

Tough choices for Canadian banks



Canadian banks have rarely been seen at the forefront of trade finance developments, but with both domestic and global competition becoming tough, they are now picking up the pace, writes Rebecca Spong.

Canada's trade banks are facing some difficult decisions over how to maintain and develop their trade finance products. The Canadian market has remained fairly stable, but, to a certain extent, it has been lacking innovation. Alexander Malaket, principal at Opus Advisory Services, based in Toronto remarks: "The Canadian banks as a group are not particularly 'out front' in terms of supply chain finance, or indeed innovation in the trade finance space, but they are working to keep pace."

Yet patterns in Canadian trade and financing methods are rapidly evolving, and the banking sector will need to decide whether to adapt or retreat entirely from the market. Around 80% of Canada's trade is conducted with the US, and most of this is now conducted on an open account unsecured basis. This development has the potential to push the banks out of the finance supply chain, unless they create a means of still adding some kind of value to a trade transaction.

The decline of traditional trade products is a theme echoed across the globe, not just in Canada. A new trade finance survey from the association for financial professionals (AFP), and sponsored by Canadian bank Scotiabank, reports that organisations that use open account methods usually use it as their primary method of trade finance. In total, companies use open account for nearly 47% of their trade activity, while just 36% of their trade transactions use letters of credit.

Not only are financing tools changing, but the general economic and trade outlook for Canada is also looking relatively gloomy. The Bank of Canada issued a report in October predicting reduced economic growth for Canada. It blames defaults in the US subprime mortgage market for weakening US demand, and also predicts the unexpected strength of the Canadian dollar will cause a "significant drag" on Canadian exports.

"Canadian banks will need to make

decisions about their level of interest, risk tolerance and commitment and commitment to the business of international trade finance. Canadian banks, as a whole do not have the capabilities to sustain a global footprint, and will need to devise some creative strategies to remain relevant over the long term," observes Malaket.

A place for traditional products?

Despite the majority of exports heading across the border to the US, trade between Canada and the emerging markets is rising, and to a certain extent it is providing banks with an outlet for their traditional trade finance tools such as letters of credit.

"The majority of our LC business is conducted with emerging markets. Our longer-term structured finance transactions tend to be conducted in markets in Central and Eastern Europe, such as Turkey or Kazakhstan, and in Asia, including India," comments Charles Attard, vice-president of structured trade finance, at Toronto-Dominion Securities, part of the TD Financial Group.

Allen Barabas, head of global transaction solutions at Royal Bank of Canada, adds: "If you have your biggest trading partner south of the border whom you trade over 90% of your exports, and the culture of the country is similar to yours and the laws are more or less tied into yours and you have entered into a bilateral trade agreement under Nafta eliminating barriers and tariffs it becomes more or less transparent to deal with. You deal on an open account and don't use as many trade finance instruments and products.

"On the other hand you will deal with countries from whom you buy raw material and semi-finished/finished goods and who need trade instruments to sell you products therefore you rely on trade finance products and services."

Statistics from Canada's department of foreign affairs and international trade have demonstrated that exports to the emerging

markets are growing at a far faster pace than trade with the US.

In August, US\$29.163mn-worth of export business with the US was recorded. A significant amount of business, but it was a decrease of 1.9% compared to the previous month's statistics, as well as a decline of 3.2% compared to August 2006 figures. In comparison, exports to markets outside the EU, Japan and the US reached US\$5.186bn, declining by 1.1% compared to the previous month.

However, it represented 17.8% of growth compared to business recorded in August 2006.

In turn the Canadian banks are following their exporters. "We are very active in trade finance in the so-called Bric countries, and also have a significant presence in Mexico where Scotiabank is the sixth largest bank," remarks Alberta Cefis, executive vice-president and group head, global transaction banking at Scotiabank. In August Scotiabank also expanded its presence in the Chilean market, after agreeing to purchase 79% of Banco del Desarrollo for US\$810mn, with the intention to purchase up to 100% of the bank.

Inevitable trends

Yet, emerging markets may soon no longer be an outlet for traditional trade products, with the AFP survey suggesting the long-term use of letters of credit in these regions may not be as entrenched as once thought. It predicts that business in China and India is likely to involve an increasing proportion of trade transactions carried out on an open account basis.

It reports that 57% of transactions for those organisations that conduct business in China do so via open account, compared to 29% of transactions that are conducted via letters of credit. It also reports that 42% of organisations that trade with China expect their use of open accounts to grow, while just over a quarter expect to increase their use of letters of credit and just 14% believe they will need to increase their use of guarantees.

Looking across at the Indian market, the survey reports that 48% of organisations trading in India expect their use of open accounts to rise, while just under a third predict their use of letters of credit to grow and only 9% forecast any hike in the use of guarantees.

Convergence of product lines

The AFP report suggests that rather than acting as a safe hold for letters of credit, the emerging markets are helping shape complex new global supply chains.

Scotiabank's Cefis observes: "In addition to the flow of finished goods and services, the globalisation of production sources is leading to increased trade of raw materials



Fitzsimmons at BMO Markets:
Creative thinking

parts that are being traded several times before they become finished goods.

"The challenge and opportunity for trade finance providers is to understand this new dynamic."

One tactic adopted by Canadian banks to ensure their product offerings can support the new demands of a globalised supply chain is to converge and consolidate their business lines.

Scotiabank is probably the Canadian pioneer in this field, being the first bank in the country to establish a global transaction banking (GTB) division, through which it integrated its various products such trade finance, cash management, payments, foreign exchange, and correspondent banking products and services.

A number of other banks followed suit, including Toronto-Dominion Securities which also has an integrated global transaction services division.

Technological developments

Implementing the necessary technology is essential to Canadian banks wanting to support Canada-US trade flows, and Canada-emerging markets trade.

"CIBC believes that having a product solution in the area of supply chain financing is mandatory in trade finance business these days," remarks Silvia Brudar, head of financial institutions at CIBC.

She adds: "If you talk to any of the other Canadian banks active in the trade market, they will likely all report that they are developing some method of supporting open account trade transactions.

"There are a few options available to us, we can either buy the necessary supply chain finance software and a vendor-based solution, or partner up with another global bank that has an international footprint and a platform. You can also develop your own product that not only serves as a vehicle for the transfer of information, but also provides the financing capability, a solution that therefore supports both the physical and financing aspects of the supply chain."

Several years ago, in an effort to make operations more cost-efficient CIBC decided to outsource some of its trade banking operations. The arrangement was only a partial outsourcing, covering credit and standbys, and the bank remains highly active in other fields of trade finance.

Outsourcing trade transaction processing is something the Canadian market might soon have to consider very seriously.

"Given the size of the market in Canada, and the operating scale and cost base of the banks here, it would be reasonable to believe that outsourcing operations is a serious consideration, and will become more compelling as the capabilities of providers continue to improve. Whether certain banks will look at outsourcing as a strategic option, or whether market realities will force them to do so, the question is a very real one," she suggests.

Platforms and partnerships

BMO Capital Markets is one of those banks which has looked to partner with other banks, and share processing capabilities. In 2001, it founded the Proponix platform along with Barclays and ANZ.

It was originally a joint venture company which offered trade finance services to banks wanting to outsource their operations. It acts as a web-based global trade finance platform that integrates transaction processing, web-based reporting and a corporate trade portal, all of

GTR

which aims to make trade processing more cost efficient.

The platform has now been acquired by CGI, a Canadian technology company, which has maintained the banking practice within the group.

In October during Swift's annual Sibos financial services conference, held in Boston this year, BMO launched a new open account product via the Proponix platform. It is known as 'bank-assisted open account' and is a hybrid between a letter of credit and an open account transaction.

"Technically this is an open account transaction, but we do some form of document checking," remarks Philippa Fitzsimons, director, supply chain and trade solutions at BMO Markets.

Fitzsimons reflects on the decision to set up the Proponix platform: "Like all banks, our volumes for LCs had been in decline, but we did not retrench. We had made a very strategic decision a number of years ago to pursue the Proponix platform, and that coupled with new alliances, has enabled us to do more creative types of trade finance and stay ahead of the curve as the market evolves."

BMO Capital Markets has also just signed up with Swift trade services utility (TSU).

"Our new Proponix enhancements will be compatible with the TSU enabling communication back and forth with the TSU to maximise the potential benefits," Fitzsimons explains.

She adds: "The beauty with all these initiatives, whether it is payables financing for a large corporate buyer, or receivables discounting for a large corporate or mid-market supplier, is that we can load all of this data on to the Proponix platform. In turn, this information will be available on our front-end portal, so that our clients will be able to get comprehensive reporting on all of their trade activities, including collections and open account financing." Also during Sibos, Citi announced it had signed a collaboration agreement with CGI to jointly market trade services processing and technology infrastructure by linking up Citi's established global trade finance capabilities with the Proponix technological platform.

US bank TD Banknorth, the wholly-owned subsidiary of The Toronto-Dominion Bank in Toronto, has followed suit and

announced a partnership with Citi. It has appointed the global bank to provide an Asian re-issuance processing service for its commercial letters of credit in the region. By tying up with Citi, TD BankNorth aims to take advantage of Citi's document checking and processing services based in the bank's trade operations centre in Penang, Malaysia.

Connecting to the core

Scotiabank is also working to develop cost efficient technological solutions for its clients, and is developing its own technological platform to support the needs of clients within its core regions of Canada, the US and Mexico.

It is creating a Nafta platform that will provide the bank's clients with integrated cross-border cash management, trade finance and FX capabilities for Canada,

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Mexico and the US. "We will gradually extend this platform to other regions to provide a more robust global offering for our customers that increasingly more integrated international banking requirements," Cefis at Scotiabank explains.

The bank's GTS unit, in conjunction with its subsidiary Scotia Capital, has just taken one step closer to consolidating its product offerings, after having launched its new US-based services, covering cash management and payment services at the end of October.

The new product is now available to Scotiabank's corporate and commercial clients across the US, allowing them access to ScotiaConnect electronic banking service for real-time balance and transaction information, among other features.

In an official statement, Cefis comments: "It becomes expensive and inefficient to buy different services in each market, so it has become a worldwide trend to look for financial services providers that can offer global solutions and capabilities wherever they operate."

Mergers and acquisitions

With concerns about how Canadian banks should sustain their trade finance activities given the pressure of a small marketplace, limited deal pool and increasing global competition, there was much talk a few years ago about the possibility of mergers between Canadian banks as a potential growth strategy.

However, the political world and the general public were at the time not convinced by the proposition, and the lack of enthusiasm for the concept remains and is unlikely to change while a minority government is in power.

But some in the market have suggested that with there being a possibility for an election before the end of the year, the topic could be up for debate again. Yet others believe the interest has permanently waned, as Attard at TD Securities explains: "The will for bank mergers within the Canadian market has declined with banks finding they can grow organically themselves both through domestic expansion and also through acquisitions outside of Canada, thus avoiding the need to merge."

Attard speaks with experience, as the TD Bank Financial Group has completed its acquisition of US bank Commerce Bancorp, having signed a US\$8.5bn transaction at the beginning of October. Through this, the TD group has access to a further 2,000 branches in North America, and becoming the first bank with critical mass in both Canadian and US markets. This deal follows the group's previous acquisition of another US institution, BankNorth.

On the same day TD Securities announced the acquisition of Commerce Bancorp, RBC also revealed its US\$2.2bn acquisition of RBTT Financial Group based in Trinidad.

These are just further examples of how Canadian banks are trying to employ "creative strategies" to stay relevant in the global trade finance market.