International Trade
and Forfaiting Association

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It's time to talk about trade finance

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A couple of years ago, I made a pitch to a group of investors. During the pitch I mentioned the problem I was trying to solve in trade finance was ultimately quite dull. The investors were not sold on the idea. To them, Fintech should be exciting, dynamic and fast moving. My version of trade finance was not something for them.

Two years on and with the Greensill saga still unravelling, this may be an appropriate time to point out just how wrong those investors were. Like most areas of day-to-day banking, trade finance functions well when it is boring. It accounts for around $17tn of financial flows around the world, or around 80% of the value of world trade and yet most of it is back-office, manual and hidden from view. When it comes out of the shadows, as it has done recently, it is for the wrong reasons.

Perhaps as a reaction to the events around Greensill and supply chain finance, and in a continued bid to educate the industry at large, the International Trade and Forfaiting Association (ITFA) published guidelines last week on the difference between traditional letters of credit and their more exotic cousins, structured letters of credit.

A letter of credit (LC) is simply the means by which a supplier gets paid by its bank as soon as the goods are delivered to the buyer. To simplify, the buyer approaches their bank for a letter of credit that covers the costs of the goods that are being supplied to them, and their bank then issues a letter of credit in the name of the buyer to the seller's bank., The supplier then gives their bank all the documents relating to the sale, and if the seller's documents are compliant with the terms of the letter of credit the seller gets paid – and this can be before the goods arrive at their final destination.

While these are not the instruments used by Greensill, and while its use has declined over the past five years, Coriolis estimates that they still represent around a sixth of the value of world trade – that's over $3tn in trade finance a year - so it's important to understand what is going on.

The structured letter of credit is more complex than its traditional countpart. For example, the seller could be exporting something like oil or metals to a subsidiary within their own group. The deal is likely to be large, and the time frame during which the commodities are being shipped is likely to be between 180 and 360 days. During this time, the parent company may want to make money from that shipment while it is in transit. The parent company will present the contract for supply, not necessarily to a bank, but this bank may not be in the same country either as itself or as its subsidiary. Similarly, the bank issuing the letter of credit may not necessarily be in the same country either.

The reason for the disconnection with the initial deal is that the contract between the seller and the buyer is being used as a means of leveraging the value of the shipment through the value of the documents so the ultimate sources of finance may not need to have any connection with the trade flow itself. It is purely using the trade flow, documented through a Bill of Lading for example, as an instrument to negotiate more efficient working capital or, in the case of the issuing bank on behalf of the buyer, potentially to get US dollar liquidity since most commodity trade is priced in US dollars. Its advantage is that the contract is paid up front to the seller, who then sells it to a financial intermediary at a discount while the goods are in transit. This financial intermediary (usually a bank) then works with an issuing bank on the buyer's side – the issuing bank is often in an emerging market and needing dollar liquidity.

The resultant structured LC provides dollars to the issuing bank, pre-payment to the supplier, and a return on financial instrument of the difference between the discount rate contract and the original contract. It lasts for up to a year and is fully paid off at a discount once the goods have been delivered.

A real challenge for the sector is that the documentation required to get a structured letter of credit like this is less rigid and on occasions may not involve the same scrutiny at every level as a result. A lot will depend on the approach to risk, anti-money laundering (AML) and know-your-client (KYC) practices in the two financial organisations facilitating the Structured LC and this is where the real issues lie: there is potential for the perception that this is a “murky and uncontrolled environment” because the clarity behind what is involved is not immediately obvious.[1] In other words, they may just be slightly too interesting.

To be clear, however, these instruments are subject to exactly the same risk assessments and compliance procedures as so-called traditional letters of credit. Banks are heavily regulated and the strength of the regulatory regime and their own compliance processes ensure that most will not participate in structured letters of credit deals unless it is with “well-known” and “long-standing” clients and “under specific conditions.” They will generally be subjected to higher levels of scrutiny in the largest trade finance banks and therefore ultimately be more time consuming and more manual than a traditional letter of credit.

And this is the heart of the challenge for trade finance: world trade cannot function without global trade finance, but because so much of it involves manual checking and risk assessment it is time-consuming, expensive and prone to human error. Ultimately because of all of this opacity, there is a risk of fraud and non-compliance that means that many smaller businesses and many emerging market traders do not get the levels of trade finance that they need if trade is to be the process of economic development and growth that it should be.

It is critical, therefore, that we have clarity on the steps involved with these complex and opaque processes if the innovations in the sector are to make the difference in facilitating finance to SMEs and emerging markets in particular that they need to. Trade finance Fintechs are all about enabling these ultimately dull and time-consuming processes to minimise fraud and to facilitate access to liquidity and working capital to businesses of all sizes. Where this should become interesting in a good way is in making these digital processes routine so that the processes of scrutinising documents and managing risk becomes standardised globally.

If the Global Financial crisis taught us anything, it was that Financial Services are dangerous when they are interesting. There is a revolution, accelerated by the Covid pandemic, towards greater digitisation both of trade finance generally and of the documentation and financial instruments around it. This will lead to greater standardisation of the processes governing the industry and that can only be a good thing. In the end, trade finance should be made quicker, easier and more inclusive. In order to do that, it can continue to be as dull as it likes!

[1] https://itfa.org/: Guide to Structured Letters of Credit: https://itfa.org/wp-content/uploads/2021/04/ITFA_Structured-Letters-of-Credit-Guide_20-Apr2021_final.pdf/