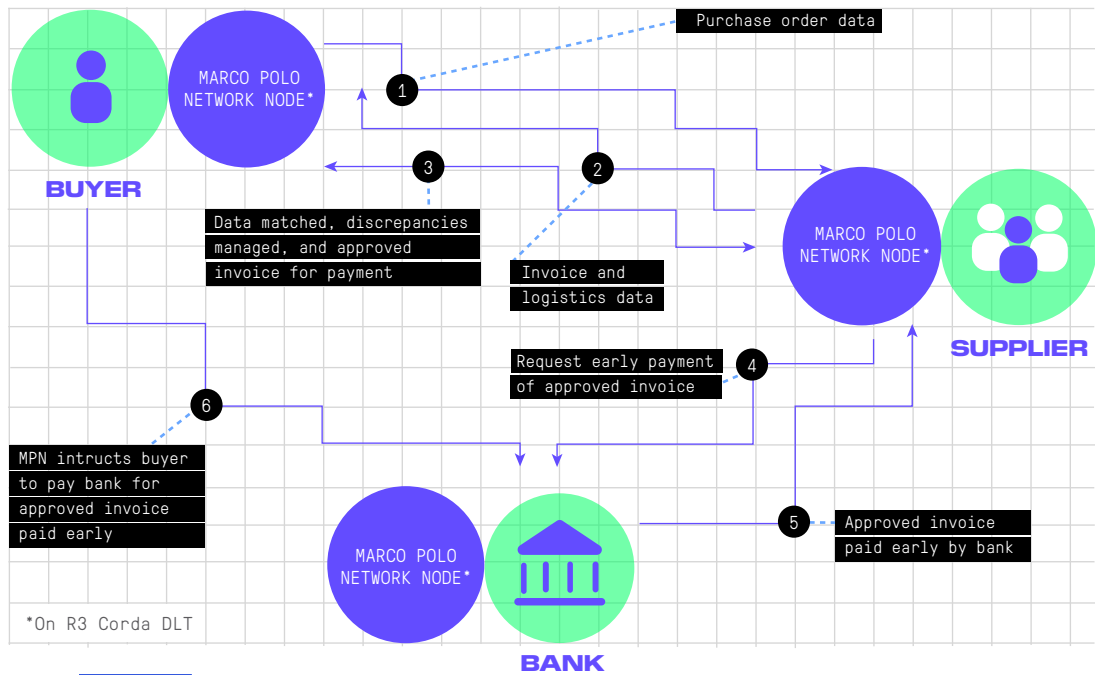


FIGURE 4

SOURCE: MARCO POLO NETWORK

## BATTLING INFLATION

Inflation could take two years to come down, according to some estimates.

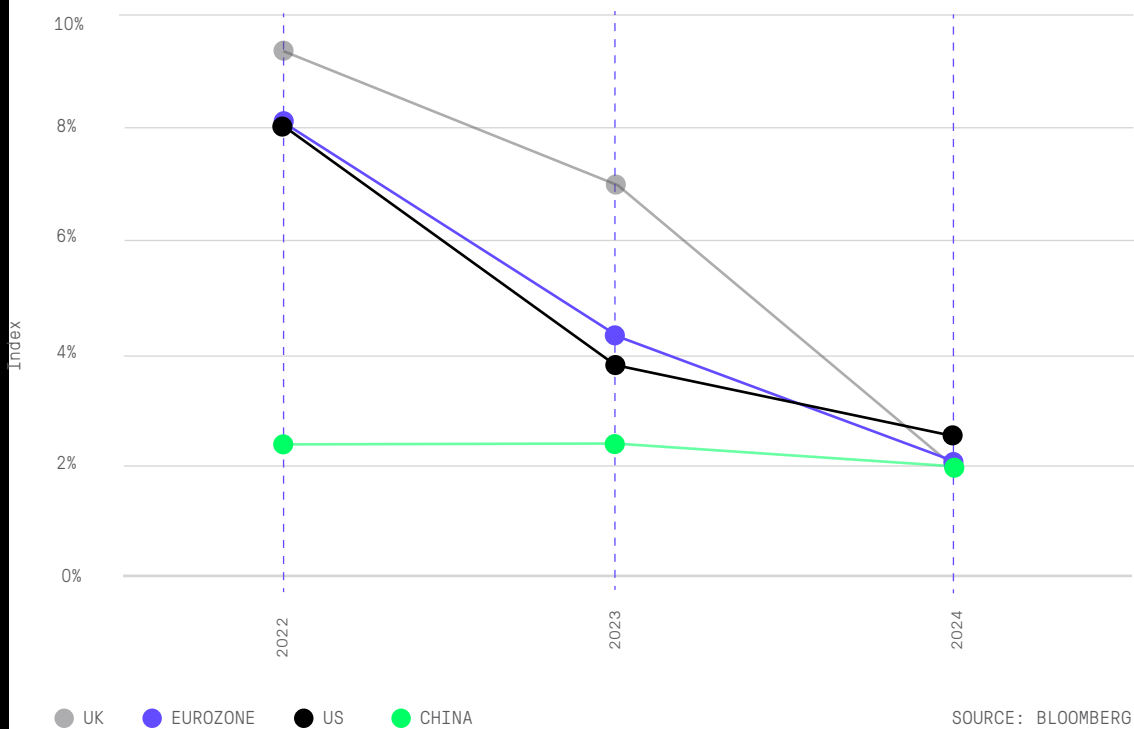


FIGURE 5

SOURCE: BLOOMBERG



**Each quarter, corporates will be required to disclose details on the SCF amount outstanding—effectively the amount that remains unpaid by the buyer, where that amount is presented in the company’s balance sheet, and any changes in that amount during the relevant period.**

— ZORAN KANLIC, BNY MELLON



# NEW RULES OF THE ROAD

BY ZORAN KANLIC  
HEAD OF FINANCIAL SUPPLY CHAIN  
PRODUCTS, BNY MELLON

**A** lack of automation in trade finance means that many of the deals are difficult and time-consuming for banks to screen, which can make regulatory compliance more challenging. There are also new reporting requirements on the horizon, which may require disclosure of more information on supply chain financing programs, such as their size and terms. In July, the U.S. Financial Accounting Standards Board (FASB) voted to approve new disclosure requirements for SCF, which seek to standardize how public and private companies report on their programs in financial statements.

Each quarter, corporates will be required to disclose details on their SCF amount outstanding – effectively the amount that remains unpaid by the buyer, where that amount is presented in the company’s balance sheet, and any changes in that amount during the relevant period.

According to the FASB, this will bring enhanced visibility into all such arrangements and improve business confidence in the solution’s accounting treatment, because it removes some uncertainty about how to report SCF programs on the balance sheet. It is also expected to help improve a company’s credit profile by enabling a ratings agency to evaluate the company’s standing and financial performance more effectively.

The new reporting requirements, which are due to be implemented in early 2023, also are expected to help banks better assess corporate creditworthiness by providing a better indication of whether they are over-leveraged or well-placed financially for further supply chain financing.

Currently, the standards apply only to certain types of SCF, focusing on buyer-led arrangements, rather than disclosures by the supplier or finance provider. Whether the requirements will be revised and expanded in the future to incorporate other varieties of SCF remains to be seen.

In addition to the new rules being implemented in the U.S. by FASB, plans are also in motion to introduce disclosure requirements within the International Financial Reporting Standards (IFRS), the most commonly used standards globally. Both sets of standards seem to have the same aim of enabling financiers to have a more comprehensive overview of a company’s financial position and potential risks. And while there are many similarities between the two disclosure standards, there are differences that will need to be observed. The IFRS standards are expected to require more granular detail, for instance.

Corporates – especially multinational companies, which use both sets of standards – will need to be mindful of the developing disclosure landscape, including what is required where, and when different reporting requirements come into effect.

While adapting to new reporting requirements can present challenges, the prospect of greater transparency and standardization – within SCF and across the industry as a whole – will only enhance the effectiveness and value of trade finance. By introducing disclosures, funders can be confident that SCF is being directed towards responsibly managing working capital and providing optimized support for businesses and supply chains.

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