Le dernier mot

Jean-François Lambert asks why credit committees and regulators do not give transactions embedded in global supply chains special treatment when it comes to capital allocation

This month, I would like to bring up a topic that has been discussed at every conference on commodity and trade finance for years: the benefit of structuring bank financing around supply chain and why this is not properly recognised by credit managers and regulators.

Dynamic banking

To the practitioner (and I know a few of them who will accuse me of stating the obvious) financing a flow of goods is so much more pertinent than lending bilateral money to a company. I call it dynamic banking, as opposed to static banking.

Let me explain: what can be considered the strongest relationship, if not the one that links a buyer with its supplier? Is it stronger than the one linking any company with its banker? Of course it is. Imagine a company running into cash problems, potentially compromising its deliveries to its key customers. What would be its course of action? Contact its customer to apologise and explain that the expected cargo will be delayed by one month, or call its banker and ask for temporary additional liquidity or loan extension? It will be the latter in 90% of situations. Telling its large customer that delivery time cannot be met is a very risky move, as the buyer might be inclined to direct its orders to a more reliable supplier. So it amounts to a business death warrant.

What does this mean from a banker's perspective? Simply, that structuring its financing along established relationship, which link a buyer and a seller, is a much more comfortable proposition than outright lending. Yet, as obvious as it may be, the bank's culture remains by and large one that prioritises the bilateral assessment – where the supply chain merely provides information as a risk mitigator.

How wrong this is, in a world where the rhythm of trade is beaten by sophisticated supply chains, spanning across continents, linking developing country suppliers to multinationals; a world where the relationship between buyers and sellers has kept risks to a marginal level in all sectors – commodities included!

Capital allocation

How is it that capital requirements do not acknowledge this reality? Why is it still so challenging to get a credit committee to approve a structured trade finance transaction, along strategic commodity supply chains?

The answer lies within the culture of banking which, despite its very (perhaps overly) sophisticated capital models, it has remained firmly in the 19th century. Give me your balance sheet and we will tell you what, how much and for what price we can establish a relationship. Where your company is positioned on a key supply chain, who are your key strategic partners along them is, at best, a nice-to-have.

Regulators are even less interested in supply chains. Thanks to the strenuous efforts of the trade finance industry and the help of organisations such as the WTO and the ICC, they eventually acknowledged that trade was relatively safe and the use of trade finance instruments such as of documentary credit and guarantee was granted a decent capital treatment. However, we are miles away from properly rating a supply chain. Recent developments, whether in the Basel Committee on Banking Supervision's 'Revisions to the standardised approach for credit risk' regarding specialised commodity lending[1] or the current internal debates among large banks with regard to receivable finance treatment[2] bode ill for devising a set of rules in line with modern trade dynamics.

Inside the supply chain

Where do we go from there? Arguably, the practitioners have to raise their game. However, the first cultural revolution lies with the banks themselves. In most institutions, structured trade and commodity finance is viewed as a specialty shop when in fact, it should be at the centre of the transaction banking engine. A large player in trade finance should shape its strategy around the mastering of the key supply chains. In other words, who deals with who? What is the track record of the relationship between buyers and suppliers?

But banks need help too. There is not enough default data recorded. Large consulting firms in tandem with the ICC Banking Commission could play a key role in gathering data from a pool of banks as well as from the large buyers. Then a more meaningful dialogue can resume with the regulators around empirical evidence.

Baby boomer bankers have dwelt on trade finance. It is now up the millennials to bring banks resolutely at the service of supply chains. This is for their own sake as well as for the world.

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References

1. www.bis.org/bcbs/publ/d307.pdf
2. Receivable Finance industry usually assesses capital requirements on the seller rather than buyers on the strength of payment track records and relationship (mostly with sellers). This is more and more challenged with a more granular –and orthodox approach whereas capital is aligned with credit risk (buyers), and a residual dilution risk with the seller