



Insights into the dynamics of new trade flows

Major structural shifts in the global economy are creating new opportunities in transaction banking, particularly in trade finance. International trade is growing faster than global GDP, and Asia is now the center of global expansion, driving trade growth in other emerging markets and in developed economies as well. Where trade flows were once concentrated in a limited number of North-North corridors, trading relationships today extend to more geographical endpoints and encompass a broader range of companies. As small and medium-size enterprises (SMEs) become more active in cross-border commerce, banks of all sizes—global, regional and local—face significant challenges to winning in trade finance. The stakes are high: trade finance revenues approached \$100 billion in 2012. To tap this important market, banks must first understand the increasingly complex nature of the trade finance landscape, and follow the five core principles outlined in this article.

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Bigger, freer and more complex

Commercial activity everywhere is increasingly dependent on international trade services. From 1990 to 2012, cross-border trade as a share of global economic output grew from one-fifth to one-third. This long-term growth can be attributed to a variety of factors, including the expansion of the middle class in emerging markets (especially in Asia) and trade liberalization. While recent protectionist measures and a preference for regional over global trade agreements suggest that the pace of globalization may be

slowing, McKinsey expects that cross-border trade as a share of total output will continue to expand, outpacing GDP growth by 20 percent over the medium term. (This projection is based on IMF trade data and McKinsey Global Institute's Global Growth Model.)

The ongoing fragmentation of supply chains reinforces economic interdependence among national markets, as companies of all sizes seek to reduce costs and boost the quality of intermediate goods. In aeronautics, telecommunications, consumer packaged goods and other industries, companies are increasingly

reliant on parts and components from specialized external providers spread across the globe. One of the best-known examples is Boeing: In the late 1960s when the company launched the 737, only 10 percent of production was outsourced. Today, Boeing's 787 Dreamliner is almost 80 percent outsourced to specialized providers, several of them mid-sized companies (Exhibit 1). This trend increases operational and supply chain risk for companies, who need fast access to alternate suppliers, and some banks are finding that they can help clients reduce supply chain risk by acting (solely or in partnership) as a hub for suppliers and buyers (see discussion on supply-chain finance, page 25).

The trade ecosystem not only comprises a more diverse set of internationally active companies but is also more geographically fragmented, with new corridors linking fast-growing emerging markets with Asia, the center of global trade growth (see sidebar,

page 24). Growth is much slower in mature markets, but they still hold important opportunities. Europe remains the largest region for international trade, and North American trade with Latin America and emerging Asia (excluding Hong Kong, Japan, Singapore, South Korea and Taiwan) grew by approximately 40 percent between 2007 and 2012. To capture value from fast-evolving trade flows, banks and other service providers must rethink their offering from the client point of view.

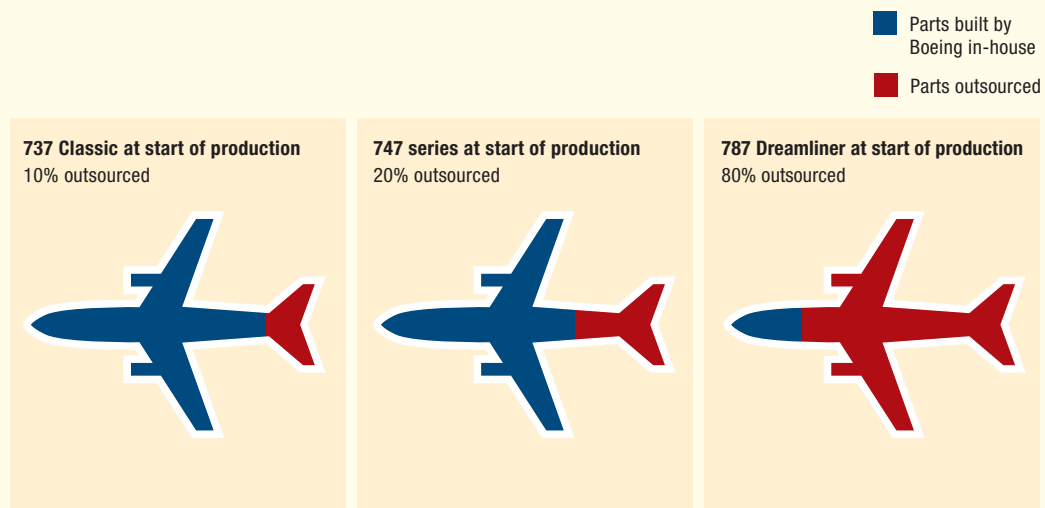
Client needs differ across regions and segments

In the U.S., SMEs are now responsible for approximately one-third of exports, a sharp increase compared to 22 percent 10 years ago. With the average size of internationally active companies decreasing, banks must understand how and why SMEs select an international transaction services provider. Companies in this segment typically have

Exhibit 1

Value chains are becoming increasingly fragmented, leading to increasing trade volumes

Boeing has transformed itself into a systems integrator and has outsourced an increasing proportion of its aircraft production



Source: International Association of Machinists and Aerospace Workers; Boeing; Reuters; McKinsey Global Institute

less sophisticated needs and tend to rely on existing cash management banking relationships. Along with risk mitigation, the priority for SMEs is usually to optimize working capital, but existing solutions often fall short of expectations, with banks not being fully able to meet SME financing needs. The result is a substantial financing gap, especially in emerging markets. The Asian Development Bank estimates that in Asia alone there is a gap of as much as \$425 billion, representing almost 20 percent of total proposals received.

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Serving large corporates poses increasingly complex challenges as well. The expectation was that corporate needs would harmonize across countries and regions in a globalized world. However, both the underlying motivation to use trade finance and the criteria used to select a service provider still differ significantly across regions.

For example, companies in emerging markets tend to use trade services mainly as a source of financing. In Asia, 25 percent of trade services fees paid by corporates are directly related to financing needs. This share is only 13 percent in Europe and 8 percent in North America, where trade services are seen mainly as a tool for risk mitigation. Pricing,

quality and “reach”—a combination of international network and local presence—top the list of decision factors in a corporate treasurer’s choice of trade services provider across all regions. But in North America and Asia, the single most important priority is price; for European companies, by contrast, quality and capability carry more weight.

Deeper analysis is necessary to understand how client segments within a specific market diverge from more general, regional trends.

Intensify the impact of limited resources

Trade services are vital to large corporates and a growing number of SMEs, and any bank unable to support its clients’ increasingly diverse and geographically extensive trading demands puts their relationships with these institutions at risk. Of course, not even the largest bank can afford to serve a broad and diverse set of clients across all geographies. Each bank must adopt a granular approach to markets and segments, building on its strengths and making selected and focused investments. In order to surmount the challenges and win in this highly complex and profitable market, it is essential to follow five core principles: segment approach, client perspective, partnerships, digitized workflow and SME focus. A number of banks have applied these principles successfully in various national markets. In the international context, whether undertaken simultaneously or consecutively, these guidelines provide the foundation for new and innovative trade services.

1. Target segments where the bank can outperform

Increasing complexity in both trading flows and corporate needs makes it ever harder to

The shift to Asia

Not only is cross-border trade growing faster than global GDP, but Asia has eclipsed Europe as the nexus of global trade growth. In each of the past five years, growth in emerging Asia has added more to global GDP than the European Union, Japan and the U.S. combined.

Intraregional trade in Europe totaled \$4,557 billion in 2012, representing 20 percent of global trade flows. While the volume of intraregional trade in Asia (\$2,963 billion in 2012) is considerably smaller, Asia is expected to surpass Europe as the largest regional trading area by 2016. Between 2007 and 2012, intra-Asia flows contributed \$1,248 billion to overall trade growth, exceeding growth in intra-European trade by more than 45 percent (Exhibit A). The growing intra-Asian trade flows also translate into new trade finance opportunities for banks. According to Greenwich Associates, nearly 75 percent of Asian corporates' trade-finance spending is devoted to domestic and intra-Asia trade flows.

Rapid expansion is also spurring growth in other regions, and growth along the corridors linking emerging markets with Asia is nearly as robust as growth within Asia. Asia's fast-growing middle class and strong demand for commodities are altering the balance of global trade flows. Long known for its surpluses, Asia is expected to become a net consumer of goods in 2013, and forecasts from the McKinsey Global Institute indicate imports to Asia will exceed its exports by 12 percent by 2020.

While Asia takes the spotlight in the shifting dynamics of global trade, bankers must accommodate the diverse needs of each major region. In Europe growth is quickening, at least for the short term, and it remains an important anchor that must not be neglected. Growth in Africa, meanwhile, will pose significant challenges and opportunities over the long term.

It is important to note that one-quarter of growth in trade has been in commodities, which increased from 10 percent of global trade in 2007 to 14 percent in 2012 (Exhibit B). Growth, particularly in Asia, has increased demand for commodities, especially from the Middle East and Africa. In fact, if we look at emerging markets, commodities—mainly mineral fuels—represent 35 percent of overall exports. However, with the recent stagnation of commodity trade (driven both by volume and price stagnation), emerging markets now face the challenge of developing their internal economies, and are moving away from heavy reliance on commodities exports for growth. This trend is already manifest across much of Asia, where commodities now account for only 20 percent of exports. The road is still long for other emerging regions such as Africa, where commodities represent 55 percent of exports.

Exhibit A

Intra-Asia trade flows are expected to surpass intra-Europe flows as the largest in the world by 2016

Total cross-border trade (excl. services) 2012

Growth 2007-2012
U.S.\$ billions

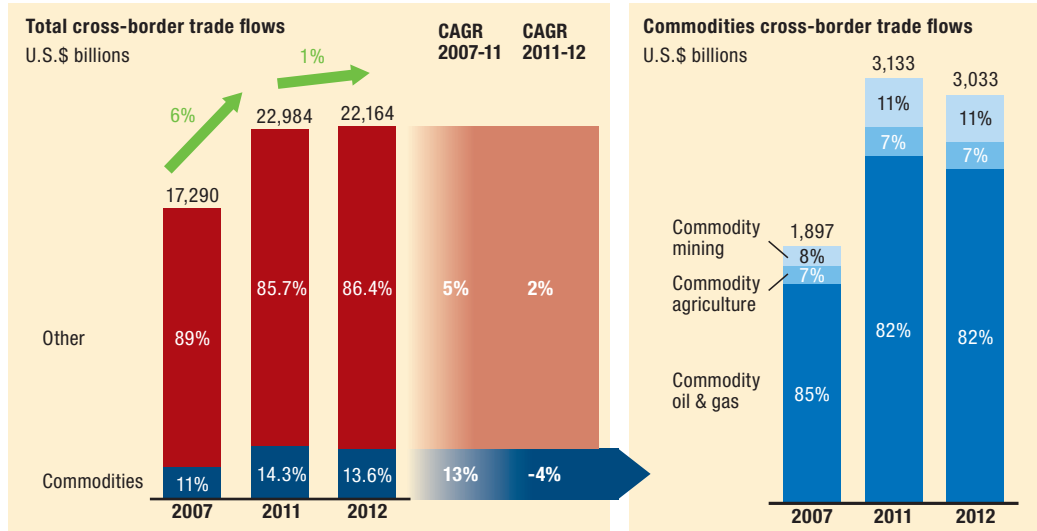
- Trade > 20% of total/growth
- Trade > 10% of total/growth
- Trade > 5% of total/growth
- Trade < 5% of total/growth

Trade flows from	Trade flows to							
	Africa	Oceania	Asia	Europe	Latin America	Middle East	North America	
Africa	2012	56	8	214	232	21	24	83
	Growth	29	6	140	65	7	10	(9)
Oceania	2012	5	19	229	25	5	10	17
	Growth	2	6	131	3	2	4	3
Asia	2012	160	162	2,963	903	296	321	983
	Growth	94	76	1,248	215	161	177	217
Europe	2012	193	60	856	4,557	173	315	522
	Growth	81	23	410	851	80	96	76
Latin America	2012	23	6	253	159	213	21	502
	Growth	11	4	169	44	87	11	135
Middle East	2012	53	10	780	204	14	129	140
	Growth	28	5	454	61	8	70	54
North America	2012	38	39	476	304	383	92	587
	Growth	18	13	160	38	151	46	67

Source: IMF DOTS; McKinsey Global Payments Map

Exhibit B

Trade growth has been fastest in commodities, mostly fueled by mineral fuels



Source: IMF DOTS; UNCTAD; UN ComTrade; McKinsey Global Payments Map

win across the board, and banks must choose the segments where they have a truly distinctive offering. Traditional approaches to segmentation (geography, size, sector), although critical, are not enough to fully differentiate transaction banking needs. With the analytical support of McKinsey's Global Payments Map, many global and regional leaders have targeted geographical areas and market segments where client needs best match their strengths. As part of the effort, each bank should benchmark its organizational skills and knowledge, technological capability and funding capacity to understand precisely where it serves with distinction and where it must fortify its offering. Capital is particularly important. For example, European regional banks have gained market share in their home markets largely on the strength of lending relationships, but these same banks face serious hurdles in Asia due to limited access to U.S. dollar funding.

Deeper technological integration among partners in various industries has opened access to underserved markets while streamlining processes and improving transparency.

2. Take a CFO perspective

Corporate treasurers and bankers see things differently, according to a recent Greenwich Associates survey. Many bankers, for example, focus extensively on Basel III impact and the fact that it could discourage or even reduce international trade. Corporate treasurers, on the other hand, tend to be less pessimistic and focus more on opportunities to optimize working capital and cash flows. If a bank aims

to lead in a particular segment, the entire organization, from product managers and technology developers to frontline sales representatives and relationship managers, must gauge the market from a CFO perspective. This means focusing on the key challenges: reduce days sales outstanding; lengthen days payables outstanding; minimize inventory and the cash buffer; secure the best financing terms; and negotiate the best commercial terms with suppliers and clients.

3. Optimize network coverage through innovative partnerships

Trade flows today encompass a broad diversity of endpoints, and no organization can aspire to cover the entire globe with adequate breadth and depth. Global banks' large yet often thin networks were typically designed to meet the needs of large corporate clients based in Europe or the United States, but now these networks are costly to maintain and inadequate in geographical reach. Regional and domestic banks typically enjoy strong relationships with SMEs, but they need access to an increasing number of foreign markets and want to defend against global players reaching downmarket. Correspondent banking and "white label" arrangements already address these gaps to some extent, but they usually provide only limited functionality within local markets, often do not cover new corridors adequately, and may expose a bank to client risks they do not understand and cannot evaluate thoroughly.

Deeper technological integration among partners in various industries has opened access to underserved markets while streamlining processes and improving transparency. The airline industry's multicarrier alliances have improved scheduling options

and reduced operating expenses; automotive manufacturers have invested in shared manufacturing facilities to reach scale and improve profitability in given markets. Within trade services, alliances that help integrate operations and technology architecture are enabling banks (and nonbank providers) to combine geographical breadth and local depth. The Wells Fargo-Ecobank alliance in African markets, for example, combines the local market strength and depth of Ecobank with Wells Fargo's expertise in trade finance operations and technology.

Technologically integrated alliances require broad client adoption of digital processes, either in parallel with the current documentary workflow or as an entirely new supply-chain interface for sourcing, financing and tracking.

Banks should optimize the costs and timeliness of documentary services in order to provide a sustainable alternative workflow to open-account transactions, which increasingly are corporates' preferred avenue.

4. Digitize the traditional documentary workflow

Documentary credit (such as letters of credit, letters of guarantee and documentary collection) continues to serve as a vital source of risk mitigation and access to financing for trading partners of all sizes. Banks should optimize the costs and timeliness of documentary services in order to provide a sustainable alternative workflow to open-account transactions, which increas-

ingly are corporates' preferred avenue. Many trade banks have simplified their processes, removing manual steps and digitizing paper documents, but these improvements still fall short of straight-through processing. Processes can be improved both internally and, possibly, through industry-wide innovations such as the bank payment obligation offered jointly by SWIFT and the International Chamber of Commerce. The savings associated with a digital workflow benefit both banks and corporates and open the door to new innovation.

5. Extend transaction services to SMEs via supply-chain finance

By reaching companies along the entire supply chain, banks can position themselves to support the 75 to 85 percent of trade flows transacted through open accounts. Banks differ in how they define *supply-chain finance* (SCF), but most agree broadly that it should offer SMEs better access to trade finance within the Basel III regime.

SCF, often comprising a large corporate "anchor" and its trading partners, is a mechanism to reduce supply chain risk and finance working capital needs, for instance by speeding up collections and delaying payments. The main financing techniques used are factoring, in the case of buyer finance, and reverse factoring, in the case of supplier finance. Supplier finance enables banks to use their existing relationships with large corporates to offer SMEs short-term financing at the superior credit-worthiness of the importer—thus creating a beneficial credit arbitrage for the SME. However, it is primarily the technology and platform leveraged by SCF that makes it truly distinctive and innovative, rather than the financing tech-

niques used. While some banks have opted to create their own SCF platform, there are technology players (e.g., CGI, Demica, PrimeRevenue) that provide a common network to multiple parties, facilitating interactions among a large array of suppliers, buyers and funders.

To navigate the transition and stand out from the competition, banks must pay close attention to the changing needs of their clients and take a CFO perspective on diverse trade processes, from sourcing and logistics to payments and liquidity.

The critical success factor for an SCF program is to understand the strength of the full supply chain, from suppliers to large corporate “anchors” to buyers. This requires banks to shift from the traditional individual risk assessment approach to evaluating the entire production and sales cycle. The broader and more diverse the platform becomes (both by geography and industry), the more challenging it is to make this happen. Indeed, there is considerable complexity involved in onboarding clients and assessing the risks of suppliers and buyers located outside the bank’s footprint, and most banks rely on technologically robust partnerships and alliances to support “know your customer” procedures and risk assessment around SME participants. Though SCF is a challenging arena, the promise of lower risk and financing costs can help a

bank build relationships with SMEs in diverse markets.

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Cross-border trade is growing relative to global output, making trade finance crucial to a wider cross-section of cash management clients. This creates highly lucrative opportunities for banks of all sizes, but geographical breadth and technological complexity pose significant challenges. While North-North corridors are still core to the business, the best opportunities for growth—and future market leadership—are in corridors linking Asia and other emerging markets. This expanded landscape, combined with wider participation of SMEs, is pushing global players to become more selective in whom they serve and where. In the past, proprietary networks were adequate, but going forward, most banks will seek technologically innovative partnerships and alliances to achieve geographical reach and local depth, in addition to continued digitization of trade finance processes. To navigate the transition and stand out from the competition, banks must pay close attention to the changing needs of their clients and take a CFO perspective on diverse trade processes, from sourcing and logistics to payments and liquidity.

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