



OLIVER WYMAN

Financial Services

The Future of Transaction Banking

Volume 2: Trade Finance



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Executive summary

Trade finance products are the backbone of a globalising economy as they intermediate a commercial transaction flow to provide short-term working capital and/or mitigate the commercial risk of a transaction. The importance of the product is especially evident at present as the global economic crisis has led to a severe reduction of financing capacity and a resulting dramatic slowdown of trade activity in the last two months.

Globally, the trade finance market is worth \$18 BN, of which more than 60% is accounted for by traditional trade products such as letters of credit (L/C) or confirmations. Supply chain finance solutions and structured trade finance products such as commodity trade finance now account for more than a third of the revenue pool, up from less than 20% back in 2000.

The market for trade finance services is very concentrated, with the top five institutions accounting for almost 40% of the revenue pool. Most of these banks have a strong footprint in Asia, allowing them to capture both sides of a trade, which is ultimately reflected in both a higher revenue growth and higher efficiency in operations.

We have observed two global trends over the past decade:

1. Asia is becoming the hub for global trade finance. This is driven by strong growth rates in trade with the US and Europe, the growing maturity of intra-Asian trade, and the small but fast growing inter-emerging-markets trade flows (particularly driven by China's demand for commodities). Despite current financing constraints, we expect Asia's importance to further increase over the next few years and see a revenue pool of more than \$2.5 BN to emerge
2. Globalisation has now arrived at the European middle market (across both manufacturing and service industries). Interestingly, the relative growth of exports compared to imports has been stronger, again underlining that economic power is increasingly shifting to emerging markets, as a broader range of consumers are now able to purchase products produced internationally

While we believe that in the mid term these macro trends will lead to further consolidation, credit capacity has now become the most critical component for business success, allowing a range of well capitalised mid-tier competitors to fight back.

Apart from the globalisation of corporate business models, incumbents' success in trade finance will be driven by three factors:

- Ability to cope with the growth in supply chain finance solutions and hence increased credit requirements as well as the difficulties posed by the Basel II regulatory environment
- Ability to profit from the opening of the value chain and new competitive solutions
- Ability to react smartly in the technology race. Leading competitors are creating online working capital solutions with a much broader focus than trade finance, also covering payments, FX, and securities servicing

Hence, understanding global trade flows, changing client needs and emerging competitor models is important to strategically (re)position the business. We observe that substantial value also lies in optimising the current business – particularly in terms of efficient operations (and the required investment budgets), focusing on a client-centric value proposition and service delivery that includes cross-selling with other corporate and private banking services, as well as applying best in class risk management practices.

In terms of risk management, three areas are of particular importance. In combination they can lead to a return on equity improvement of up to 5 percentage points:

- Fully understanding the nature and causes of risks in trade receivables (the long term credit rating is a bad proxy)
- Better assessment of counterparty bank risk (rather than focusing predominantly on country risk)
- Using a syndication desk to better handle country limits and to further diversify the portfolio

We believe that the global trade finance market will reach ~\$24 BN in revenues by 2012. This implies an annual growth rate of 5-7%, somewhat lower than the growth rate of ~8% we have seen over the last decade. While we believe that supply chain finance solutions will grow further in importance, we project a more mixed outlook for other trade products. As the global economy is likely to turn into a recession, global trade volumes will be reduced. However, this is compensated by higher spreads and product margins but also higher risks. We believe that growth among competitors and regions will be distributed unevenly and see particular value in four distinct business models:

- Global supply chain managers are likely to succeed if they can handle the increased exposures and risk complexities of their client base, given the macro and business trends outlined above. These players will need to increase their middle market footprint with less resource

intensive coverage models. It is also critical for them to foster a climate of innovation and to smartly integrate start-ups and logistics players to remain at the forefront of innovation

- Specialists and innovators leverage a deep industry expertise to offer competitively priced and flexible trade finance solutions. We believe that the highest risk for bank disintermediation could come from joint ventures between logistic firms and credit insurers. While the former bring their information capabilities to the table, the latter are advantaged over banks as they essentially only capitalise default but not credit migration risk. Despite the current market turmoil and restricted leverage opportunities, we also see room for hedge funds, as trade receivables risk are comparatively low risk and correlation figures with other asset classes look attractive. Finally, Chinese banks will increasingly look to secure a piece of the global trade bonanza as manufacturers move downstream and abroad. We expect a number of integrated houses to emerge focused on trade and logistics. The challenge for these players will be to master downstream risk management and the volatility inherent in the specialist's business model
- In-sourcers and processors are also well equipped to succeed in the evolving trade finance landscape as the technology race will force an ever growing number of banks to outsource. Best-practice operational risk management and the ability to continuously invest in the business will be the most critical factors for winning client confidence, and hence, long term success
- Defenders realise the risk of continued client erosion as specialists or more global banks enter the relationship. They should therefore focus their efforts on relationship management and analytics and seek efficiency in the middle and back office, potentially via outsourcing

While these four models differ substantially, we are convinced that only those players willing and able to rethink their strategy and operation models now have a chance at success. These players must address the following key questions:

- Which markets/client segments should we focus on?
- Where do we play on our own and where do we use alliances, JVs and outsourcing to cope with global demand?
- How should we manage risk and allocate respective capital?
- How will we win, retain and incentivise talent?
- How will we achieve the right level of operational industrialisation?
- How will we reap cross-division synergies and cross-sell potentials?

Introduction

Traditionally, trade finance centred on documentary credit products and ancillary services such as documentary collections or confirmations. However, globalisation, technology-driven data availability and a broadening of client requirements have led to the introduction of innovative trade solutions and the entrance of a range of non-bank competitors into the trade finance market.

From that background we define trade finance as “a product or service offered by a third party (still in most cases a bank) that actively intermediates a commercial transaction flow to provide short-term working capital and/or mitigate the commercial risk to the buyer and/or seller”. It is therefore important to distinguish trade finance solutions from open account relationships where the counterparty risk remains with the selling corporate and the role of banks is limited to performing a payments transaction.

The importance of trade finance is especially evident at present as the global economic crisis has led corporates to insist on guaranteed forms of payments. On the other hand, a severe reduction of financing capacity has resulted in a dramatic slowdown of trade and shipping activity in the last two months.

A further categorisation of trade finance products is provided in the table below:

Figure 1: Trade finance definitions

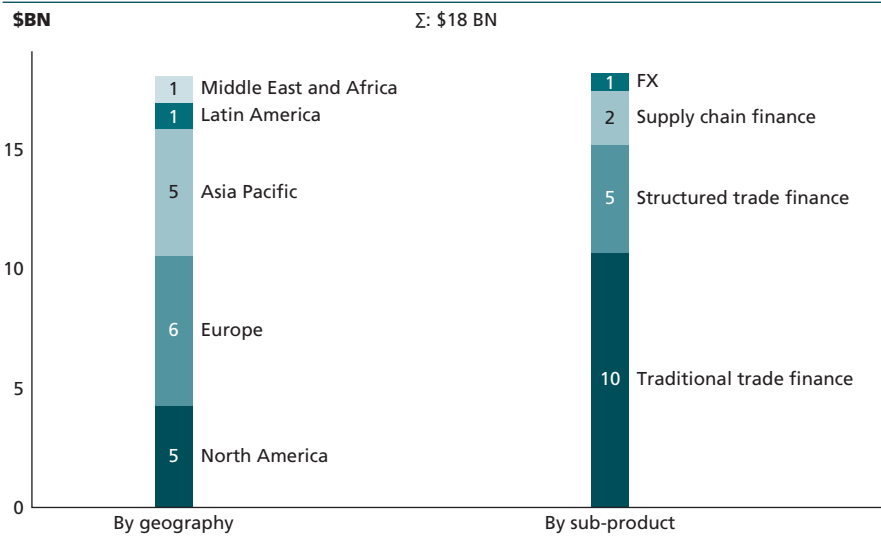
Product	Description
Traditional trade finance	<ul style="list-style-type: none"> ■ Traditional products/services offered to mitigate risks/provide financing in trade transactions ■ Examples: Letters of Credit, Documentary Collections, Confirmations, Documentation Services, Bill Discounting, Invoice Discounting, Forfaiting
Supply chain finance	<ul style="list-style-type: none"> ■ More streamlined, working capital and risk management products/propositions that take a holistic view of the commercial transaction ■ Examples: Reverse Factoring, Tailored Vendor Finance Programs, Distributor Finance Programs
Structured trade finance	<ul style="list-style-type: none"> ■ Solutions that often require specialised credit skills and are more highly tailored around the specific needs of a client, transaction (or series of specified transactions) ■ Example: Commodity trade finance
Trade derivatives	<ul style="list-style-type: none"> ■ Products that are not typically managed by the Trade Finance business unit and are not actively intermediating in the commercial flow ■ Examples: FX and FX hedging products (FX revenues included are only the portion of the margin allocated by the Markets Division to the Trade Finance business unit for distribution)

Source: Oliver Wyman analysis

Globally, the trade finance market is worth \$18 BN, of which more than 60% is still accounted for by traditional trade products. Supply chain finance and structured trade finance products now account for more than a third of the revenue pool, up from less than 20% back in 2000. This was driven by both soaring commodity prices (e.g. the financing volume of a Suzemax class crude carrier amounted to \$250 MM at the peak of the oil price) and the need for alternative finance solutions as the relative importance of letters of credit (L/C) has continued to decline.

Europe still accounts for a third of total trade finance revenues, but globalisation is now turning Asia into the global hub for trade finance, and the strongest growth experienced in the Middle East based on the recent oil price boom.

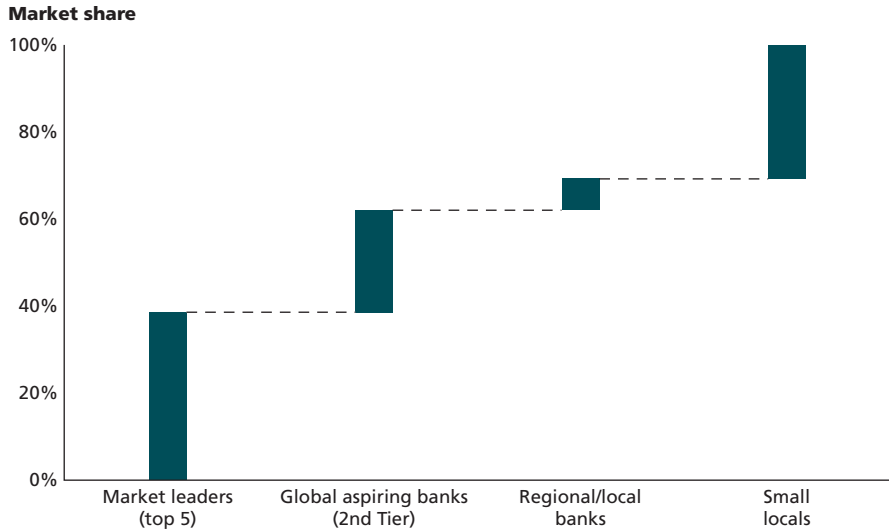
Figure 2: Global trade finance revenues (\$BN)



Source: Oliver Wyman proprietary data and analysis

The market for trade finance services is very concentrated, with the top five institutions accounting for almost 40% of the revenue pool. Most of these banks have a strong footprint in Asia, allowing them to capture both sides of a trade, ultimately reflected in both higher revenue growth and higher efficiency in operations.

Figure 3: Trade finance market-share distribution

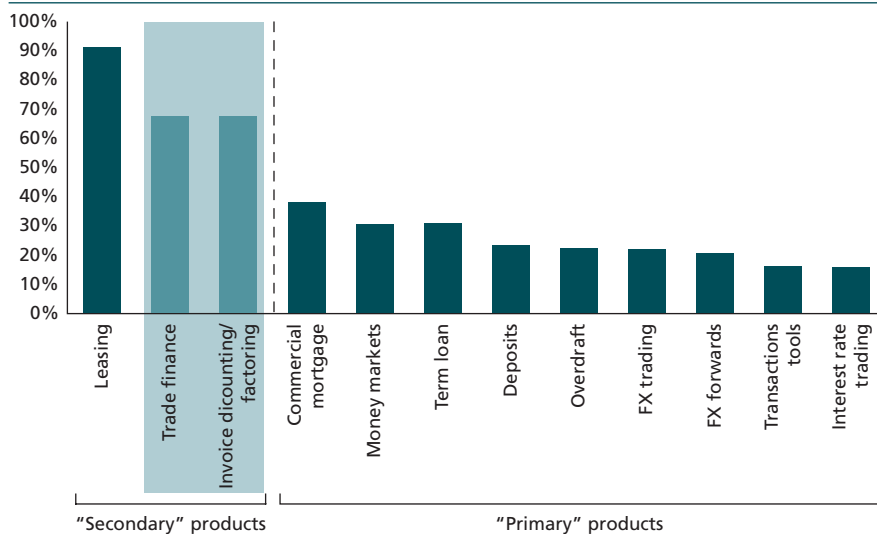


Source: Oliver Wyman proprietary data and analysis

However, approximately 30% of industry revenues remain in a long tail of relatively smaller local players, with average revenues in the range of \$15-30 MM. Many of these struggle to break even, whereas some of the market leaders are able to operate the business at a cost-income ratio (CIR) below 50%.

Looking forward we expect consolidation to further increase as many corporate clients do not consider trade finance a relationship product, which is not necessarily sourced from the primary banking relationship. This is based on the fact that trade finance has by definition an international angle which typically does not play to the strengths of domestic banks. In fact, global competitors have recently made substantial inroads into a number of Central European countries that were historically dominated by the domestic banks.

Figure 4: % of companies holding products with a secondary bank



Source: Oliver Wyman interviews with more than 80 European corporates

Yet as a result of the credit crunch, margins have increased substantially and credit capacity has now become the most critical component for business success, allowing a range of well capitalised mid-tier competitors to fight back.

In the US, we consider that the credit crisis will trigger an inevitable reversal of the long-term pattern of trade deficits. The dramatic slowdown in US consumer spending is certainly impacting the import side of the deficit. While short-term actions by the US government or agencies such as the Export-Import Bank may have some effect in mitigating the sharp reduction of short-term export financing by large commercial banks, ultimately recovery for the US economy needs to be fuelled not just by multinational corporations but by the middle market segment. Regional banks that typically serve these types of companies often have limited capabilities in trade finance. However, we see a large opportunity for these banks by focusing on relationship management and credit provision.

In summary, the industry faces a number of challenges including understanding the areas of accessible trade flows, adapting the product offering, as well as optimising internal setup and processes. From that background we have structured the report as follows:

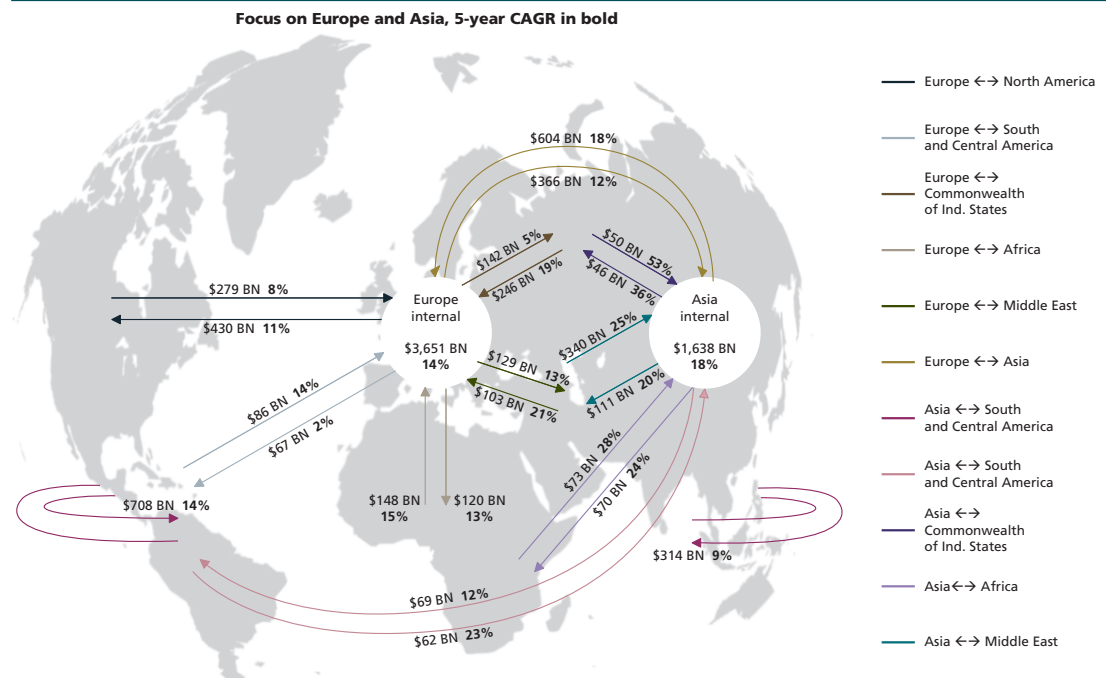
- Section 2 maps out the shift in relative earnings power to Asia and the middle market segment
- Section 3 discusses the strategic implications of changing client requirements and their competitive impact
- Section 4 focuses on “managing the business”, addressing the key dimensions of organisation, operations and risk management
- Finally, we conclude with section 5 by discussing four distinct business models in which we see future value

A shift in relative earnings power to Asia and the middle market

Global merchandise trade flows have grown strongly over recent years, nearly doubling between 2001 and 2006. This has been on the back of the increasing importance of Asia as the new centre of global trade, driven by intra-Asian trade flows growing at almost 20% per year and high double digit annual growth rates in exports to the US and Europe. China in particular has been at the forefront of this trend due to its demand for commodities and supply of manufactured goods.

While trade flows have severely slowed globally at present, particularly Europe and the US show clear signs of a weakening economic climate which is likely to further erode their historic dominance of the trade business over the next few years.

Figure 5: 2006 Global merchandise trade flows



Source: WTO and Oliver Wyman analysis

In fact, we see a new Asian revenue pool of more than \$2.5 BN to emerge over the next three to five years.

- Regional trade within Asia is growing quickly and we foresee an incremental revenue pool of close to \$2 BN by 2012, an increase of over 50% compared to present volumes. Trade finance products are in high demand given different national regulations, tax regimes and currencies. In addition many companies still have substantial potential for improving their working capital (WC) management

- While China is clearly at the forefront of cross-border exports, India stands out due to the fact that recent economic growth has largely been driven by domestic demand. Many export finance transactions are also not handled by banks, but rather specialist trading houses that get financing in the form of bank loans from their banks. As trade and the size of the commitment increases we expect more and more business migrating towards traditional bank solutions. The major client segments are local multinational corporations (MNC) and middle market corporates looking for innovative trade solutions. We estimate that the India-related trade finance business will offer yearly revenues in excess of \$350 MM by 2012, an increase of over 70% compared to today's volumes
- We also see indications that the importance of the fast-growing inter-emerging-market trade is set to increase rapidly. The boom in Asian demand for raw materials and commodities has not only greatly increased trade with the Commonwealth of Independent States (CIS), but also a number of resource rich countries in sub Saharan Africa and Latin America. As demand for raw materials from Asia show no signs of abating in the medium term we believe that inter-emerging-market trade will account for a new revenue pool of ~\$300 MM by 2012

Apart from the growth in Asia, globalisation is now a reality in the European middle market, with both imports and exports growing quickly (although a weakening economy, partially driven by the credit crunch, has somewhat slowed the growth trend in 2007).

Figure 6: European middle market globalisation



Source: ISTAT, INSEE, DSTATIS, HM Revenue & Customs, Oliver Wyman analysis

Note: Germany, UK, Italy and France were included in this analysis

Increasing competitive pressure has led many corporates to consider outsourcing to lower cost countries. In addition, distribution channels have globalised. Interestingly, the relative growth of exports compared to imports has been stronger, again underlining the fact that economic power is increasingly shifting to emerging markets, as a broader range of consumers are now able to purchase products produced internationally.

In combination with more attractive margins compared to the MNC segment, this trend of a globalised middle market business model has put stress on the trade finance offering of domestic banks, as global competitors are increasingly expanding their target client range. However, some innovative domestic banks are fighting back by financing business and factory relocations (e.g. from Germany to Eastern Europe) in exchange for a broader trade finance/supply chain management mandate.

Looking forward, we believe that banks still have substantial room in better understanding the individual global trade relationships of their clients, starting from the entire supply chain down to their distribution models, adjusting their offering accordingly. In fact, our experience shows that inter-regional trade flows are growing the fastest, and that the ability to cover 5-7 markets allows the capture of ~70% of the relevant revenue potential. However, doing so requires a solid understanding of evolving client needs and respective competitive implications.

Impact on the business model

Apart from the globalisation of corporate business models, incumbents' success in trade finance will be driven by three factors:

- Ability to cope with growth in supply chain finance solutions and hence increased credit requirements as well as the difficulties posed by the Basel II regulatory environment
- Ability to profit from the opening of the value chain and new competitive solutions
- Ability to react smartly in the technology race

Growth in supply chain finance

There has been much enthusiasm about supply chain finance over the last few years. Originally, the need for supply chain finance solutions was driven by the reluctance of MNC buyers to bear the implied costs of L/Cs as well as the continued integration of emerging markets into the world's economy. For example, over the last few years, L/Cs covering Chinese trade flows grew by 5%, compared to a 15% annual growth rate for open account business. Although the current environment shows a countercyclical move towards L/C usage, the long term trend of increased open account business will continue. Yet as a consequence of the open account environment, financial strain on small (emerging markets) suppliers has increased and alternative financing solutions are required.

While every bank defines supply chain differently, it ultimately is “a set of solutions available for financing the goods or products as they move from origin to destination”.

Figure 7: Supply chain



Suppliers typically need funds to finance production, pre-shipment warehousing, and the costs of shipping. The borrowing base for financing improves along the value chain, starting with a purchase order, moving to non-approved and finally approved invoices. Inventory finance, on the other hand, is demanded by buyers/importers, typically with the inventory itself as the borrowing base.

However, the Basel II treatment of these types of loans can be punitive for a secured type of risk:

- For eligible purchased receivables, capital is required for both default and dilution risk
- For default risk, if the bank cannot estimate probability of default (PD) or loss given default (LGD), it must estimate overall expected loss (EL), and then apply 100% LGD (unless it can be shown that claims are all senior)
- Under Advanced IRB, banks that can calculate both PD and LGD have far greater scope for reducing risk weights; however, the lack of data and the bespoke nature of supply chain finance (SCF) make this approach difficult

In fact, many banks need to handle more than 10 different models for trade/supply chain finance solutions. In combination with many MNCs reluctant to provide recourse for financing programs aimed at stabilising their own supply chain and the increased need for shared information between the bank and the participants, effective take up of SCF has been relatively low.

Nevertheless, supply chain finance solutions have in many cases reduced financing costs for suppliers by as much as 5% compared to the alternative of receiving working capital loans or A/R financing from their local banks. As a consequence of the credit crisis we have also seen some corporates lending directly to either their suppliers or their distributors in order to strengthen relationships. While this is based on the current environment where bank's credit spreads are frequently larger than those of cash rich corporates, only the lack of a transparent and effective third party clearing mechanism protects banks from further disintermediation. Hence, banks should begin to fundamentally rework their supply chain offering.

Converging business models

Historically, trade services were provided by four types of players:

- Corporate/transaction banks
- Export agencies
- Credit insurers
- Payments infrastructure providers¹

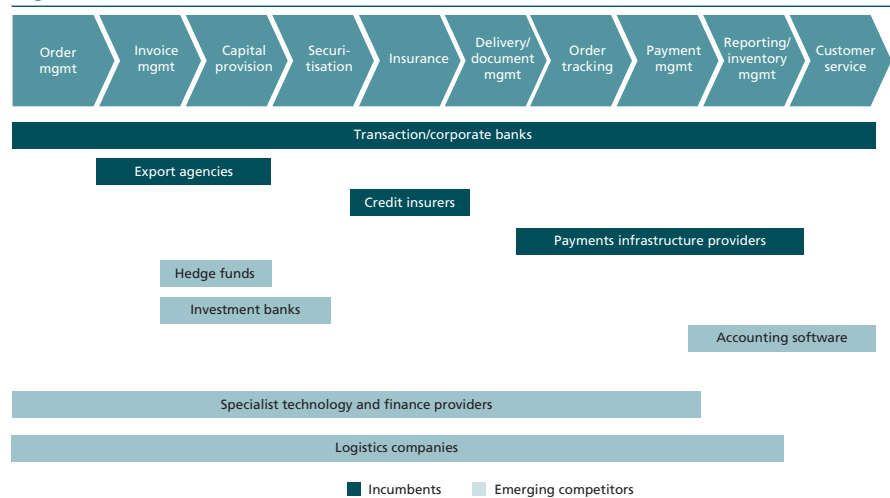
Export agencies intend to foster global trade flows. They can provide financing alternatives to traditional banks, but can also help banks to finance larger transactions by taking a share of the financing.

¹ A detailed discussion of Payments and Cash Management services will be given in Volume 3 of our trilogy report on Transaction Services

Credit insurance provides sellers with protection against their buyer's credit risk. Leading competitors like Coface and Atradius leverage their proprietary data base covering around 50 million corporates, providing them with a substantial information advantage over most banks. While credit insurance can complement a bank's offering by reducing financing cost, receivable financing solutions offered by credit insurers actively compete with a bank's offering. In addition, many credit insurers are also expanding into the corporate value chain by offering receivables management programs (e.g. monitoring changes in clients' payment behaviour, debt collection, and recovery services).

Over the last few years, the value chain has broken up, with a range of new competitors emerging:

Figure 8: Trade finance value chain



Before the credit crunch, investment banks were becoming increasingly involved in trade finance, applying credit facilitation, but offering fairly limited adjacent services. Also hedge funds had shown an increasing engagement in the trade finance business, led by two main factors:

- The recent surge in commodity prices has not been adequately accompanied with an extension in bank-credit lines
- Hedge funds do not have to comply with the capital requirements for banks established under Basel II, therefore benefiting from cheaper refinancing (future regulation, e.g. leverage restrictions are likely to reduce that advantage). They engage in trade finance as either an arranger or participant in the funding of transactions by providing a direct down-payment or through syndicated loans

While hedge funds will always focus on niche opportunities, understanding the challenges but also the opportunities driven by specialist technology and finance firms as well as logistics players will be key for banks. Figures 9 and 10 give an overview of the range of services emerging:

Figure 9: Specialist technology and finance firms

- Global Supply Chain Finance Ltd. offers a platform that enables the servicing of payables and receivables, including the analysis of credit exposure and the rating of buyer risk. The company works in collaboration with large global financial institutions, including Citibank and IBM Global Finance, to offer comprehensive trade finance services. It finances approximately \$12 BN in annual receivables
- TradeCard is a technology firm which combines on-demand technology, financial services, global trade experts and a trading network to automate trade transactions from procurement through to payment, and to integrate sourcing, finance and logistics. This is achieved through partnerships with many finance and logistics companies
- Ariba Inc., a leading provider of spend management solutions and owner of a large sourcing-supplier network, entered trade finance in 2007 – “a natural outcome” – by teaming up with Orbian, a post shipment and receivables financier, to provide “bank neutral” third party financing to its network members
- Some banks such as Standard Chartered Bank or Banco de Nacion Argentina provide importers and exporters with a credit card. In cooperation with one of the major credit card companies like American Express, the banks can offer their clients immediate credit loans for a defined period

Logistics firms have entered the market on the basis of their high level of information transparency along the physical supply chain, enabling real time access to the status of goods and reducing the possibility of discrepancies which can result in refusal or delay of payment. This can be leveraged to assess financial risk in a more sophisticated fashion, often leading to lower-cost financing for the parties involved along the supply chain. Due to their technological advantage, logistics companies now stand to profit, either as independent players or by providing infrastructure to banks.

Figure 10: Logistics companies

- In 2005, JP Morgan acquired Vastera, a logistics management provider, becoming the first global financial institution able to offer clients a “one stop shop” for their trade finance and management needs by covering both the physical and financial supply chain. This works by leveraging combined expertise on trade, proprietary global trade methodologies and processes, and technology. In 2007, JP Morgan also acquired Xign, enabling them to offer a premier global settlement network
- UPS Capital, the finance arm of UPS, levers its financing capabilities with UPS's logistics solutions in a “synchronised supply chain” so as to provide holistic trade finance solutions
 - UPS Capital targets to be a SCF “translator”, positioned between the logistics provider and the financial services provider, and acting to facilitate the supply chain process through their knowledge of both the logistics and the financial processes involved. By accessing a bank's balance sheet, UPS Capital can achieve more business, while itself participating in lending activities selectively

While handling the logistics link will be challenging for banks, the majority of corporates still look to their banks for advice and as a vital partner in achieving their SCF objectives; in a recent Financial Insights study², 88% of the corporates surveyed believed that in the future they would be equally or more dependent on their bank for their SCF solutions (however, in the car industry, for example, we also see trends of

² gtnews: Trade Finance? It's All About Trade Services, Olivier Berthier, Misys – 04 March 2008

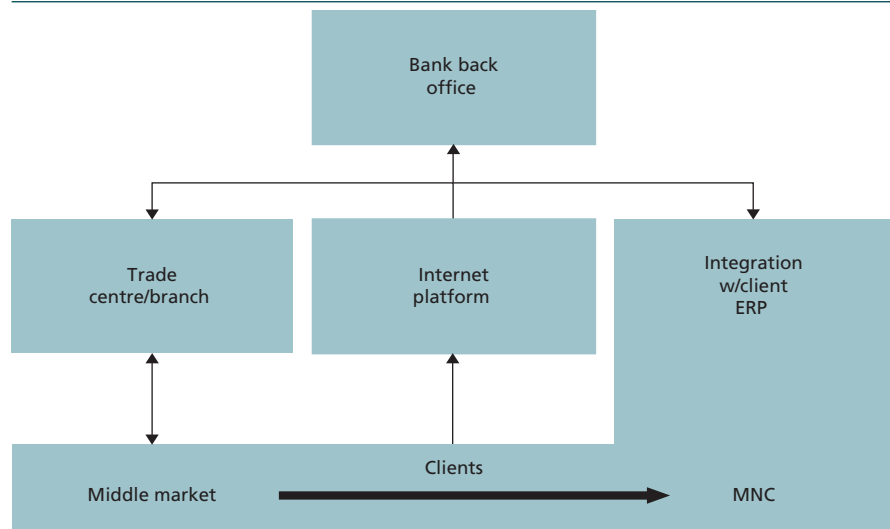
internalising the supply chain). In particular, many corporate clients will look for banks to work as advisory partners and jointly develop initiatives rather than act in a supplier/client relationship.

Technology race

A recent study by the Aite Group found that 33% of US banks surveyed currently offer their corporate customers a web portal for the management of cash and trade finance, and a further 40% plan to implement such a system over the next two years³. In fact, we have observed a technology race in recent years, moving banks' trade offerings online and reducing paper-heavy processes. For some banks the pace of this technological development has resulted in flawed integration to back-office processing platforms (e.g. driven by mismatches of data fields) and therefore poor efficiency.

Things are made worse by the fact that client requirements differ substantially across segments. MNC's typically require seamless integration to their enterprise resource planning (ERP) systems and accounting packages, while middle market firms are open to using their bank's internet based trade platform. In addition many emerging markets firms do not have electronic accounting systems rendering many systems ineffective.

Figure 11: Client interface



³ Aite Group. "Trends in U.S. Cash Management: A Survey of the 50 Largest Banks", February 2008, <http://www.gtnews.com/article/7186.cfm>

To provide clients with the levels of IT integration they now demand, links are emerging between banks and information technology companies. Even the largest banks are now relying on the technology of third party suppliers, often after failing to make sufficient progress using their own in-house platform.

Furthermore, as corporates are looking to implement straight-through-processing (STP), there has been a paradigm shift away from banks offering bank centric proprietary online platforms, towards collaborative multi-bank platforms. Developed by technology companies, these platforms place the corporate at the centre of the supply chain and provide end-to-end links to all partner banks.

Among the significant technological developments focused on open account transactions has been the SWIFT Trade Services Utility – the first industry-wide centralised collaborative bank-to-bank data matching system and workflow engine, developed by a number of financial institutions working with SWIFT. The premise is based on both collaboration and competition; all banks can use the standard platform to offer clients a more efficient trade finance service, but can also individually build on the basic functionality to provide offerings that will enhance their own product suite and allow them to be involved over a larger part of the supply chain.

We believe that such functionality will cover a broader working capital perspective:

- Offering holistic cash management solutions (integrated with payments and trade finance)
- Combining trade finance solutions with FX, including CLS
- Expanding the scope of the platform to include securities servicing
- Offering more bespoke solutions, e.g. involving multiple parties or multiple trades linked together, and risk hedging via derivatives

As leading competitors have invested amounts ranging from \$20 to \$70 MM to modernise their platforms, smaller competitors should increasingly look for white label solutions. Such a deal can also be part of a larger outsourcing deal covering back-office processing and/or securities servicing and should always focus on freeing up time for client relationship management.

Focus on business operations

While understanding global trade flows, changing client needs and emerging competitor models are important to strategically position the business, substantial value lies in optimising the business model – particularly in terms of efficient operations, having a client-focused organisational setup, fostering cross-selling with other corporate and private banking services, and following best-in-class risk management.

Operations

Improving operational efficiency initiatives typically focus on reducing costs. While we believe that most banks still have substantial potential to do so in the back office, the story is altogether different for the front and middle office.

Figure 12: Business optimisation impact

	Main functions	Areas of improvement	Upside
FO	<ul style="list-style-type: none"> ■ Sales, relationship maintenance 	<ul style="list-style-type: none"> ■ Level of cross-selling by RM ■ Ensuring incentive system enforces the above 	<ul style="list-style-type: none"> ■ ~25% revenues improvement
MO	<ul style="list-style-type: none"> ■ Customer service operations, Credit processing, Discrepancy approval, Compliance 	<ul style="list-style-type: none"> ■ Optimised level of centralisation ■ Develop systems and practices to minimise operational risk 	<ul style="list-style-type: none"> ■ ~5% reduction in CIR
BO	<ul style="list-style-type: none"> ■ Controls and settlement processes 	<ul style="list-style-type: none"> ■ Improve efficiency of processing ■ Possible further centralisation ■ Geographical placement ■ Integration with IT platform 	<ul style="list-style-type: none"> ■ Up to 30% reduction in BO cost/transaction

Source: Oliver Wyman proprietary data and analysis

Our experience shows that front-office efficiency in terms of revenue improvement can be increased by as much as 25%. This is primarily driven by increased client proximity requiring relationship managers (RM) to spend more of their time on-site with their clients (our benchmarks show that more than 15% of RM's time can be freed up for client facing activities) and the following supporting measures:

- Backing RMs with specialist trade finance sales people
- Actively promoting cross-selling efforts and adjusting incentives accordingly
- Detailed business planning at a client level with specific product targets rather than just global client budgets

Compared to the back office, middle-office operations at most banks tend to be relatively lean. The key focus on improving efficiency should lie in reducing operational risk, which is largely documentation risk.

Finally, streamlining of back-office operations has a substantial impact on business profitability. Traditionally, back-office activities were driven by a high degree of manual processing. Hence the automation of trade operations has been identified as a key source for increased operational efficiency, including:

- Reengineering and optimisation of processing trade finance transactions (e.g. applying predefined levels of manual controls depending on the type and size of the transaction)
- Front to back IT integration, with data capture initiated through a web based graphical user interface
- Direct and faster access to trade transaction data across different locations
- Consolidation of processing centres

Organisation

In terms of organisation, banks need to answer two critical questions:

- How to facilitate cross-sell?
- How to foster efficiency in processing?

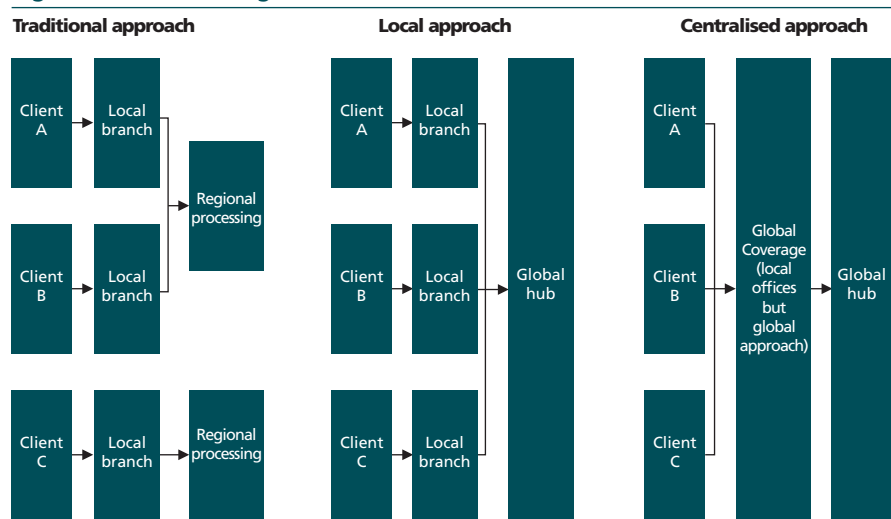
Global competitors have historically run their trade finance business out of a GTB (Global Transaction Banking) unit, covering Securities Servicing, Trade Finance and PCM (Payments and Cash Management). More domestic players, on the other hand, frequently manage Trade Finance out of the Corporate Banking business unit, with TF operations and pure payment transaction management typically provided by the back office. Our experience shows that banks which have integrated client coverage and operations achieve much higher scores on client satisfaction surveys. Secondly, the growing importance of open account business makes the link to PCM much more important. In fact, as outlined above, many banks offer integrated online transaction banking solutions, ideally also accounting for FX.

Apart from FX, private banking is a critical area of cross-selling, particularly for the traders segment in commodity trade finance. While still neglected by many, leading banks achieve more than 70% of incremental revenues on top of trade finance revenues.

In terms of efficient processing, traditional trade finance remains a labour intensive business, despite recent automation initiatives. From that background various organisational models have emerged that aim

to improve operational efficiency. We do not see any one of the models discussed below as naturally superior, as the organisational model should always be an outcome of the overall corporate banking strategy.

Figure 13: Process organisation



The traditional approach is built on local coverage of each client with processing done on a regional basis. This approach tries to achieve the benefits from local client coverage, while simultaneously achieving some economies of scale. In fact we have seen that, in countries such as Germany, a range of second tier competitors have further centralised the number of regional processing centres over the last few years.

The local approach can be extremely flexible and responsive to the needs of both large and SME clients, as staff are familiar with local clients' business needs and can offer more tailored services. In addition, local language capability to handle paper documents efficiently is particularly important in markets such as China or India. Finally, a retail branch strategy allows banks to take advantage of low labour costs in emerging markets whereas decentralisation makes it harder to manage operational risks and to maintain a global client view.

A fully centralised approach is primarily applied by large Universals and Tier I specialist institutions. It is clearly the most efficient and cost effective method of trade processing. However, there are significant challenges in handling the rapidly increasing BO-staff costs and required IT investments (e.g. for document imaging), loss of local client proximity and the need for multiple language and products expertise in the global coverage. Centralised processing requires strong central headquarters setting the rules and standards for business processing. Since country specific adaptations have to be minimised and centrally controlled, introducing a single BO is often implemented against regional objections.

In summary, we believe that centralisation in low labour cost locations comes with higher risks for a moderate reward. High staff turnover and relative inexperience lead to increased operational risks and client frustration. In addition, strong demand for outsourcing services has led salaries in Indian processing centres to increase by more than 30% over the last two years, with further rises expected going forward.

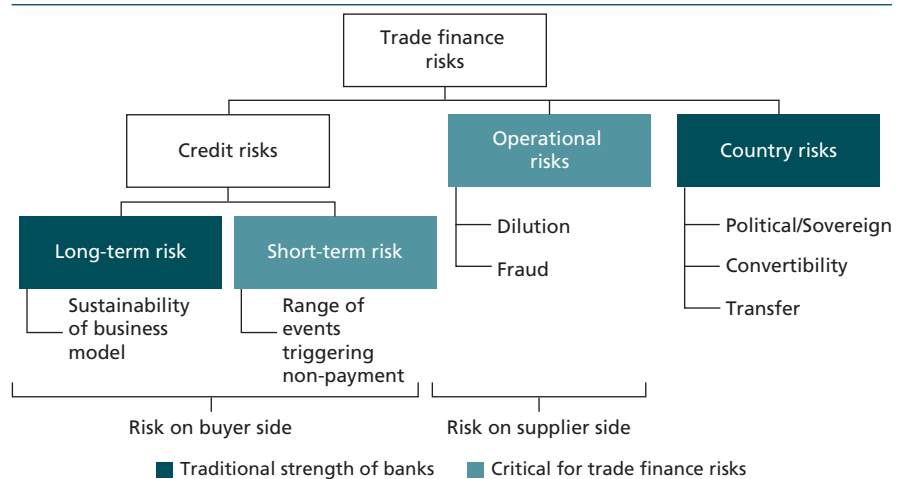
Risk management

From our work with trade finance banks we consider a systematic approach to risk management as the most evident area for improvement. Three areas are of particular importance:

- Fully understanding the nature and causes of risks in trade receivables
- Assessing counterparty bank risk
- Using a syndication desk to better handle country limits and further diversify the portfolio

Many incumbents do not sufficiently reflect upon the fact that long-term credit ratings are a poor proxy for evaluating the risk of trade receivables. Long-term credit risk pertains to the business model and its long-term viability whereas short-term risk predominantly depends on a range of trigger events which may cause non-payment.

Figure 14: Trade finance risk



Source: Oliver Wyman

Also, operational risk is of importance. Particularly when banks only rely on information provided by the seller, fraud risk is high. In addition, there is dilution risk caused by contractual disputes between the seller and the buyer. State-of-the-art risk management provides transparency in the supply chain by reconciling buyer and seller information, which for example depends on confirmation from the buyer's side that invoices are not contractually disputed⁴.

⁴ Also see "Trade Receivables Risk: An Insider Perspective", GARP, 2007

Secondly, we believe that many mid-tier banks should improve the assessment of the counterparty bank risk in an export L/C transaction. Traditional risk assessment and hence pricing typically focuses on the country risk of the counterparty bank (particularly when the buyer in a trade finance transaction sits in an emerging market country). While political/sovereign risk is evident, we believe that banks should focus more on assessing the individual counterparty bank's risk profile, not only from a risk management perspective but also from a business perspective (as this can result in competitive advantages driven by more differentiated pricing).

Finally, developing syndication capabilities is critical for domestic banks, as their trade finance portfolio is frequently determined by the export structure of their home country. This typically results in a situation where some country limits are quickly filled up, limiting the ability to service key corporate clients. Syndication capabilities come with two key advantages:

- Gross exposure to key countries can grow above net exposure
- By acquiring risks in the secondary market, the overall portfolio can be further diversified

However, the credit crunch has also led to challenges in the syndication market; earlier in 2008 we saw a discrepancy between primary and secondary markets, as secondary markets have contracted significantly in response to the credit crunch and are consequently asking for higher margins than those found in the primary market. However, fees in the primary market, which typically adjusted more slowly, have now shot up, in some cases by more than 300%.

Nevertheless, diversification benefits achieved through active syndication are a critical driver of the return on equity (ROE) in trade finance. Our experience when working with banks in the areas above show that by addressing all the points discussed, banks can improve ROE by as much as 5 percentage points.

Business models for success

Looking forward, we believe that the global trade finance market will reach a level of ~\$24 BN in revenues by 2012. This implies a growth rate of 5-7%, somewhat lower than the growth rate of ~8% we have seen over the last cycle.

While we believe that supply chain finance solutions will grow further in importance, we have a mixed outlook for other trade products:

- The global economy is likely to turn into a recession, reducing global trade volumes. However, that is compensated by higher margins (but also higher risks)
- A weak economy will also have a negative impact on commodity prices and hence financing volumes, as currently seen in the decay of the oil price. However, in the mid term, particularly Asia's demand for commodities remains strong
- The long term trend of increasing open account business will continue, although the increased risk awareness will have some positive impact on L/C usage in the short term

As we have discussed above, understanding the strategic imperatives in the trade finance market and efficiently managing the business will be key determinants of success across the board. Nevertheless, we see particular value in four distinct business models.

Global supply chain managers

The global banks, particularly those with a strong foothold in Asia, have a natural advantage. They have the scale necessary for investments in people and technology as well as the global reach enabling them to capture both sides of a trade.

Focal points going forward for these players are:

- Increased targeting of middle market clients
- Further penetration of clients' supply chains
- Continued emerging markets expansion (leveraging their broad network)
- Foster a climate of innovation and smartly integrate start-ups to remain at the edge of innovation

As middle market corporates further globalise their operations both in terms of sourcing and distribution they are increasingly open to having their trade finance needs serviced by a more global player which can offer

a product and expertise scope not matched by regional banks. Global banks should actively move to service such needs, especially as there is a growing awareness that the credit risk associated with middle market firms is much lower than historically assumed. However, the key challenge lies in getting the cost and service model right (not all services/levels of customisation can be economically offered to the middle market).

Actively targeting supply and distribution chains of MNC clients will be crucial for stemming the decline in traditional trade finance products. This requires, for example, convincing MNCs of the benefits in stabilising their supply chain with buyer-backed finance programs, and in some cases even avoiding bank disintermediation.

The biggest risk for globals is to lose sight of innovation and overestimating their advantage as financiers. From that background we believe that the most successful globals will excel at acquiring and integrating specialist expertise, particularly in the field of technology.

Specialists and innovators

There are a number of banks in trade finance that have developed very specific business models. What many of these have in common is a niche strategy which leverages a deep industry expertise to offer competitively priced and flexible trade finance products and players that have managed to creatively cross-sell or utilise their suite of trade finance products.

Examples of this category include Garanti Bank's focus on the steel industry, Rabobank's focus on agricultural products and Wells Fargo's JV with Cargill for accessing agricultural expertise. For continued success of such models it is imperative that players maintain their focus on harnessing industry expertise and further develop sophistication of products and internal risk management.

Chinese banks will increasingly look to secure a piece of the global trade bonanza as manufacturers move downstream and abroad. We expect a number of integrated houses to emerge focused on trade and logistics. The challenge for these players will be to master downstream risk management and the volatility inherent in the specialist's business model.

Technology and logistics firms are also set to see further growth in trade finance if they focus on increasing transparency along the value chain and better link buyer's and seller's information. On the back of this we believe that innovative banks which develop more trigger based financing models (the risk decreases along the chain from shipping to delivering) are likely to see strong revenue growth.

In fact, we believe that the highest risk for bank disintermediation could come from joint ventures of logistic firms with credit insurers. While the former bring their information capabilities to the table, the latter are advantaged over banks as they essentially only capitalise default but not credit migration risk.

Finally, despite the current market turmoil and restricted leverage opportunities, we see room for hedge funds, as trade receivables risk are comparatively low risk and correlation figures with other asset classes look relatively attractive. While most of the funds we have seen in the market focus on silent participations, allowing them to outsource operations, some hedge funds are now moving into the primary space (in areas where the managers have specific industry expertise), typically focusing on warehouse and receivables financing.

Processors and in-sourcers

Banks focusing on in-sourcing processes are also well equipped to succeed in the evolving trade finance landscape, while players with insufficient scale will be increasingly willing to outsource.

We also see value in a processor model which enables the automation of the end-to-end communication for both importers and exporters. A processor therefore provides an electronic multi-banking channel solution for corporate customers, while at the same time offering a separate multi-corporate electronic channel for each bank, thereby preventing both communities from needing to support multiple bank and/or corporate specific processes, interfaces and data formats.

Best-practice operational risk management and the ability to continuously invest in the business will be the most critical aspect for winning client confidence and hence, long term success.

Defenders

As outlined above, trade finance is a secondary product, allowing trade finance banks to penetrate long term core banking relationships of corporate customers. Defenders realise the risk of continued client erosion as specialists or more global banks enter the relationship. They should therefore focus their efforts on relationship management and analytics and seek efficiency in the middle and back office, potentially via outsourcing.

We also believe that a number of strategic partnerships of mid-tier European banks with emerging market banks will ensue over the next few years. This would particularly allow European banks to better follow their clients by accessing the know-how and local expertise of their partner bank.

Figure 15: Summary value framework

Players	Strategy	Upside	Considerations
Globals	<ul style="list-style-type: none"> ■ Target middle market ■ Penetrate supply chain for opportunities ■ Continue expansion of EM coverage to capture growing non-OECD trade 	<ul style="list-style-type: none"> ■ Double revenues over five year horizon 	<ul style="list-style-type: none"> ■ Can middle market needs be profitably serviced? ■ How can supply chain be captured and kept even if a client switches suppliers? ■ What is the critical mass of business opportunity needed to justify market expansion?
Specialists and Inventors	<ul style="list-style-type: none"> ■ Focus on areas of strength to capture market share and further develop successful product portfolio ■ Examples: <ul style="list-style-type: none"> - Hedge Funds - Credit insurers - Non-banks 	<ul style="list-style-type: none"> ■ Varying according to focus 	<ul style="list-style-type: none"> ■ How do you develop/expand product offering? ■ Can expertise be leveraged to adjacent client sectors? ■ Can geographical expansion be of significant benefit? ■ How to maintain high levels of flexibility?
Processors and In-sourcers	<ul style="list-style-type: none"> ■ Focus on capacity for in-sourcing processing and documentation steps to capture increased rationalisation by sub-scale banks 	<ul style="list-style-type: none"> ■ Emerging revenue potential of \$1-3 BN 	<ul style="list-style-type: none"> ■ How can op risk sophistication be balanced with the drive for scale? ■ How do you ensure that your IT platform is flexible enough to capture widest scope of product types?
Defenders	<ul style="list-style-type: none"> ■ Focus on relationship management and middle- and back-office rationalisation as well as cross-selling of adjacent products 	<ul style="list-style-type: none"> ■ Up to 20% reduction in variable costs 	<ul style="list-style-type: none"> ■ What is the extent of outsourcing possible which still enables an attractive service to TF clients? ■ Are there cross-selling opportunities not currently captured?

Hence challenging but interesting times are ahead of us in the trade finance industry. Only those players willing and able to rethink their strategy and operation models now have a chance at success. These players must address the following key questions:

- Which markets/client segments should we focus on?
- Where do we play on our own and where do we use alliances, JVs and outsourcing to cope with global demand?
- How should we manage risk and allocate respective capital?
- How will we win, retain and incentivise talent?
- How will we achieve the right level of operational industrialisation?
- How will we reap cross-division synergies and cross-sell potentials?

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