“The ‘New Normal’ of Trade Finance - more Regulation, less Trade Finance”

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  - using a network of international clients
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  - sharing leadership experience from locations like Buenos Aires, Sao Paulo, Dubai, Düsseldorf, London, and Malta

- offer a practitioner's view, ideally combined with numerical tools whenever needed and required to gain insights into the subject matter.

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Introduction

- Choosing the content to the workshop!

Context

- Introduction
- Properly structured trade finance transaction
- New Regulatory Scrutiny
- Trade & Structured Trade Finance
- Getting the “Deal to Market”
- Winning the Deal & Internal Considerations
- Basel III and Trade Finance Industry
- Consequences
- Closing words

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Properly structured TF transaction

- Modern banking based upon approved business strategies and plans which are executed by management
- Once the strategy is approved and implemented, risk takers / sales person and risk controller / risk officers should embrace the strategy
- A perfect strategy should have identified most risk element which the STF Dept is ready to take on and those which it should not at any price

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Properly structured TF transaction

… will have to deal with the following question:

- Where shall I conduct my trade business?
- With whom shall I conduct my trade business?
- And what is the expected return, I will receive for my risk taking banking business?

- … indeed, if we break it further down we have….

Properly structured TF transaction

… to find an answers to the following **STF strategy points**:

- **Countries involved**
  - Origination, transit and destination countries
  - Where is my credit risk and my collateral?
- **Traded goods**
  - Are my traded goods to be financed clearly defined?
  - Minimum security structures accepted
  - Do and don‘t – clear guideance given?
- **Counterparty defined**
  - Company size & revenue thresholds,
  - Minimum equity endowment,
  - Minimum years in business,
  - Minimum commerical track record,
  - In-house level of expertise,
  - Financial reporting,
  - Etc

Properly structured TF transaction

…to find answers to he following **STF strategy points**:

- **Tenor –** as defined in your strategy
- **Capital & funds** made available for the business
- **Portfolio Management**
  - What is my maximum STF portfolio size?
  - Do we have a sell-down or syndication team and policy in place?
  - What is our model?
    - Origination, structuring and holding
    - Origination and distribution? Does it still work in the Post Financial Crisis Area?
- **Risk – Return requirements** met?
- **Staff** employment & development

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Properly structured TF transaction

- Assuming you have ***identified*** this “perfect deal“ fitting into the bank‘s strategy, will it run well with increased regulatory scrutiny?
- What do I mean by regulatory scrutiny?
  - Compliance
  - Regulator

New Regulatory Scrutiny - Compliance

- Know Your Customer, KYC
- Know Your Customer's Customer, KYCC
- Customer Due Diligence, CDD

- Ultimate Beneficial Owner, UBO
- Politically Exposed Persons, PEP
- Anti-Money Laundering, AML
- Counter-Terrorsit Financing, CTF

- Above terminology is fully supported by today's bank management which have empowered **Compliance Officer** to ensure that bank's business, including TF and STF, is complaint and is not taking any risk – <u>mainly reputational or solvency risk</u> - due to violaton of existing international and national laws.

- Banks are under pressure from the FIAUs, Regulator and Governments to achieve compliance with the AML directives

New Regulatory Scrutiny - Compliance

- Time-to-market impact due to higher mandatory level of CDD and
- the development and construction of sophisticed intelligence system used before and after
  - client contacts have been made and
  - the financial products has been provided

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New Regulatory Scrutiny - Regulator

Who is the regulator?

- **Malta**
  - MFSA
  - ECB via Single Supervisory Mechanism (Nov 2014)
  - Government of Malta via Laws and Decrees
    - FIAU Malta
- **Outside of Malta**
  - National regulators (i.e. Bafin, FCA)
  - European Banking Authorities
  - ECB
  - EU Legislation & Directives
  - International organization
    - Egmont Group
    - FATF

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New Regulatory Scrutiny - Regulator

Basel III

(CRD & CRR – Capital Requirement Directive & --Regulation)

- was understood as the Regulators response to the Financial Banking Crisis of 2007-2010

- favors non-banks by reducing the barriers to entry the financial industry and increased (unregulated) competition and brought innovation (i.e. Fintech, Alternative fund provider, etc) and brought about

- unintended consequences, in particular, for **Trade Finance**.

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New Regulatory Scrutiny - Regulator

Basel III – in a nutshell

- Strengthend capital adequacy
- Defined new standards for liquidity and leverage ratios
- Supervisory Review Process – Basel Accord
  - Basel II / III– Pillar 2 Supervisory Review Process got strenghtend.
    - If the regulator sees and finds deficiences, the supervision may be very detailed about capital, liquidity and business planning, risk mgmt, evaluation of internal systems, procedures and controls, and a review of compliance with all regulations and is able to set penalities.
  - Assessment of risk related to capital, liquidity and funding
    - ICAAP and ILAAP
    - SREP – Supervisiory Review & Evaluation Process

Regulatory effects

- capital requirements have risen and, in turn, raised cost of doing business
- higher cost of credit by inclusion of off-balance-sheet TF products into the calculation of leverage ratio with 100% credit conversion factor

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New Regulatory Scrutiny – Regulator

Basel III – in a nutshell (continued)

- **due to overall impact most bank's reviewed**
  - business priorities / models
  - operating models as well as
  - customer service standards and relationships

- **major cost drivers are found most likely in**
  - IT requirements
    - have led to an increase in the amount, frequency and complexity data management, calculation and reporting
    - IT legacy issues seen with older financial institutions – invest to remain competitive
  - Finance, Compliance, and Legal Dept

  - Regulation is for most <u>international banks</u> not an national issue anymore but an international, cross-jurisdiction an cross-purpose regulatory issue (data governance issue)

New Regulatory Scrutiny

- The new demands, in terms of regulation and compliance work, required to be adhered to by regulated banks has been coined by many in the industry as the **„new normal“** or the **„new paradigm**“ of banking.

- How this „**new normal**“ might affect the trade and structured trade finance business will now be discussed.

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Trade & Structured Trade Finance

- **TF / STF is very particular business**
  - It is short-term lending business across borders where participants or counterparties between different countries interact
  - Which finances trade flows & growth between countries and mostly likely between high and low income countries
  - It favors small-medium sized business and
  - Enhanced banking business in developing countries.

- **Counterparty Risk vs. Transactional Risk**
  - TF/ STF is known that the risk with a trade finance deal does not lie so much with the actual borrower or counterparty but rather with the financed, underlying transaction (transactional structure matters). Hence, it is viewed to be asset-backed and the creditworthiness of the borrower is still important but less so in TF / STF.

Hence, a properly structured TF transaction are generally designed to protect from counterparty risk by relying on the goods being financed and having control over the cash flow generated by the transaction.

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Getting the "Deal to Market"

- Any identified transaction today requires collaborative work between all internal bank deparments to get the deal secured which was identified and brought in by TF / STF bankers
  - STF unit
    - Sales team
    - Risk team
    - Middle office team – deal-driven, transaction & control
  - Other bank units
    - Back Office
      - payment & documentary business
    - Correspondent banking
    - Risk
    - Compliance
    - Legal

→ Are your ‚processes & procedures' up-to-date to minimize credit and operational risk and to satisfy the banking regulators?

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Winning the Deal

„Winning a trade deal"

- Only a front office job?
- No, collaboration with other departments ever more …
- **„Time to market" effect**?

- STF transaction (like other) must meet the increased demand of the „new normal"

- Observation: mostly due to ‚new normal' inquiríes and the element of being in ‚untested waters', decision maker often involve the Legal and Risk Dept. for additional opinion and inputs to understand and interpret the ‚new normal'.

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Winning the Deal & Internal Considerations

Correspondent banking – the skeleton of TF

- TF and STF relies heavily on correspondent banking for
  - Commercial credit line business with foreign correspondent banks / accounts for
    - international payments and / or
    - documentary credit business and often
    - source of funding (money market lines)

- Correspondent banking business is commonly divided into
  - Upstream
  - Downstream banks
  - What kind of banking clientele is targeted depends on your bank‘s own credit rating as well as on the rating and business model of your counterparty bank.

Correspondent banking is linked to <u>business reciprocity consideration</u> and as well as to

- Risk and
- **Compliance considerations**

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Winning the Deal & Internal Considerations

Correspondent banking – the skeleton of TF (continued)

1. Compliance – does it accepts the correspondent counterparty?

- Country assessment - checking socio-economic and political factors, government, corruption level, transparency commitments, integration into international organization local regulation, etc
- Counterparty assessment – checking banks' shareholder, management, clientele, business model, etc

2. Risk Department approves the counterparty limit and must have a Country Risk limit in place (see next page)

3. Financial Institution / Correspondent Banking Departments decision

- Sales point of view is still important – is there sufficient business / revenue / profit and will it cover for the above mentioned expected costs of managing the correspondent relationship?

  Cost – benefit decision is to be made

Winning the Deal & Internal Considerations

Country Risk

This credit risk on cross border obligations will only be taken if the

- Country in question has been assessed by Risk Dept.
- Positive risk assessment leads to the establishment of a country credit limit
- Without an existing country limit - no business

- Compliance – does the Country passes the approval test?
  - Geographical risk assessment (4th ML directive)
  - Every jurisdiction need to be assessed from a compliance point of view
  - **Multi-faced** risk perspective (AML, CTF, sanctions, FATF, Worldbank date, etc)

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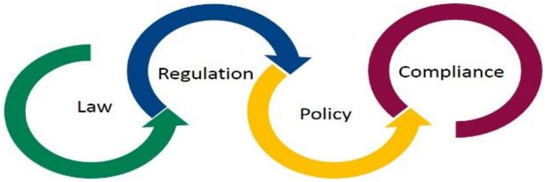
Winning the Deal & internal Considerations

Compliance



- KYC / AML /CTF procedures have had its effect on STF
  - 4th-Anti Money Laundering Directive will be effective in 2017 in Europe
    - Risk based approach (vs. Rule based approach)
    - Ongoing monitoring
    - Beneficial ownership/ Customer due diligence (CDD)/ Politically exposed persons (PEP)
    - Third party equivalance countries – those who are not Member States but having equivalent AML/CTF system in place

- National & international legislation which required the strengthing of internal and external level of controls

  - **FATF (Financal Action Task Force) Recommendation**
    - EU framework require Member States to introduce measures, requiring Financial Institution, Designated Non Financial Business and Person to take approprate action to prevent them for being used for the purpose of ML and TF
    - Interdependent inter-governmental body tasked with devloping standards and promoting policies aimed at protecting the global financial system against ML and TF and the financial proliferation of weapons of mass destructions
    - etc.

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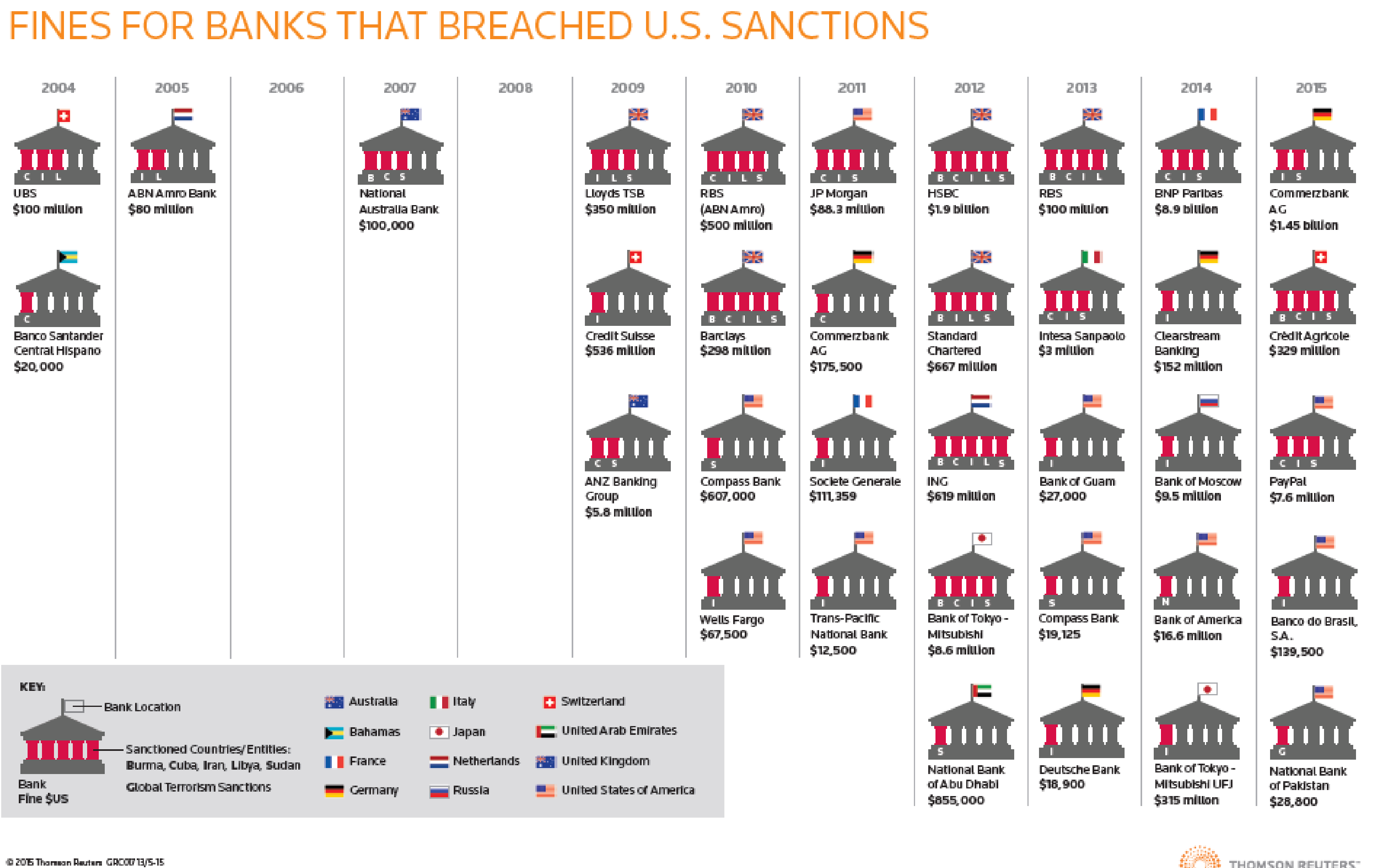
Winning the Deal & Internal Considerations

Compliance (continued)

- National & international legislation **(continued)**
  - EU Legislation – 3rd Money Laundering Directive & the 4th ML Directive will be effective 2017
  - Local EU Member State Legislations to be followed
  - **Financial Intelligence Units** work nationally and they are responsible for monitoring compliance issues
    - implementation, give guideance, overlook and provide reporting, call for penalties, etc.
    - Egmont Group of FIU fosters cooperation between the national FIUs internationally

- Compliance & **Bank Fines**
  - Relative importance of compliance grew, in particular, after globally acting banks were fined large amounts of money due to breaking of sanction laws.
  - Importance to be ‚in line‘ grew for
    - Banks‘ shareholder,
    - Management,
    - Employees and
    - Customer,
    - Regulator and Financial Intelligence Units

Breaching US Sanctions



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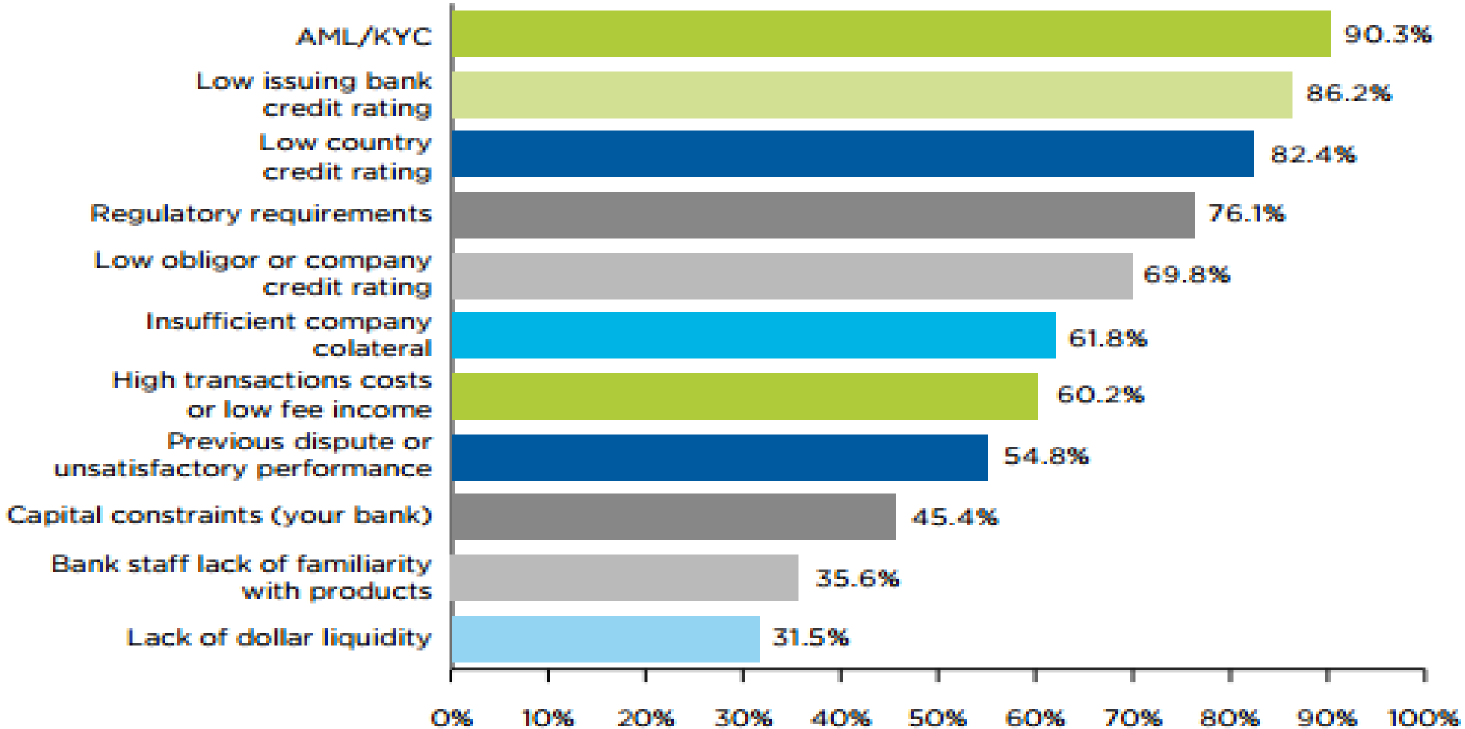
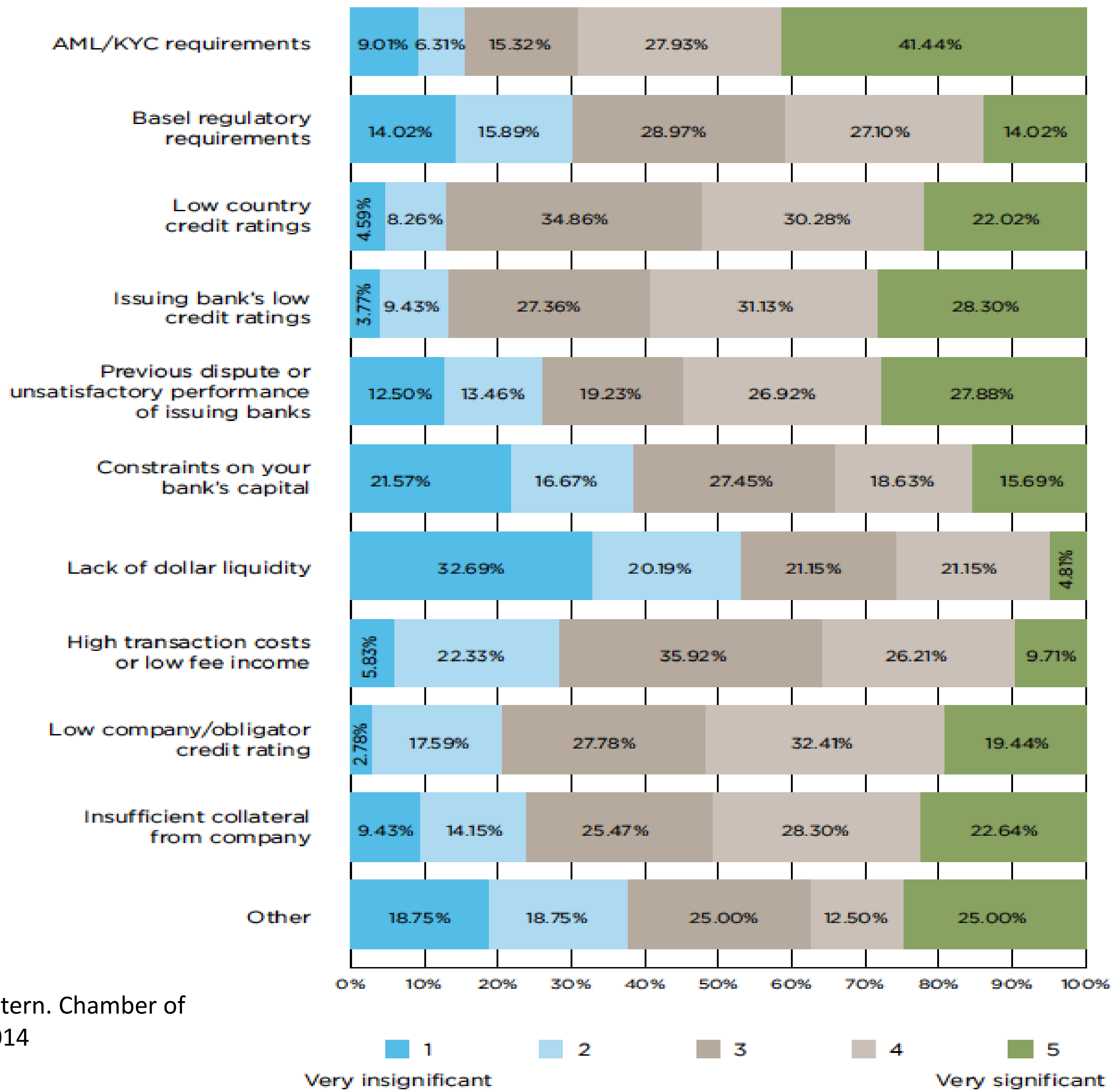
Impediments to Trade Finance 2016

Figure 23: Significant and very significant impediments to trade finance



Source: ICC Global Survey on Trade Finance 2016

Impediments to Trade Finance 2014



Source: ICC Intern. Chamber of Commerce 2014

Basel III and Trade Finance Industry

- **Trade Finance** – as a bank business segment – **has been significantly impacted by the „new normal“**

  - TF asset divestment took place, short term nature of TF assets offered a quick fix to big balance sheet problems or increasing cost of capital
  - Formerly global banks in Europe re-treated into their home or regional markets
    - funding gaps arose in LATAM, Africa, elsewhere
  - Created a funding gap in the market fostering ***shadow banks*** to develop
  - alternative financiers stepped in – investor groups like pension funds, insurance companies, hedge funds, sovereign wealth funds, private equity
  - It was argued B III will damage world trade by having **less bank funding available**
  - B III outcome is still uncertain for TF because of the discussion
    - on „Liquidity Cover Ratio“ (LCR) and
    - „Net Stable Funding Rate“ (NSFR) and
    - 100 % conversion factor for off-balance-sheet (OBS) items

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Consequences

What are the possible consequences of the increased regulatory scrutiny on TF and STF?

Higher overall costs for Trade & Structured Trade Finance!

- Reasons are:
  - TF and STF assets quality
    - Diverse in nature (i.e. cross border business, transfer & conversion issues, etc),
    - TF an individual asset class (as compared to others)
    - Cross-border business – do you know foreign markets and customers? If not, higher costs involved.
    - High manual intervention (when compared to other products)
      - Paper / document driven
      - High monitoring & controlling activities
      - Since underlying traded goods are main security to the transaction
- Due to
  - **Compliance cost - charges will be higher** – in comparision to other banking units -, due to the fact that in trade finance several risk counterparies, stage providers and countries are involved which needs checking **in time** and **over time**.
  - Operational risk elements are higher, hence, require a higher operational risk capital charge

ACCUITY calls this ‚trade compliance'!

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Consequences

What are the possible consequences of the increased regulatory scrutiny on TF and STF?

Higher overall costs for Trade & Structured Trade Finance!

- Due to:
  - Imposed bank penalty charges, linked to breaking the Laws, have irritated shareholders, banks' top management and customers in a way that „complicated, individualized" or „tailor-made" businesses, like TF and STF, are less desired in today's banking product world
  - Possible increased capital charges for TF assets (if the OBS items will be taken into the calcualtion of the leverage ratio with 100% credit conversion factor as suggest by BIS)
  - Liquidity Cover Ratio and Net Stable Funding Ratio discussion on what are liquid asset might influence the discussion as well

→ If additional costs can not be passed on to the business, shareholder, bank management might re-consider the value of TF and STF as a business units

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Consequences – client focus

- **Clients**
  - Can they digest the increased costs?
    - SME &
    - Financial Instituions located in low income countries
      - both dependent upon TF and the geographies drive economic growth / trade

  - They could be driven to other funding sources
    - Smart funding and cash management solutions that take into account the value of their business
    - Alternative trade funds offer new client solutions

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Consequences – investor focused

- **Investors (non-banks)**
  - Get TF asset ready to attract non-bank investor to increase liquidity
    - Most TF products aren’t harmonized within the banking industry and asset class is not defined in a constant fashion
    - Reduces attractiveness for capital market investors (buying & selling in the secondary market)
    - Asset class is much less impacted by interest rate or stock market volatility
      - BAFT – IFSA - Bankers Association for Finance and Trade (BAFT) and the International Financial Services Association (IFSA) works hard on it
  - **Alternative Trade Finance** provider emerged in Europe, ME and Asia
    - Benefitted from the shrinking balance sheet of larger and traditional trade finance providers
      - Typical clients are SME but larger midsize companies are being targetted
      - Benefit from being unregulated …..

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Consequences – bank focused

- **Banks / Financial Institutions**
  - Difficult to judge but most banks are in the adjustment process, banks start to adjust to the new regulatory and compliance framework
  - In-house collaboraton has brought various bank teams together to master the regulatory requests, extending the collaboration theme, banks might engage into new services offered to clients to support them in adaption to the „new normal“ (i.e. consulting services covering compliance, reporting, supervision, technical requirements).
  - Due to higher regulatory and compliance cost,
    - Banking business models are being adjusted
    - Related profits are falling,
    - Incentive schemes have been broken and
    - Innovation appears to have stopped in banking.

Some see that regulated banks might resemble **utility companies** in the future - just providing basic services to client!

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Consequences – trade finance focused

- **Trade Finance /Structured Trade Finance**
  - Get assured that your STF strategy still fits into the overall strategy of the host bank
  - Understand your competitive position in the bank and in the TF markets you are operating in
  - Communicate with adjacent business units (i.e corr banking, treasury, HR, compliance, operations etc) to understand their current and future role
  - Explore with captial markets units how to tap into the liquidity of capital market
  - Explore the creation of ‚in-house' trade finance funds
  - Team up with banks or alternative fund providers whenever necessary to exploit an advantage.
  - Centralize and automate middle office / back office functions as much as possible, control your operational risk, have a second look at outsourcing or insourcing functions
  - Can you offer new products internally or externally given your specialzation expertise in trade finance?
    - E.g. concentrate on selling the delegated monitoring function that is
      - monitoring & controlling the traded goods / inventories for others and/or
      - managing security pools for the benefit of other investors.
  - Prepare your existing clients to changing ‚time-to-market' patterns and /or changing workflows – reasons explained
  - Embrace new and old banks which have entered the TF market which, in general, is positive for all involved, clients, banks and certainly investors.

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Closing words……..

- With Basel IV, there is no end in sight the banking industry needs to think strategically about a global integrated regulatory platform

- Entire banking industry remains concerned about regulation and de-globalization of regulation

- If it varies from jurisdiciton to jurisdiction, we have an uneven playing field for TF and STF provider.

- The uneven playing field might bring about deviation from risk mitigation for some deals which ultimately may hurt the industry and changes the overall risk profile of TF!

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- Thank you for your attention!

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