Diversifying sources of USD liquidity

(Photo: courtesy www.pexels.com)

How to remain competitive in the International Trade Finance market?

pinnacle TRADE FINANCE

Background:

US Dollars (USD), as a currency, plays a very prominent role in international trade finance. As one would observe, most commodity prices e.g. crude oil, gas, gold, coal, etc. are all quoted and traded in US Dollars. A number of emerging market currencies are pegged to US Dollars e.g. Indian Rupees (INR) or Emirati Dirham (AED) i.e. Indian Rupees are first converted into USD and then USD into other international currencies like Euro, GBP, Yen, CHF, etc.

US Dollars (USD), as a currency, plays a very prominent role in international trade finance

In addition, a significant portion of global trade flows in Asia, Latam, North America, Middle East and Africa is denominated in USD especially across geographies. Even when clients based in European Union (EU) who are trading goods and commodities across different countries/ continents outside EU, a high portion of these trades denominated in USD.

Current market conditions:

In the normal course of business, customer deposits from retail and institutional clients play a significant role for bank's liabilities positions. In addition, a number of banks are dependent upon the local wholesale market for raising their liabilities as well. However, most of these liabilities are usually denominated in the currency where these banks are located.

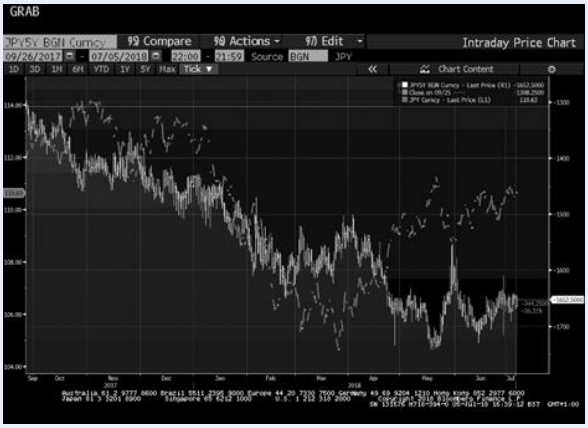
In order to raise USD funding, banks use another two routes i.e. some banks issue commercial paper as one of the channels for shorter-end USD funding and the other being banks are swapping their Euro, GBP, Yen, CHF, etc. deposits into USD.

The rising USD interest rates are adversely impacting banks USD funding costs (especially where the banks don't have core customer deposits in USD). As per Federal Reserve (www.federalreserve.gov/releases/cp/rates.htm) USD 90-days AA rated commercial paper has moved from 0.64% p.a. to 2.01% p.a. and sometimes higher for certain types of obligors.

(90-days CP rates – courtesy: Bloomberg)

While the graphs (below) show high volatility and increase in 5-years swap rates between Euro/ USD and Yen/ USD, which adversely impacts USD funding costs on a short-term basis (90-180 days) vis-à-vis longer term (>1-year).

(5-year USD/ Euro swap rates – courtesy: Bloomberg)



(5-year USD/ Yen swap rates – courtesy: Bloomberg)

Client needs:

Once banks have their own USD liabilities, they extend trade financing via two channels i.e.

bank-to-bank lending and directly to corporates. When the lending bank's internal USD funding cost goes-up, it passes its increased costs to its clients i.e. corporates and banks, thus, impacting their costs.

As an end-user of these trade financing, both corporates and banks, need to continuously monitor and diversify their sources of USD funding on the shorter-end of the curve to help reduce their internal pricing and remain competitive in the market place.

Possible solutions:

A number of banks based in Asia Pacific and North America have access to USD liabilities and have stepped up to the opportunity to grow their trade asset book. Post oil prices going-up, most large Middle East banks also have access to USD funding and extending USD trade financing to their clients across geographies.

However, even these banks are unable to meet the growing demand for USD funding requirement in international trade finance (as per ICC, the trade finance gap is estimated at $ 1.6 trillion) given the increase in commodity pricing and growth of cross-border trades.

Some possible ideas for find new avenues for USD funding:

1. 'Club' deals:

Majority of large corporates and banks have over 50-75 'relationship' banks, with around 10-15 'core' relationships. The client can create a 'club' facility by asking each of their banks (outside the top-15 banks) to extend $10mm-$20mm of unutilised capacity which can add upto a large amount of $200mm-$300mm 'club' deal quite easily. This also gives the client the ability to put small ticket underlying trade transactions, as a portfolio, for refinancing from these banks. This 'club' facility can be structured via syndicated route or bilateral loans where banks participate under risk participation structures. It could be a win-win for both parties as the client gets to diversify their USD funding sources at competitive pricing while these banks get to increase their share-of-wallet.

2. MLAs/ DFIs:

Majority of Multilateral Agencies (MLAs) and Development Finance Institutions (DFIs) have investment grade ratings between AA- to AAA, thus, giving them access to lower cost of USD funding. Number of these MLAs and DFIs are already extending credit facilities on unfunded basis under trade facilitation programs or risk participations structures to a number of emerging market clients (both corporates and banks). Some MLAs and DFIs are also extending 3-7 years term-funding to these clients as well.

These current market conditions gives an opportunity to MLAs and DFIs to expand their product offering i.e. extend short-term (upto 1-year) working capital/ trade financing to their corporate and bank clients based in emerging markets.

Opportunities for Institutional Investors, MLAs and DFIs to grow their short-term self-liquidating asset portfolio

3. Institutional Investors:

In current market, a number of institutional investors have surplus funds and they are exploring different avenues/ asset classes for deployment. Given limited amounts of short-term investment grade assets available in the market, a portion of their surplus funds are in bank deposits and US Treasuries which are generating sub-Libor returns (as per new Basel guidelines, banks don't get liquidity ratio benefits for funds belonging to institutional investors).

Most institutional investors already have exposure to prominent corporates and banks via their investments in various debt instruments like bonds, syndicated loans, medium-term-notes, commercial paper, etc. Thus, these institutional investors understand these obligors credit history and will be open to short-term exposure via trade finance assets as well.

Trade Finance teams can easily get access to these institutional investors via their market/ treasury teams in order to show them trade assets, however, obligors need to re-structure the underlying trade finance facility documentation in line with institutional investors standards.

4. Reduce asset-side balance-sheet:

There is another possible solution for banks i.e. instead of raising liabilities; they also have an option to reduce their balance-sheet (i.e. asset side). However, there is always a dilemma for trade finance team on how to balance between assets and revenues.

One of the options is for banks to sell their investment grade trade finance assets that are usually finely priced trade (some investment grade assets are priced range between L+0.25%-0.50% p.a. for 90-180 days tenor). These fine pricing levels are especially prevalent for trade financing deals for commodity firms and global multinational clients.

Once the trade finance business gets internal allocations of liquidity premium from its treasury, there is very limited revenue generated from these finely priced trade assets. This gives an option to trade business managers to sell these investment grade assets, making marginal impact to their revenues.

However, the moot question arises, who will buy these finely priced investment grade trade finance assets ranging from L+0.25%-0.50% p.a.? There are some 'regional' banks with limited international branch network with high USD deposits looking for investment grade trade finance assets only. Also, these assets might be of interest to institutional investors, if properly structured for sale.

Way forward:

In these challenging times and rapidly changing market conditions, corporates and banks are being forced to explore new avenues to manage their USD liquidity requirements especially on the shorter-end of the curve.

The International Chamber of Commerce ('ICC') 2018 Global Survey report (https://iccwbo.org/publication/global-trade-securing-future-growth) indicates that 48% of the respondents felt that **'attraction of non-bank capital to create additional trade financing'** over next 3-5 years is critical for international trade finance business.

Diversified source of USD funding on the shorter-end of the curve to help reduce pricing and remain competitive in the market place

It creates incremental opportunities for institutional investors, MLAs and DFIs to play a more prominent role in providing USD liquidity and simultaneously growing their short-term self-liquidating asset book as well. The industry experts should work together to bring various parties together i.e. borrowers (banks, fintechs and corporates) with the lenders (institutional investors, MLAs, DFIs) for <1-year trade financing opportunities.

The end-result is certain i.e. it's expected that some key players will change some of the archival ways of undertaking traditional trade finance structures in global markets and getting competitive edge to help grow their businesses.

About the Author

Anurag Chaudhary is the CEO at Pinnacle Trade Finance, United Kingdom. Prior to that Anurag was working at Citibank as Managing Director – Global Head – Trade Distribution & Syndications and Regional Head – FI Trade Origination/ Sales team based out of Citibank's London office.

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