THE WAY FORWARD FOR TRADE SERVICES BUSINESS
A NEW CHALLENGE FOR BANKS

By
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Introduction

Trade Finance is a key business area for commercial banks as it provides an opportunity to earn interest income as well as non-interest income. Many banks, both locally and overseas, target this market for a significant contribution to their financial performance. As a result it has become a highly competitive market segment. However the business environment is undergoing a radical change, creating a new challenge for banks.

The traditional Receivable Trade Finance Instruments create significant value to both the importers and exporters. To the exporter, they facilitate maintaining ownership of goods; to the banks, guarantee of payments, greater predictability of payment timing, provision of credit and outsourcing debt collection. To the importer, they facilitate management of country risk, Exchange Control, provision of credit, outsourcing of document checking, comfort on performance/ quality of goods. In the past it was only the banks, which were able to exploit these opportunities and create value to their import and export customers. Therefore importers and exporters were highly dependant on the banks to provide them the required services to enable them to continue their business operations.

During the recent years the business environment has undergone a major change and become highly competitive. This current market situation has made not only importers and exporters but all businessmen adopt a three-pronged business strategy (refer Figure 1). The first strategy is Cost Reduction. During the last decade it has been very common to eliminate waste and have strict control over costs, especially by the management of the supply chain, for the purpose of increasing the profits of any business. The savings made by firms by using this strategy has been,

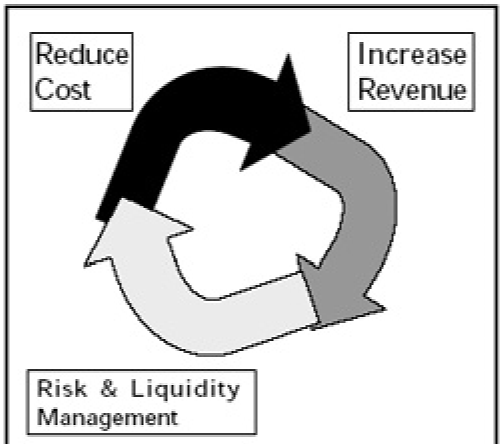

Figure 1: Business Strategy

in some cases, quite significant. The second strategy is to Increase Revenue. Today organizations expand their scope and venture into new areas well outside the traditional boundaries of their industry in order to increase their revenue. The third strategy is the Management of Risk and Liquidity. This is an area that has received a high degree of attention in the more recent times since stability and reliability are considered extremely important for continuing business relationships.

Therefore, it is desirable to examine the evolving market situation and the developments that are taking place in the industry in order to adapt to this changing environment. What would be the role of the banks in the new arena and what would be the competition that they will be required to face are all questions that need to be addressed.

The Trade Market

The changing market situation and this dynamic environment of the Trade Market has become the most important factor that needs to be addressed by banks if they are to survive and be successful in facing the competition. Therefore let us start by examining the market conditions.

The Evolving Market Situation

When the importers and exporters who were all relying on services provided by the banks for the servicing of their financial value chain are, today, looking at ways and means of reducing costs whilst managing their risks in keeping with their business strategy, they have a good understanding of the Corporate Risk Spectrum (refer Figure 2) and they are no longer prepared to pay the banks for handling their low or no risk transactions. The Corporate Risk Spectrum clearly indicates the fact that lesser the involvement of the banks, the greater is the corporate risk they have to take and vice versa. Therefore, whenever the corporate risk is low, it does not make sense for importers and exporters to pay high fees to banks to handle such transactions and they are bound to pursue cheaper and more efficient alternatives.

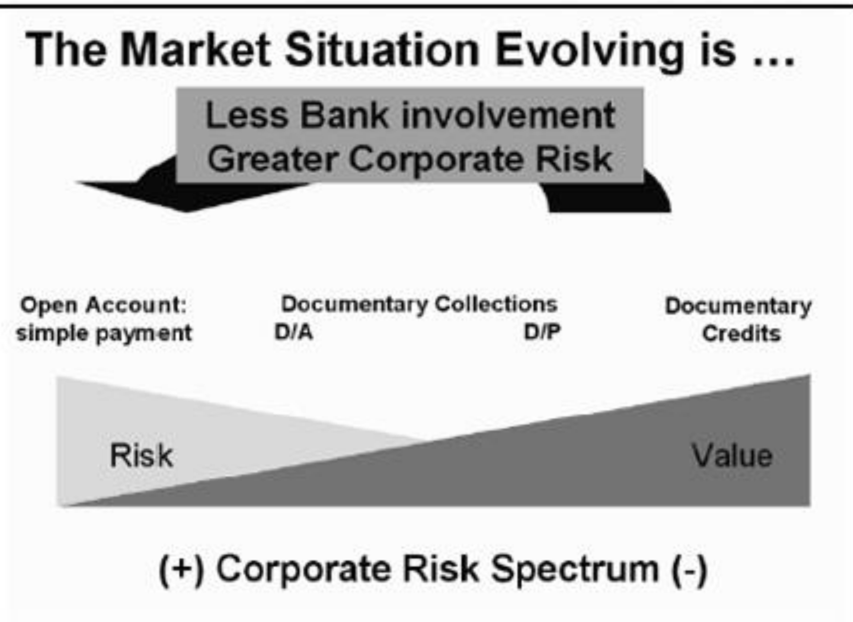

Figure 2: Corporate Risk Spectrum

Over the years there has been a rapid increase in the global trade being carried out on Open Account basis. At the end of last year an estimated 81% of global trade was being done on Open Account. This has led to a slow growth of the traditional Trade Finance business. Since SWIFT is used extensively by banks for transmission of messages relating to Documentary Credits and Collections, one can estimate the volume of trade business handled by banks by examining their growth rates. The growth in SWIFT's Category 4 & 7 messages (which deal with Collections and Documentary Credits) during the last five years is around 2.7% whereas the growth in world trade has been around 10%. The bulk of the growth in SWIFT message traffic in the category 4 and 7 messages has been due to the growth rates in Asia with China leading the way.

The market drivers have increased the challenges in the banking industry. Let us examine some of the market drivers and the challenges they create to the banks.

The first market driver is Geographic Volatility and the challenge, arising from it, is managing of changing country risk profiles. The next is Investor Confidence and the challenge that it creates, is protection of shareholder value. New Entrants into the market is another and it leads to increasing competition, resulting in erosion of margins. Another driver is Global Participation which makes the constraints of operating costs and increasing IT burden on banks, a major challenge. One of the most important market drivers is greater Customer Mobility. This has been a highly critical factor for banks that have been enjoying customer loyalty for many a decade. Risk Management has come into focus in recent times and new initiatives like Basel II has been another market driver. This has brought in the challenge of capital efficiency to banks.

In the light of the changing business environment, banks are reviewing aspects of their Trade Finance business in order to remain competitive. Customer demand is one aspect that needs to be reviewed. Banks have been forced to introduce new functionalities and achieve a higher level of quality at a lower cost. Regulatory changes also cause changes in some of the aspects. New directives have been introduced on cross border payments, which will need to be adhered to.

Implementation of Basel II will bring in additional capital requirements on operational risk. The Patriot Act, the Know Your Customer (KYC) requirements and Asset and Liability Management (ALM) measures all need to be addressed thereby increasing the operating cost.

Competitive pressure is affecting the home markets and is under severe threat from new entrants. Many of these new entrants introduce solutions, which are propelled by cutting edge technology. The revolution in the industry has created a movement of the method of payment from Documentary Credits to Open Account hybrid solutions. They have also forced the banks to have web-enabled development of information exchange. Banks have also started looking at outsourcing of the non-core activities so that they could concentrate better on their core activities.

The Current State of the Trade Market

The Trade Market is therefore undergoing a major change and the following characteristics have started emerging. Banks are coming under severe pressure from both the local and global competitors; not only from other banks but also from those outside the financial services industry. Furthermore, the banks are being pressurized by their customers to improve on their capabilities while reducing the costs.

Consolidation of trading partners, taking place in select industries result in the movement towards integrated supply chain management solutions introducing new needs and new products to the market. Technological enhancements are seen in the supply chain management creating a paradigm shift from the traditional Documentary Credits to hybrid Open Account methods for their trade settlements.

Financing of international trade risk mitigation for importers and exporters and settlement of payments by banks will continue to play a vital role in trade. However the margins on both the processing and the risk components of the business are shrinking. This has motivated a number of banks to move processing offshore either directly or through alliances, in order to reduce their costs. Enhanced imaging and web capabilities have also allowed more efficient processing in the back offices and better reporting of information to clients.

The Customer Needs

Let us now look at the changing customer needs in order to find appropriate solutions. Most Banks will continue to have an 80 – 20 rule. Since 80% of the business comes from 20% of the customers they will need to handle those 20% of the customers cost efficiently and with extreme care.

The provision of credit facilities will continue to drive the small and medium enterprise customers dealing in trade. On the other hand Straight Through Processing (STP) with lowered procurement costs will drive the Corporates. Corporate customers will themselves be looking into making investments in their supply chain in order to become cost efficient.

Vendor financing and Liquidity management will drive the need for the active involvement of the banks. The customer usage and need for Documentary Credits will continue. Banks will need to provide enhanced capabilities in order to continue to support the customers requiring trade products.

Response From Individual Banks

A number of initiatives have been taken by the individual banks in response to this changing business environment in order to create value and maintain customer loyalty in order to improve their trade services business.

Trade Origination Processes, Trade Information Exchanges and Trade Partners are all schemes designed by individual banks to assist their customers to increase their trade business and thereby winning not only the ensuing business but also customer loyalty.

Bank-to-Bank Reimbursement, Outsourcing of Global Treasury and FX Trades are initiatives designed to add value to their correspondent banks and their customers and for increasing revenue whilst managing costs.

Some of the other initiatives that the individual banks had to move into are Consolidated Payment Capabilities, Integrated Treasury Workstation, Centralized Disbursement, Pooling of Services, Payroll, Petty cash and Transportation pending Some of the Information Technology initiatives that resulted in banks coming up with e-Enabled Trade Data Warehouses, Electronic Commercial Trade Documents, Online Integrated Reporting, Transaction Initiation Investments and Inquiries, Electronic Invoice Presentation and Payment, Online Document Image Archiving and Retrieval

Bolero

Bolero was founded in 1998, with significant backing from the bank community and from the global logistics industry. Bolero was created as a neutral, trusted third party to develop a comprehensive set of standards that would remove the barriers to global, cross-enterprise business.

Bolero implements and enforces these standards in an open platform to enable paperless trading between buyers, sellers, logistics, banks, agencies and customs anywhere in the world, delivering transaction visibility, predictability, speed, accuracy and security.

Building on this platform, Bolero delivers applications that enable the merging of the physical and Financial Supply Chains, allowing companies to fundamentally re-engineer the way that business is done and take advantage of electronic trading.

Customers and their trade partners are rapidly deploying Bolero solutions delivering significant reductions in cost and working capital, increased visibility and improvements in operating efficiency.

Bolero Financial Supply Chain Solutions

Bolero, with the cross-industry representation and significant community expertise of founding shareholders were founded to build a platform, which conformed to their fundamental pre-requisites, providing a unique and substantive technology to underpin electronic trade. They primarily cater to corporate Importers and Exporters and the integration of their trade activity with the two communities on which their trade processes are dependant are highly interrelated. On one side the Freight Forwarders and the broader logistics service providers; and on the other, Banks and other Financial Institutions. They deal in the global world where there are a number of customs, industry and particularly in Asia, regional trade community platforms, introducing aspects of paperless trade to the global Physical and Financial Supply Chain. Bolero has been designed to integrate with these emerging platforms as well as providing incremental steps of value to these inter-related communities.

The bolero solutions consist of the Bolero Trusted Trade Platform, which is the core investment and infrastructure underpinning all Bolero services, the Bolero Open Account Suite and the Bolero Documentary Credit Suite. The entry-level component of the credit Suite is Bolero-Advise, which provides multi-bank electronic Letter of Credit Advise capability.

Bankers' Overview of Bolero

For many Banks, the traditional trade services business faces challenges while significant new opportunities have begun to rise. Trade finance volumes are flat, traditional paper-based processes offer no great economies of scale, and Banks are faced with the continual need to improve their trade transaction margins. At the same time, both Importer and Exporter Banks are seeing an increased risk of disintermediation as some of their customers move towards Open Account banking.

Clearly there's an imperative for Banks to develop new credit, risk and transaction revenue streams to address this challenge. However, the concerns and issues that this causes, aren't necessarily the same for different Bank functions. So it's important to look at how evolving International Trade pressures can impact them.

- For banking *Relationship Managers*, the goals are fairly clear – growing business with current clients, winning new business and developing the revenue potential from each corporate relationship. To date, open account banking has left Banks only handling transactions and payments, and that's diluting the strength and value of many relationships.

- In the *Payment Services* business, bankers are looking to differentiate their services in a utility market, finding ways to increase margins in a commodity sector, while also addressing the challenge of domestic/EU cross-border payment charge alignment.

- With *Risk and Credit solutions,* bankers are searching for ways to acquire more 'good' business from its best customers at the expense of the competition. At the same time the focus is on ways to deepen lending margins and reduce the engagement costs associated with setting up and maintaining a loan portfolio.

- For *Cash and Treasury Management*, the focus is on ways of providing enhanced working capital solutions, perhaps offering new information services and developing greater cross-selling opportunities.

- *Trade Services* are investigating ways to offer customers a trade solution that provides the level of transparency and accuracy that their trading customers need.

Exporter Overview of Bolero

The Financial Supply Chain refers to the end-to-end processes and information that drive a company's cash, accounts and working capital. For the Exporter, this covers the full order-to-cash cycle and is a source of significant trapped value in the key areas of Working Capital, Cash Flow and Accounts Receivable processing.

Bolero's solutions are designed to unlock this value for companies that rely on international export markets. Their Open Account and Documentary Credit solutions provide a fully integrated order-to-cash solution that can be implemented in a simple, phased approach, enabling you to achieve Financial Supply Chain benefits rapidly. For Exporters, these include:

- The ability to optimise working capital
- Removing slack from the order-to-cash cycle
- Improving discount offers
- Ensuring better financing terms
- Improved cash flow management
- Reducing Accounts Receivable (AR) processing costs

Importer Overview of Bolero

The Financial Supply Chain is increasingly recognised as an area offering significant potential for generating bottom-line improvements and creating competitive advantage. However, many of the core processes underpinning International Trade have hardly changed since trading began. At Bolero, they believe there's a huge opportunity to improve these processes and deliver substantial financial and business returns for all parties involved in the trade process.

Bolero works closely with corporate Importers to optimise the integration of their trade activity with the two communities on which their trade processes are dependent and highly inter-related – on one side the Global Trade Banks and Financial Institutions, and, on the other, freight forwarders and broader logistics service providers.

From an Importer's perspective, the Financial Supply Chain involves the full procurement-to-payment process and specifically the end-to-end trade processes and information that drive a company's cash, accounts and working capital. Unlike the Physical Supply Chain – which has seen improvements ranging from containerisation to fulfilment management/just-in-time inventory – there still remain significant gaps in the Financial Supply Chain, particularly in the optimisation of working capital efficiency, the development of vendor/client relationships and overall financial performance.

For Importers the gaps between the Physical and Financial Supply Chain are making it more difficult to manage daily reconciliation of invoices to purchase orders, and the negotiation of financing and the precise management of payments. Typical challenges include:

- Reducing the time needed to create, transfer and process paper documentation.
- Eliminating the cost and errors associated with the manual creation and reconciliation of documentation.
- Lack of transparency in inventory and cash positions when goods are in the supply chain.
- Disputes arising from inaccurate or missing data.
- The physical disconnection between all the different parties in the Financial Supply Chain.
- The spread of fragmented 'point' solutions that don't address the complete end-to-end processes of the trade cycle.

As Bolero has been designed to act as a platform that brings together all the constituent parties involved in International Trade, it can provide importers with a powerful framework to help address many of the key challenges they face.

Bolero's Trusted Trade Platform is bank-neutral and scalable to all settlement types, documents and parties. It also has cross-industry applicability, so makes an ideal platform to help importers address some of the key issues that can cause friction in the vendor/client relationship.

Collective Response from Banks

SWIFT, which is a cooperative owned by the member banks, has been one of the biggest service providers to banks in recent times and any impact on the business of banks will also have a direct influence on its operation as well. Therefore SWIFT appointed a sub-committee of The SWIFT Board as the Trade Services Advisory Group (TSAG) to recommend the strategy that SWIFT should adopt to be successful in the evolving business environment. SWIFT's Trade Services Advisory Group (TSAG) was formed in early 2003, as a sub-committee of SWIFT's Banking and Payments Committee to:

- Define and clarify community needs
- Advise the SWIFT Board of Directors in formulating SWIFT strategy and tactics
- This review was timely in the light of:

\- Bolero, TradeCard etc
\- New bank service offerings and cost reduction strategies
\- Evolving market trends

The twelve member banks which took the initiative to embark on this venture were:

ABN Amro Bank, Bank Tokyo Mitshubishi, BNP Paribas, Citigroup, Deutsche Bank, HSBC, KBC, JPMorgan Chase, OCBC, Royal Bank of Scotland, Standard Bank of South Africa, and UFJ Bank.

TSAG Recommendations

The TSAG studied the current situation in the market and the emerging market scenarios and came up with the following recommendations::

SWIFT's Strategic approach:

- Expand SWIFT's focus from traditional trade instruments to supporting bank services across the entire corporate supply chain.

SWIFT's two-part tactical approach:

- Continue to maintain the current FIN Category 4 and 7 Message Types, with appropriate enhancements, eg, to reflect ICC's UCP requirements.

- Develop a central Trade Services Utility (TSU) to enable banks to provide new and enhanced services in the trade area.

SWIFT was at this time in the process of upgrading their system and moving into a private Network using IP technology called SWIFTNet. Since the member banks have already incurred the overhead, it made good business sense to make optimum use of the SWIFTNet system as a platform for the TSU in order to be more cost efficient and to have better risk management.

The Swiftnet Trade Services Utility (TSU)

The Trade Services (TSU) is a SWIFT service using SWIFTNet and XML messages to access a Central Data Matching and Work flow engine to support bank services in the Trade Supply Chain.

Operating in the collaborative space

Since banks are in competition with each other, one may wonder whether a collective effort by banks will undermine their competitive advantages and hence have an adverse impact on their performance. There are certain areas where banks can work together for their mutual advantage and this area is called the Collaborative Space (refer Figure 3). The recommendation of the TSAG is to work together only in the Collaborative Space so that banks can collectively enjoy huge cost savings whilst they continue to compete with each other in providing the Bank's services.

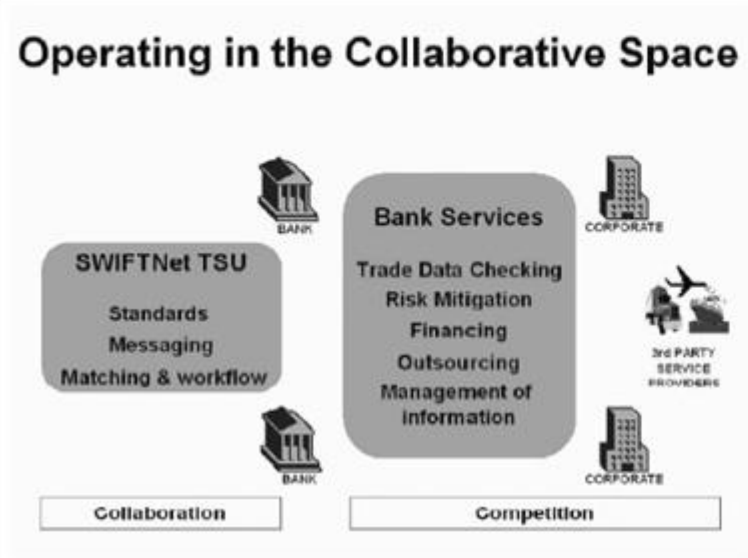

Figure 3: Collaborative Space

Overview of the functionalities of the TSU

The overview of the TSU be as follows:

There will be 4 Data Sets

- Commercial, ■ Transport, ■ Legal and Certificates, ■ Insurance

There will be 3 Ways of Initiating a Transaction

- Push Through – where the initiator pushes it through the system to the recipient.
- Lodging – where the initiator will lodge and the recipient is expected to get it from the system.
- Blind Dating – Lodging is done by both parties and the system does the matching.

For the purpose of Reporting there will be:

- Discrepancy Reports

- Status and History

- Notifications

Storage of data will be up to 180 Days
Messaging will be via ■ SWIFTNet InterAct, SWIFTNet FileAct and / or Browse

TSU is being designed in such a manner that it will support a portfolio financing instruments of banks (refer Figure 4)

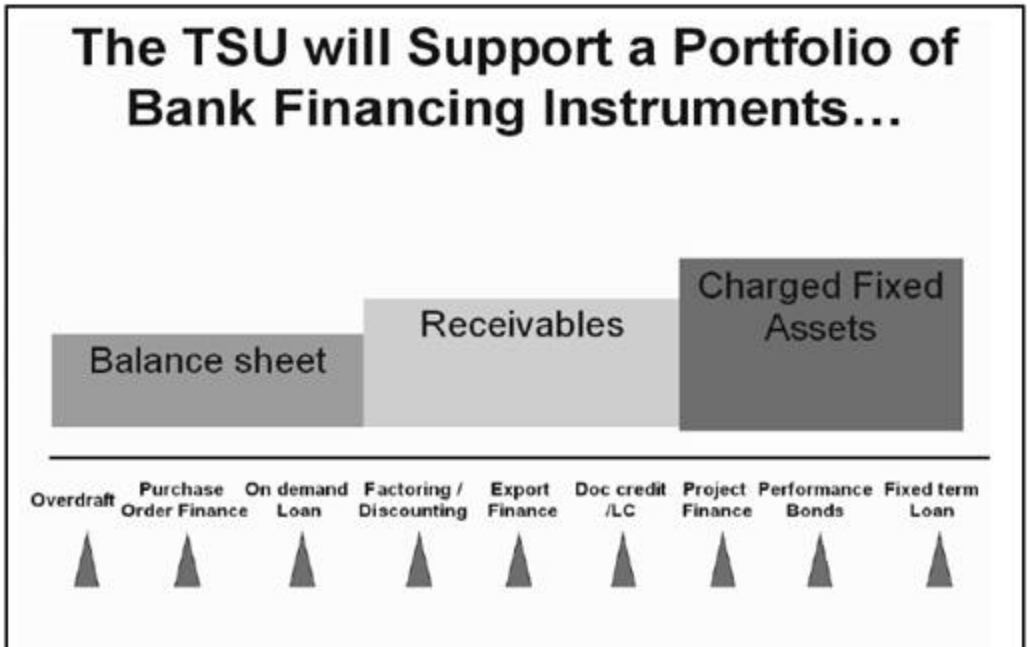

Figure 4: TSU support for Bank Financing

The potential services that banks could provide utilizing the TSU will be as follows:

Financial *Services such as PO finance, Invoice finance, Pre / post-shipment finance,*
- *'Lite' Letter of Credits, Rebate schemes, Forfaiting, Structured trade finance, Asset securitisation, With / without recourse finance.*

Risk Management / Mitigation Services including Risk insurance, Credit insurance, Collections, Automated Letter of Credits process, Improved operational risk, Conditional payment, Country risk management, Currency exposure management.

Working Capital Management- Cash Flow Management

Insourcing Services such as TSU Services to Correspondent Banks, Confirmed Payment Collection, and
Accounts Payable / Accounts Receivable

Information and Other Services including PO confirmation, Reconciliation, Netting, Documents creation, Document imaging, Market intelligence, Event tracking, Data mining

Banks offering supply chain services

The key concepts in offering these services will be a central matching and workflow engine, accessed only by financial institutions, supporting new/enhanced services to corporates, comprising of message services, standards and a business application.

Following the success of the Prototype and market validation SWIFT Board approved the going ahead with the development of the TSU commercial offering.

The TSU, a collaborated centralized matching utility, will allow banks to increase revenues and share the costs when engaging in the provision of services such as:

- In sourcing of payables and receivables
- Finance and risk mitigation
- In sourcing of trade data checking
- Management information

Banks will build on the core functionality of the TSU to individually offer competitive services complementary to their existing offerings to their corporates.

The first release of the TSU will support bank solutions based on purchase order services. SWIFT will pilot the TSU from December 2005 and the launch is expected to be around the middle of 2006 by which date banks will be geared to offer supply chain services.

SWIFT and Bolero - complementary offerings

SWIFT has chosen Bolero as a supplier of technology for the TSU. The TSU is based on SURF (Settlement Utility for managing Risk and Finance) technology and conforms to the specifications defined by SWIFT and its community of banks. The TSU is an independent, complementary and non competitive service to SURF. The TSU is a bank-centric solution with no direct corporate access. Bolero operates entirely in the corporate-centric space, where one or more corporates would always be part of the Bolero based services. Where the TSU provides matching of subsets of data from trading documents, submitted by one or more bank, Bolero offers applications designed to support the full compliance process.

“The need for banks to develop new services is compelling,” said Arthur Vonchek, Bolero CEO, at the Bolero session at Sibos 2004. “Financial supply chain management has not evolved anything like as far and fast as physical supply chain management. Given that in the complex, paper-based world where even the simplest international trade transaction can involve a dozen different parties, the TSU will introduce one standard element. It will encourage wider use of standards and push towards community-based rather than individual solutions.”

SWIFT is a founder shareholder in Bolero, with representation on the Bolero Board of Directors. SWIFT is also a supplier of services to Bolero and is the operator of Bolero’s services.

ICC’s Uniform Customs and Practice for Documentary Credits (UCP)

The need to make provisions in the UCP to cater to electronic paperless documents was first discussed during the drafting of the 1974 revision (UCP400). The drafting group of the 1983 revision (UCP500) modified some of the clauses in the UCP in order to make it more acceptable for electronic transactions. However, the provisions made were still found to be inadequate and ICC had to debate as to whether they should have another revision that facilitates the handling of electronic transactions using the evolving e-business technology or to come up with a separate set of rules applicable only to e-business transactions.

ICC finally decided on the latter option and they drafted the eUCP as supplement for UCP500 for electronic presentations (version 01), which enables the new articles (eUCP) to be revised at shorter intervals than the UCP, if the technological advancements during that time warrants the same.

Meanwhile the UCP500 itself is presently being revised and the drafting group is nearing completion of the UCP600, which is expected to come into force either from 01 July 2006 or 01 October 2006 depending on when they will be able to finalise and submit the final document to the Board Meeting of the ICC.

Conclusion

The focus on the physical chain management and the financial chain management has become a pre-requisite for any global business. Banks can no longer enjoy the comfort of Importers and Exporters coming to their doorstep. Even Freight Forwarders are said to be coming up with supply chain management solutions and if the banks are to compete in this area of business they will have to make the first move so that they can get the other players to join their system instead of the opposite.

"'Trade Finance' - I can think of no other discipline where investment bankers, commercial bankers, credit insurers, political risk insurers, guarantors, boutique advisers, specialist financiers (e.g. forfaiters and factorers), trading companies and even software houses can all choose to operate under the same generic title," says Reinhard-E. Uhl, Head of Global Trade Finance, Deutsche Bank, in his foreward for the Global Trade Review Directory 2004-5.

Therefore the Trade Services Utility is an initiative, which the banks are bound to adopt in order to remain competitive. Even for the banks in Sri Lanka, it will not be different other than probably a timing difference when it is introduced. This will become the new challenge for the Sri Lankan banks thriving on Trade Services business.

References:

www.swift.com
www.bolero.net

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