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Flight to consolidation – changed perspectives in trade distribution

Citi – trade distribution

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Anurag Chaudhary, Global Head of Trade Risk Distribution at Citi, examines the changes that have taken place in the market and the current perspective required to provide comprehensive trade solutions to banks' clients, both corporates and financial institutions, by leveraging the trade asset distribution capabilities.

The current global financial crisis has changed the requirements of trade asset distribution significantly. In the new paradigm, banks have had to rethink and redraw their business operations to enable them to optimise their credit and cross-border appetites while simultaneously meeting their clients' trade requirements.

Market changes

The recent flight to consolidation of banks started in early 2008 where the large corporates and financial institutions started centralising their business flows with key multinational banks who could meet their rapidly changing trade requirements.

Anurag Chaudhary, Global Head of Trade Risk Distribution, Citi

At that time, globalisation was in full swing – business volumes as well as asset values were increasing substantially. The Baltic Index was at an all-time high at this time. Clients started demanding additional credit capacity in line for their own business growth and no single bank had sufficient appetite to manage clients' incremental needs.

Additionally, banks faced difficulty meeting all their clients' requests for additional capacity in the face of rapidly increasing commodities prices. For example, the crude oil price rose in 2008 from around US$50 per barrel (p/bl) to around US$147 p/bl within a very short period of time whilst the credit limits of banks did not go up as quickly.

Subsequent to this initial boom, the market moved into a reverse spiral. The price of crude dropped to US$50 or thereabouts and at present, hovers in the US$75 – US$85 range. This pattern was repeated in other commodities and trade flows as well. However, many banks began reducing their credit capacity for their clients, or even exited certain markets. Furthermore, the liquidity constraints that developed across the banking industry put a further constraint on the ability of banks to support these trade flows.

These significant market fluctuations are detrimental to the market and the global trade business. Therefore, many clients are now looking for one stable bank with an extensive international branch network to provide a comprehensive solution for all their trade needs. This is a fundamental for the trade market.

So how can banks deal with this contradiction where on the one hand, their clients want one bank to support their trade credit needs, and on the other hand the reality is that banks no longer have sufficient

capacity to support our clients on a stand-alone basis? In light of this, what solutions are available to banks and our clients?

Possible solutions

Traditional forfaiting solutions and unfunded risk participation structures have been around for a long time in the market. Unfortunately, the reduction in credit appetite and available liquidity amongst banks has correspondingly caused the markets for unfunded risk participations and forfaiting on a 'silent' basis to contract substantially. Banks have preferred to focus on 'relationship' banking for their core clients.

As a result, two structures are emerging from the market to accommodate client trade needs. The first is for one-off episodic transactions where banks join together behind a bilateral structure to form a 'Club' to develop a comprehensive solution, with one bank playing the lead role. The second is to handle a client's regular trade flow business on an ongoing basis using a 'syndicated' trade facility.

The key question that clients should be asking themselves is how can they maximise these solutions to their advantage?

In addition to this fundamental question, we need to assess how the banks and investors fit in this whole proposition – today, no one bank can claim to be a sole banker to its clients. There is still competition, but at the same time there is now more 'collaboration' between banks as well. One bank may have difficulty taking on the whole flow for some of the big oil deals, which regularly range around the US$100 million mark. However, a bank may be able to handle these oil deals by working together with one or several other banks.

Therefore, banks need to consider the competition in a different light. Some of the banks have more leverage and others less, but there has to be a collaborative approach to providing credit and liquidity to our clients on a regular basis. This is very much more of a congenial approach, rather than one bank trying to say it has complete control of a transaction.

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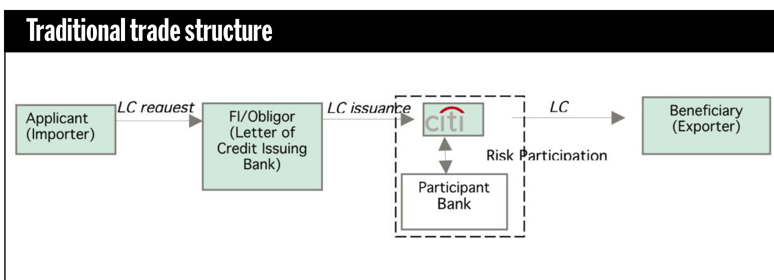
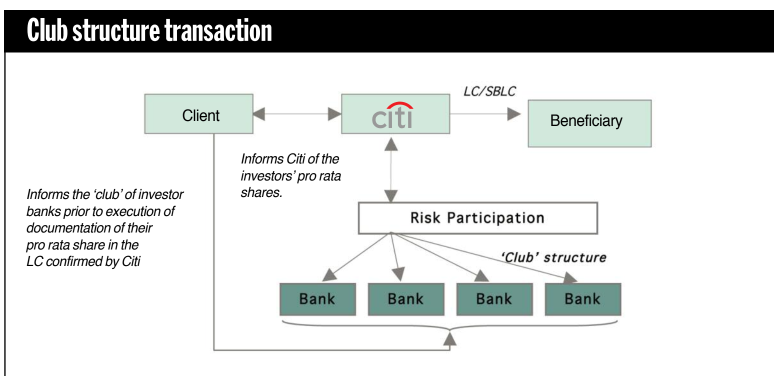


Traditional trade structure



Club structure transaction

Naturally, there are regional variations on the distribution front, as some banks have greater capacity than others in certain markets, regions or commodities. Where this is the case, it is optimal to team up with the bank(s) that has (have) the best capacity and coverage.

'Club' structures

The 'Club' structure is a very simple solution. It caters to individual large-ticket trade transactions, including commodity and capital goods flows, and the structure is offered on an un-committed basis. The ticket sizes are usually between US$50 million and US$250 million.

The 'Club' of banks comes together in conjunction with the client, i.e. the importer or exporter, or a letter of credit (LC) issuing bank and all banks in the 'Club' are disclosed to the client.

The 'Club' structure is generally used for one-off transactions with no commitment fees. Usually, one-bank will 'front' the transaction whilst the partner banks extend their credit capacity and liquidity to the obligor via risk participation documentation.

The 'fronting' bank enters into a bilateral trade agreement with the client and into separate Master Risk Participation Agreements (MRPAs) with the partner banks. Due to simplicity of documentation, the 'Club' structure can be put in place in a very short period of time with no additional external legal fees.

From the client's perspective, it is a great solution as the client only needs to deal with 'one bank' for a quick turnaround, while being able to utilise the free capacity of its relationship banks as well.

Syndication

The syndication structure provides a comprehensive solution for a client's trade needs, from small ticket regular flows to large ticket commodity flows, and capital goods financing to support the client's business on an ongoing basis.

Generally clients who opt for syndicated trade facilities want the stability of a committed facility to meet their banking requirements over a period of time (usually three-five years). This allows clients to focus more on their core business i.e. sales, business momentum, etc. The time and effort/expertise of clients can be better utilised on their core business instead of them spending time finding credit capacity and liquidity from banks in the rapidly changing global market.

From the client's perspective, corporate and financial institutions will go to 'one bank' i.e. the agent, and the agent will coordinate the whole process with the consortium of banks, regardless of the size or type of each specific transaction being covered under the facility.

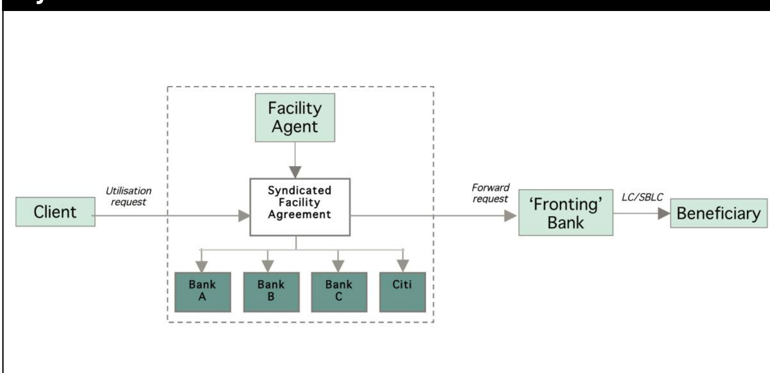
Syndicated trade facilities can be created for both corporate and financial institution clients. Corporate clients usually look to banks for their short-term trade financing needs, for the issuance of performance bonds to cover completion of their sales, or for LC issuances for their commodity flows. On the other hand, financial institution clients generally seek ongoing solutions for confirmations of their LCs and for their post-financing requirements.

The documentation for a trade syndicated facility is usually based upon the Loan Market Association (LMA) standard since this is typically acceptable to a majority of the banks. For LCs and performance bonds, one of the banks in the syndicate plays the 'fronting' role and interacts with the beneficiaries on behalf of the client. The 'fronting' bank in turn has an indemnity from each of the other lenders in the facility on an unfunded basis.

These syndicated trade facilities are committed for the entire facility period. Banks in the syndicate will commit their credit capacity and liquidity at a predetermined price, similar to any other syndicated loan facility.

This syndication structure is a comprehensive, committed, 'full-service' solution. It usually takes longer to set up than a 'Club' structure, but once in place, it makes individual transactions quicker to process, and allows for flexibility of deal sizes and tenors.

Syndicated transaction structure



There will inevitably be a flight to consolidation for corporates and emerging market financial institutions which are looking for well reputed banks with global branch networks to provide comprehensive solutions for their trade requirements on an ongoing basis.

Conclusion

We expect that these two fundamental structures, i.e. 'Club' structures and syndicated trade facilities will play an increasingly important role for clients and banks as the trade market grows in the future.

There will inevitably be a flight to consolidation for corporates and emerging market financial institutions which are looking for well reputed banks with global branch networks to provide comprehensive solutions for their trade requirements on an ongoing basis. Clients are also reviewing their existing business arrangements and realigning their commodity flows to take advantage of the best possible solutions from their banks to maximise efficiencies and cost effectiveness.

Today, more than ever, investor banks want to use their relationships to gain further lucrative customer business. There is a growing trend for banks to take a significant stake in a deal, and then ask the client how they can help further. No single institution is able to absorb the whole amount any longer. This is a real change from the situation three or even two years ago. The changed scenario means that 'relationship' banking is again coming much more to the fore than was the case in the not too distant past. ■

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