GLOBAL TRADE'S NEW NORMAL

Why Banks Must Transform Trade Finance & Supply Chain Finance

accenture

SUMMARY

- Global trade is under unprecedented pressure from COVID-19 and geopolitical challenges, with supply chains affected by a range of factors firms cannot control.
- As liquidity dries up and the global economy shrinks, banks should prepare for higher levels of non-performing loans, and should find ways to move credit risk off their balance sheets.
- At the same time, banks must transform traditional trade finance and supply chain finance (SCF) offerings to provide credit relief and flexibility to customers who are under unprecedented strain.
- **In addition, geopolitical and other factors mean some firms are shifting production out of China at short notice. If banks cannot provide appropriate core services to clients in their new locations, they risk losing them.**
- On top of that, trade finance is a predominantly paper-based, manual process that is ripe for digitisation. COVID-19 has added to the urgency to digitise, with customers and staff working remotely.
- **As a result, and with non-bank competitors moving into this space, banks must become more agile and innovative: digitising documents, streamlining processes and employing technological solutions to resolve existing inefficiencies.**
- Automating existing processes will cut risk, boost revenues and improve customer satisfaction, as well as lower banks' exposure and risk, and position them strongly for the future.
- Banks should also work with authorities to ensure standardised cross-border technology, processes and standards.

01

FROM CALM TO CHAOS:

Global Trade and Supply Chain Trends

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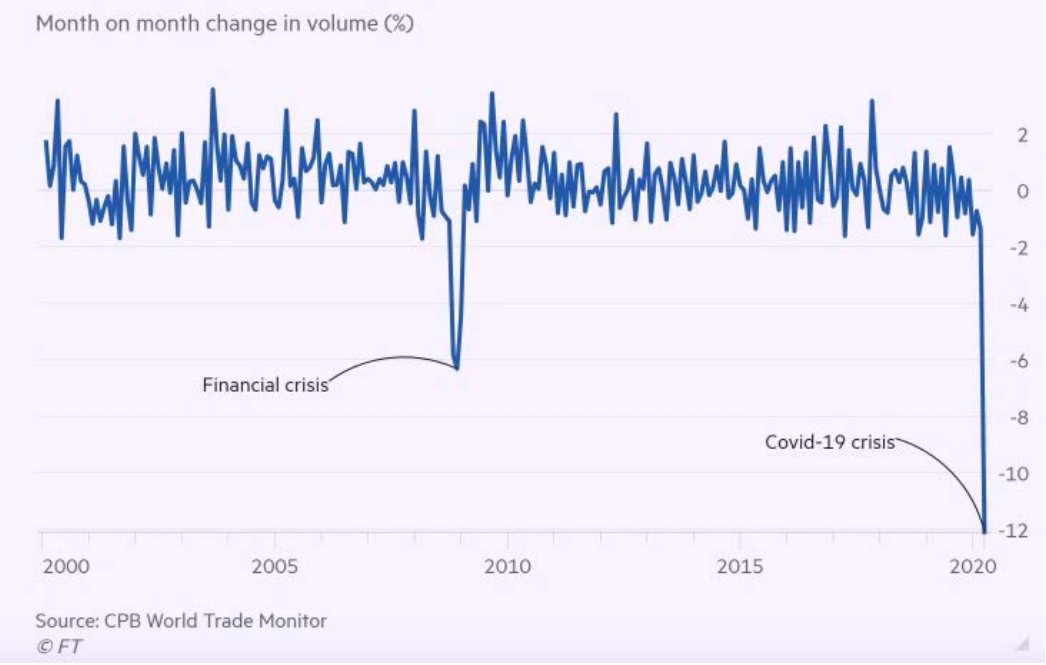
In the years leading up to the COVID-19 pandemic, global trade was in a fairly benign state. Indeed, if one excludes the 2008 global financial crisis, fluctuations in trade volumes prior to COVID-19 were modest (see chart).[1]



The month-on-month change in global trade volumes 2000-2020 (Source: Financial Times[2])

Supply chains have been less fortunate. They have suffered seismic changes as they've been compelled to adapt to geopolitical challenges including a populist move away from globalisation. This shift will likely continue: a recent Bank of America survey found 80 percent of 3,000 firms with international supply chains planned to move operations across international boundaries to meet geopolitical demands.[3]

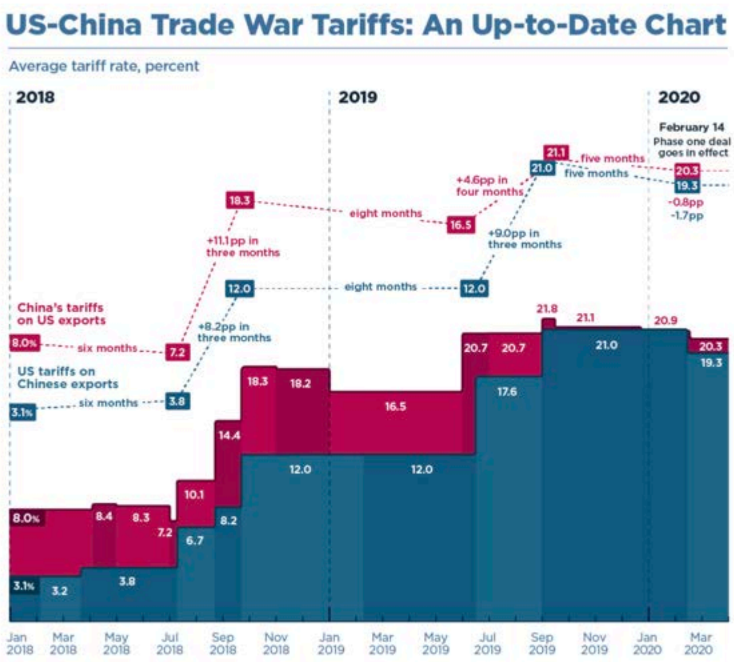
1. Pandemic causes 'unprecedented' fall in global trade, Financial Times (June 25, 2020).
See: https://www.ft.com/content/d870d304-9ee8-4699-ae02-cf4e1c488d2a
2. Ibid.
3. Breakingviews - Supply chains' tectonic shift will get viral jolt, Reuters (May 7, 2020).
See: https://uk.reuters.com/article/us-health-coronavirus-supply-chain-break/breakingviews-supply-chains-tectonic-shift-will-get-viral-jolt-idUKKBN22J2KF

01 | FROM CALM TO CHAOS:

Global Trade and Supply Chain Trends

Three factors are driving changes to the supply chain model:

1. ***US-China trade tensions:*** With little sign of a thaw and with trade tariffs high (see chart) some firms are re-shoring or near-shoring production, or using a hybrid model that keeps some production in China.



Source: Peterson Institute for International Economics (PIIE).
See: https://www.piie.com/research/piie-charts/us-china-trade-war-tariffs-date-chart

2. ***China's One Belt, One Road (OBOR) initiative:*** Over 100 countries have committed to 2,600 road, rail and maritime OBOR projects at a cost of US$3.7 trillion[4]. OBOR has seen supply chain routes overhauled, and unprecedented cross-regional input from banks and multinational corporates in the financing cycles.

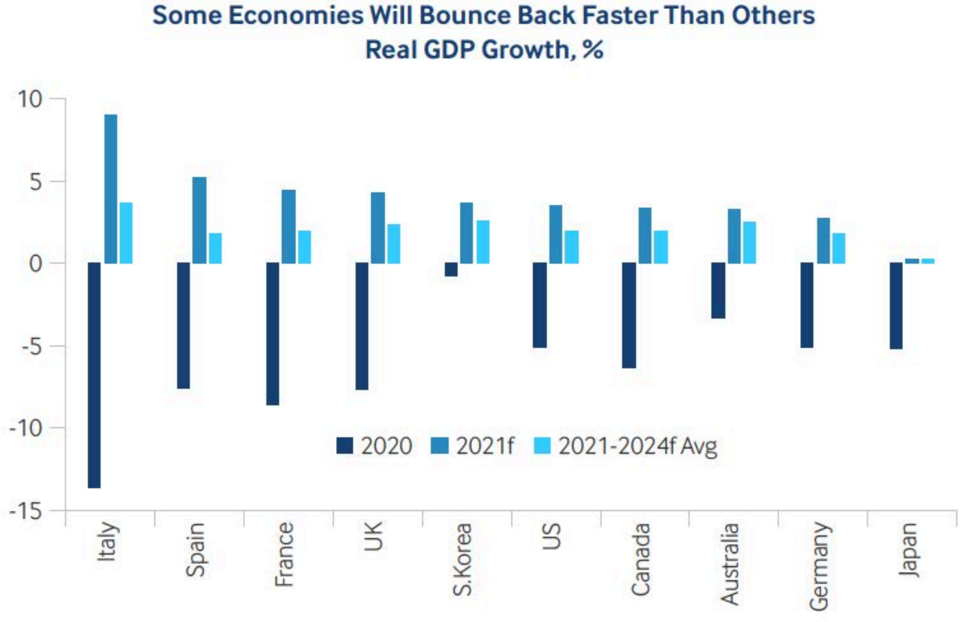
3. ***Brexit:*** The transition period, under which the UK is bound to the EU's rules, will expire at the end of 2020. The UK's exit poses enormous challenges to regional supply chains, and will affect cross-border movements and tariffs – even if the two parties reach a trade deal. The EU is the UK's pre-eminent trading partner: the UK's 2019 exports to the bloc totalled GBP300bn against imports of GBP372bn.[5] With no trade deal imminent, firms are rethinking supply chains.

4. China says one-fifth of Belt and Road projects 'seriously affected' by pandemic, Reuters (June 19, 2020).
See: https://uk.reuters.com/article/uk-health-coronavirus-china-silkroad/china-says-one-fifth-of-belt-and-road-projects-seriously-affected-by-pandemic-idUKKBN23Q0HZ?il=0
5. Statistics on UK-EU trade, UK House of Commons Library (July 15, 2020).
See: https://commonslibrary.parliament.uk/research-briefings/cbp-7851/

In addition, there is the impact of COVID-19. The World Trade Organization (WTO) forecasts a contraction of 13 - 32 percent in goods trade this year.[6] (A more sanguine estimate from consultancy Oxford Economics pegs the decline at about 10 percent for 2020.[7])

Although there have been some positive signs as markets reopen, assisted by unprecedented government intervention, the landscape remains deeply uncertain. With no vaccine imminent, a second wave of selective lockdowns could still jeopardise recovery. [8]

The WTO believes a V-shaped economic recovery for global trade is unlikely,[9] while the Economist Intelligence Unit predicts global GDP likely won't recover to pre-pandemic levels until at least 2022.[10] That said, some markets should fare better than others: Fitch Solutions forecasts that some will enjoy a stronger, faster recovery (see chart).[11]



Source: Fitch Solutions. f = forecast (Fitch Solutions Global Pulse Survey, Sixth Edition, (August 2020))

6. Will coronavirus pandemic finally kill off global supply chains? Financial Times (May 28. 2020).
See: https://www.ft.com/content/4ee0817a-809f-11ea-b0fb-13524ae1056b
7. How has trade survived Covid-19? The Economist (September 12, 2020).
See: https://www.economist.com/finance-and-economics/2020/09/12/how-has-trade-survived-covid-19
8. Ibid.
9. Goods barometer confirms steep drop in trade but hints at nascent recovery, WTO (August 19, 2020).
See https://www.wto.org/english/news_e/news20_e/wtoi_19aug20_e.htm
10. Covid-19 to send almost all G20 countries into a recession, The Economist Intelligence Unit (March 26, 2020).
See: https://www.eiu.com/n/covid-19-to-send-almost-all-g20-countries-into-a-recession/
11. Fitch Solutions Global Pulse Survey, Sixth Edition, op cit.

Other positive developments include the fact that central bank financing and liquidity were delivered more rapidly and on a larger scale than expected, keeping trade financing moving more effectively than during the global financial crisis.[12] Additionally, some countries lifted lockdowns relatively quickly, which paved the way for heavyweight exporters like Germany and China to increase output.[13] Increased demand for products related to the pandemic also provided a lift – from higher imports of protective equipment by the US to larger exports of electronics and computing equipment from China.[14]

This mixed outlook for the global economy matches that for banks. On the plus side, banks are better capitalised than during the global financial crisis, less exposed to problem loans and riskier activities, and have benefited from the liquidity provided by central banks.[15] However, many clients have been hit hard by COVID-19's impact on trade, and although numerous firms benefit indirectly from macroeconomic policy measures like lower interest rates and tax relief, most won't get direct help.

All of which means the banking sector faces a daunting outlook. A sharp rise in non-performing loans globally is likely, with many banks expected to report losses this year and next.[16] A second wave of COVID-19 would represent a further major challenge.[17]

At the same time, although the easing of lockdown restrictions brought higher order volumes, invoice volumes have fallen, which suggests supply chains are being starved of cash. That is crucial for SMEs: a mid-2020 report from Tradeshift found payment terms for firms globally are averaging around 45 days, with late payments up 23 percent since March.[18]

It's hardly surprising, then, that banks have seen heightened demand for structured trade financing, working capital financing, letters of credit and guarantees, adding pressure on them to assess risk and meet demand.

Compounding this, the post-lockdown spike in transaction volumes poses operational challenges, with many bank staff working from home, and – in a trade that remains dominated by paper – struggling with the lack of end-to-end digitisation in the processing of trade documents. And that's before taking the shifts in the global supply chain model into account.

12. How has trade survived Covid-19? The Economist, op cit.
13. Ibid.
14. Ibid.
15. Fitch Solutions Global Pulse Survey, Sixth Edition, op cit.
16. Banking – Global Return to pre-crisis solvency levels by 2022 will be a challenge for many banks, Moody's Investors Service (July 15, 2020).
See: https://www.moodys.com/research/Moodys-Coronavirus-downturn-to-challenge-banks-metrics-until-end-of--PBC_1236275
17. How resilient are the banks? The Economist (July 2, 2020).
See: https://www.economist.com/finance-and-economics/2020/07/02/how-resilient-are-the-banks
18. The Tradeshift Index of Global Trade Health – Q2 2020, Tradeshift (July 14, 2020).
See: https://hub.tradeshift.com/research-and-reports/the-tradeshift-index-of-global-trade-health-q2-2020

02

ALL CHANGE FROM CHINA?

Not So Fast

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US-China trade tensions, the impact of COVID-19 and other factors have compelled many firms at least to re-evaluate their supply chains. A genuine pushback to globalisation and worldwide supply chains, predicted for so long, might now be underway.[19]

A report from BofA Securities in early 2020 found evidence that the decades-long trend of supply chains shifting from developed market economies to emerging markets was starting to reverse. Among the reasons are the impact of tariffs, national security considerations, environmental, social and governance (ESG) factors, and advancements in technology.[20] North American firms, it noted, were far more likely to move production out of China than European peers.

Firms looking to shift their supply chain out of China have several options:

- **China main base:**
  Retain most manufacturing in China but develop a second in the region;
- **Re-shore:**
  Move manufacturing to their home market, potentially by leveraging government incentives;
- **Near-shore:**
  Move manufacturing and/or business operations into the same region as the primary customer base.

But with balance sheets under pressure, firms are limited in their ability to shift out of China, the world's largest manufacturer. That likely explains why some US firms are staying put: A recent survey of 200 companies by the American Chamber of Commerce in Shanghai found less appetite for moving manufacturing back to the US, with more than 70 percent saying they wouldn't move any production outside China.[21]

19. Will coronavirus pandemic finally kill off global supply chains? Financial Times, op cit.
20. Tectonic shifts in global supply chains, BofA Securities (February 4, 2020).
See: https://www.bofaml.com/content/dam/boamlimages/documents/articles/ID20_0147/Tectonic_Shifts_in_Global_Supply_Chains.pdf
21. US companies defy Trump's demands to leave China, Financial Times, (Sep 9, 2020).
See: https://www.ft.com/content/8d23d65b-ee20-4449-a615-e3d2a9b672f8

Part of the challenge is finding somewhere else to make goods. Consider this: India, with a comparable population, would need to grow its domestic manufacturing base more than 6 percent to accommodate just 1 percent of China's capacity, according to calculations by Fitch. Other countries would need to expand their manufacturing bases far more (see table). [22]

	If 1% Of Chinese Exports Moved To This Country, How Much Would Domestic Manufacturing Have To Increase By? (%)	Average 3 Year Growth Rate Of Manufacturing, %
India	6.4	6.9
Indonesia	11.7	4.3
Mexico	11.8	2.1
Thailand	17.2	2.7
Poland	25.5	4.1
Malaysia	33.3	5.1
Philippines	35.0	6.8
South Africa	57.7	0.5
Vietnam	58.7	13.1
Egypt	61.2	2.5
Hungary	84.9	1.8
Morocco	135.0	2.1
Myanmar	135.1	9.9
Cambodia	631.1	7.6

Shifting production, then, is easier said than done, yet it's clear that some firms have decided to look elsewhere, either in the region (see Box) or closer to home.

19. Will coronavirus pandemic finally kill off global supply chains? Financial Times, op cit.
20. Tectonic shifts in global supply chains, BofA Securities (February 4, 2020).
See: https://www.bofaml.com/content/dam/boamlimages/documents/articles/ID20_0147/Tectonic_Shifts_in_Global_Supply_Chains.pdf
21. US companies defy Trump's demands to leave China, Financial Times, (Sep 9, 2020).
See: https://www.ft.com/content/8d23d65b-ee20-4449-a615-e3d2a9b672f8
22. Covid-19 To Further Incentivise A Supply Chain Rethink, Fitch Solutions (May 29, 2020).
See: https://www.fitchsolutions.com/country-risk-sovereigns/operational-risk/covid-19-further-incentivise-supply-chain-rethink-29-05-2020

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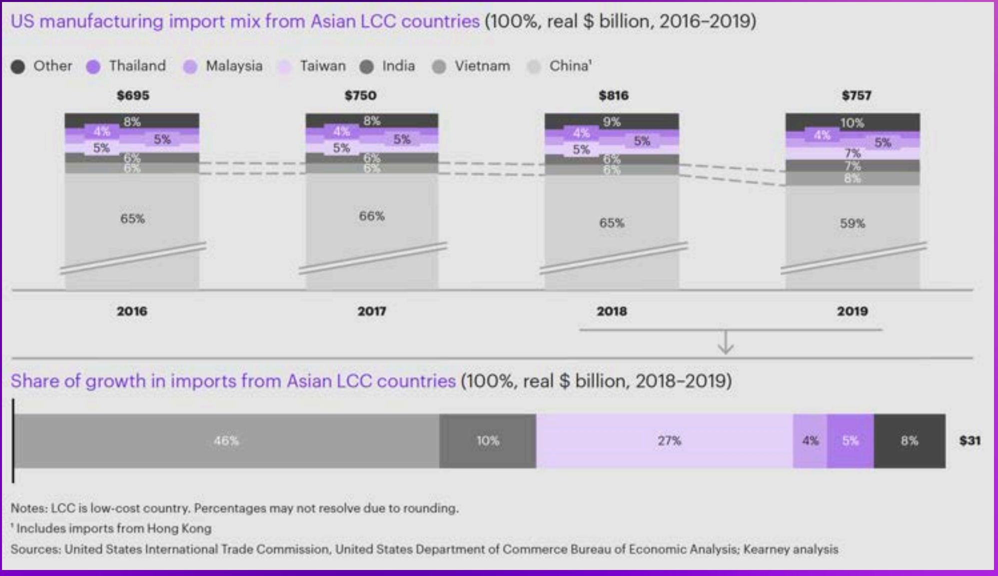
WHERE IS PRODUCTION HEADED?

A Standard Chartered Bank survey found Vietnam was the most popular within ASEAN[23] followed by Cambodia, Myanmar and Thailand.[24] Outside ASEAN, Bangladesh has benefited. India – despite interest from some key names in electronics manufacturing – has yet to see big gains.[25]

Kearney's China diversification index is a useful measure of the shift of the US's manufacturing import mix out of China and into other Asian low-cost countries (LCCs[26])[27]. It shows that China – while retaining the top spot overall – has lost share to other LCC nations: from 67 percent of the total in 2013 to 56 percent by Q3 2019 (see graphic). By the end of Q4 2019, China's share had declined to 56 percent.



Source: Trade war spurs sharp reversal in 2019 Reshoring Index, foreshadowing COVID-19 test of supply chain resilience, Kearney (2019).

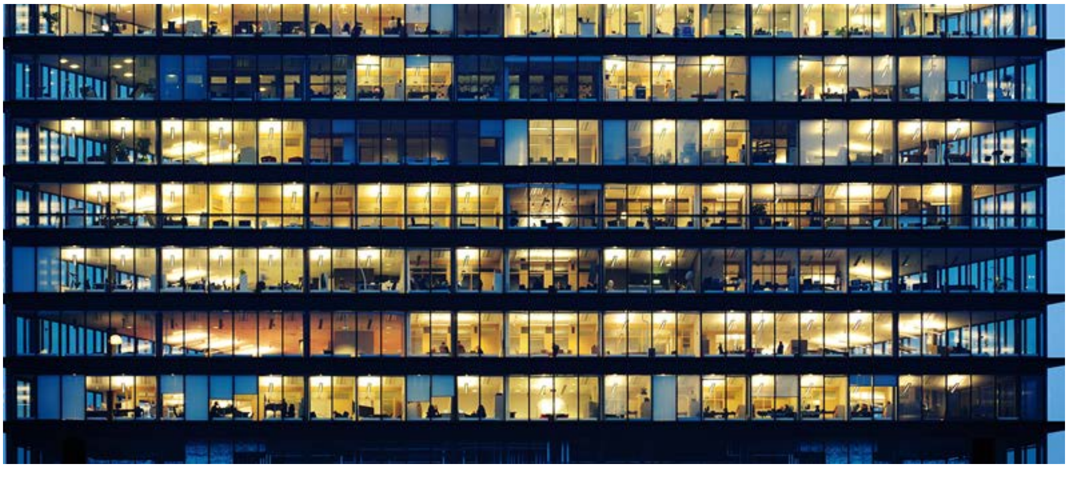
The main beneficiary in 2019 was Vietnam, which garnered nearly half of the US$31 billion shift out of China to LCC nations.[28]

23. The ASEAN bloc comprises: Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.
24. China's Loss May Be India's Gain in Shifting Supply Chains, Bloomberg Quint (August 18, 2020).
See: https://www.bloombergquint.com/business/china-s-loss-may-become-india-s-gain-in-shifting-supply-chains
25. Trade war spurs sharp reversal in 2019 Reshoring Index, foreshadowing COVID-19 test of supply chain resilience, Kearney (2019).
See: https://www.kearney.com/operations-performance-transformation/us-reshoring-index/full-report.
26. The 14 Asian low-cost countries comprise: China, Vietnam, Philippines, Malaysia, Indonesia, Pakistan, Sri Lanka, Taiwan, Thailand, Bangladesh, India, Singapore, Hong Kong and Cambodia.
27. Trade war spurs sharp reversal in 2019 Reshoring Index, foreshadowing COVID-19 test of supply chain resilience, Kearney, op cit.
28. Ibid

Firms that do choose to look elsewhere must therefore assess a wide range of factors, including whether they should move to one country or to several – bearing in mind that managing a multi-nation supply chain can prove to be even more complex.

The lesson for banks is stark: clients might shift at short notice, and indeed are being enticed by governments to do so, yet if banks can't service them in, say, Japan, India or Vietnam, they risk losing them. Consequently, banks need to be increasingly flexible in providing appropriate core services to corporates looking for supply chain financing partnerships.[29] Banks should view shifts of production both as an opportunity to deepen existing client relationships and to devise new business opportunities, including developing solutions to support clients that wish to move – ensuring their capital needs are met, for example, and developing risk models to best assist those customers.

Another aspect banks must consider is the impact of emerging technologies: automation, robotics, artificial intelligence (AI) and additive manufacturing technologies like 3D-printing will likely lower trade volumes, and could result in production moving closer to home as firms would not need to seek cost savings further afield.[30]



29. BofA Interview: Bye for now, China? The $1 trillion tectonic shift in global supply chains, Trade Finance Global, (September 10, 2020), See: https://www.tradefinanceglobal.com/posts/bofa-interview-bye-for-now-china-the-1-trillion-tectonic-shift-in-global-supply-chains/
30. The changes Covid-19 is forcing on to business, The Economist, (April 11, 2020), See: https://www.economist.com/briefing/2020/04/11/the-changes-covid-19-is-forcing-on-to-business

DECOUPLING AND RESHORING

Clothing and footwear decouple from China: Some clothing manufacturers and footwear companies, including adidas and Nike, have consolidated manufacturing in Vietnam and Bangladesh as labour costs rise in China.[31] Both now manufacture more training shoes in Vietnam than they do in China.[32]

Big-tech shifting to ASEAN: In 2019, Apple started looking to move up to 30 percent of AirPods production from China to Vietnam on the back of trade tensions and labour costs.[33]

Japanese firms re-shore and near-shore: In February, Nissan temporarily halted production over a shortage of parts from China, fears of an over-reliance on Chinese manufacturing and the impact of COVID-19. The Japanese government later announced it would help firms looking to move production to Japan or elsewhere in Southeast Asia. By July, 87 firms had received US$535m to re-shore or relocate in the region.[34]

31. Supply chains for different industries are fragmenting in different ways, The Economist (July 11, 2019).
See: https://www.economist.com/special-report/2019/07/11/supply-chains-for-different-industries-are-fragmenting-in-different-ways
32. Ibid.
33. Apple to step up diversification out of China, Financial Times (July 17, 2019).
See: https://www.ft.com/content/ed30a652-a87d-11e9-b6ee-3cdf3174eb89
34. Japan helps 87 companies to break from China after pandemic exposed overreliance, The Washington Post (July 21, 2020).
See: https://www.washingtonpost.com/world/asia_pacific/japan-helps-87-companies-to-exit-china-after-pandemic-exposed-overreliance/2020/07/21/4889abd2-cb2f-11ea-99b0-8426e26d203b_story.html

03

NAVIGATING THE NEW WORLD

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As parts of the world emerge from the COVID-19 lockdown, banks have been inundated with requests for working capital financing and traditional trade financing instruments. HSBC, one of the largest trade finance players, has seen a surge of supply chain and receivables finance in the Asia-Pacific region – some 30-40 percent – from new deals, longer tenors and an increase in suppliers.[35]

As banks look ahead, they must ensure they align with their clients' strategies and industry trends, while supporting related initiatives. They will need to strengthen and integrate their intra-bank/subsidiary networks (for example, by adopting platform models and distributed ledger technology (DLT)), and expand further into ecosystem collaborations to meet clients' needs.

Also, as we have written elsewhere, banks must become more agile and innovative with back-office processes, and resolve trade finance's paper-based inefficiencies by digitising documents. COVID-19 has heightened the demand for end-to-end digitisation, and brought the opportunity to consolidate customer relationships and build trust. Solutions include:

- "Smart" automation systems that combine optical character recognition, robotic process automation, AI and natural-language processing. These systems can read documents fast, understand what words mean and learn from manual corrections.
- Data analytics, which benefits a range of areas, including: using trade finance data to calculate payables versus receivables, then reconciling that to determine working capital needs; understanding which of a bank's clients' buyers are likely to default; and assessing compliance risks.
- Open APIs and other emerging technologies like DLT. Open APIs, for instance, ensure that information can be shared securely between firms' internal systems and those of third parties. A mature API-driven platform brings numerous client and bank benefits including lower costs, greater efficiencies, a better customer experience and new revenue channels.

35. Supply chain finance grows amid pandemic, but faces stark risk warnings, S&P Global Market Intelligence (June 8, 2020).
See: https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/supply-chain-finance-grows-amid-pandemic-but-faces-stark-risk-warnings-58841608

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As non-banks expand into the supply chain finance market, bringing disruptive digital technologies, banks will need to rally their advantages of liquidity, balance sheet strength and financing power. As we have noted previously, banks that maximise trade finance automation will be best-placed to mitigate risk, increase revenues and improve customer satisfaction.

In the digitisation drive that underpins trade finance automation, banks need to create digital documents and reengineer their processing models. In doing so, they should work closely with regulators, governments and agencies to ensure cross-border technological interoperability, standards and processes. In a world of intertwined economies, such standardisation is crucial in securing the efficiencies that automation offers.

More pressingly, credit risk is rising as liquidity starts to dry up, and banks must manage their exposure. To reduce balance sheet credit risk, banks should create monetizable assets by securitising supply chain loans. Concurrently, they must optimise cost and growth strategies as they face headwinds from low interest rates and margin compression.

Finally, even before the pandemic, banking clients were demanding a widening range of ESG initiatives. These have become more topical and popular. While some banks offer ESG solutions, many have yet to develop or fund them. They should.

As the world adapts to COVID-19, and as firms evaluate their supply chains, banks have much to do. With central bank liquidity and support reducing, and with trade volumes potentially growing, this is a moment that requires unprecedented flexibility. Banks that can navigate extending credit to support supply chain financing challenges and can maximise efficiencies, exposure and risk will position themselves strongly for the future.

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