MIT LAUNCHES A COLLATERAL MANAGEMENT SYSTEM FOR TRADE FINANCE

Improvement in Trade Commodity Finance Industry!

MIT looks at the Trade Finance software industry nowadays, and explains why he believes TRAC, MIT's latest system fills a huge gap in the Trade Commodity Finance & Structured Trade Finance arena.

Jean-Luc SPINARDI*

One can observe three major schools of thoughts in terms of Trade Finance and Commodities financing. First there is "balance sheet based financing," a type of "corporate financing" that focuses mainly on companies with a stable and solid financial background, but which require strong working capital to finance their core business. This form of financing usually requires little control once the bank has decided to finance the company, and is based on the corporate capacity to reimburse; in other words, balance sheet analysis is the cornerstone of such a financing method.

Then there is "transactional-based financing," which is not based on a corporate balance sheet, but rather on the goods that are financed; indeed, one of the major characteristics of International Trading companies, except for the large corporate, is their relatively low capitalization. With such method, the banks need to monitor the physical flow of goods since they represent their main collateral. Effectively, transactional-based financing requires a thorough evaluation of risks and an accurate follow-up of transactions financed.

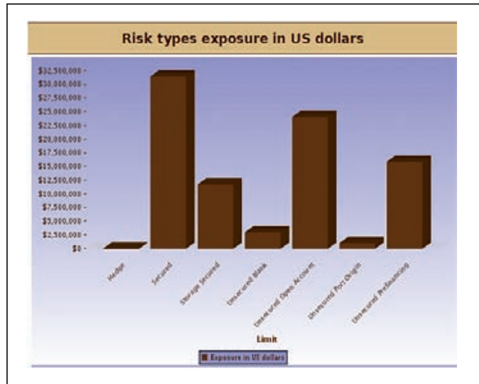
A third form of financing called "structured trade finance" is in fact a mix of the two financing methods explained above. This third method is becoming increasingly common, and represents the future in terms of trade commodity financing. The purpose of such a practice is for banks to back their risks both on collaterals and on a financed company's balance sheet; this very interesting way of financing can be defined as a tailor-made solution for corporate needing financing that depends on the particularities of their activities and their cash-flow. The main difference with transactional-based financing is a stronger balance sheet that allows more complex and "structured" financing.

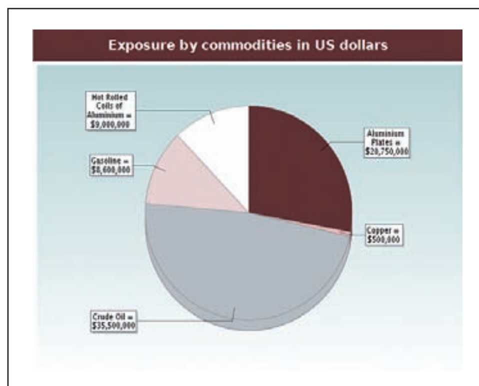
Jean-Luc SPINARDI, Banking Consultant, MIT

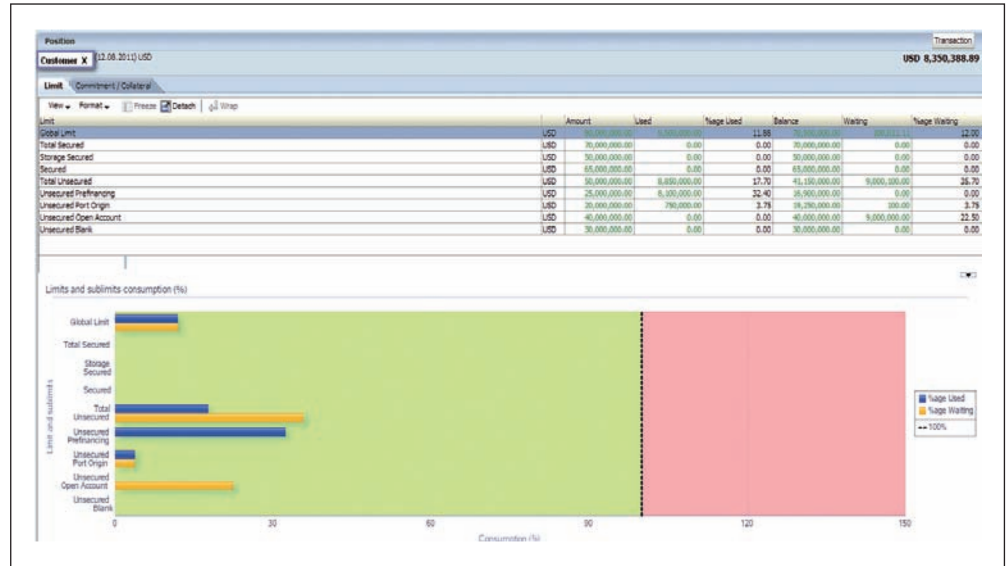
These second and third methods require a vast knowledge of the commodities markets and most of all of the customers seeking financing. In these cases, the risks will be limited in certain types of transactions due to the possession of the Bill of Lading (B/L). Nevertheless, the growing complexity of the financing structures and the increasing demands of the supply chain forces the Banking community to design more complex financing schemes better suited to customers' specific requests. The risks are higher but so are the perspectives of revenues for the Bank.

Current bank needs

Banks specializing in transactional- and structured-based financing, however, need to put in balance several indicators in order to monitor efficiently this activity – more specifically, the scrupulous respect of financing limits set for each customer, the level and type of commitments, the evaluation of its collaterals, and most of all a good comprehension of the different types of risks involved. A bank needs generally to look at several risks. *Customer Risk or "KYC" - Know your Customer:* a bank's relationship manager must know his customer well, and identify whether the skills and professionalism of the latter represent a sufficient guarantee to finance a transaction. *Country risk:* risk is evaluated differently depending on which country the goods are located at a given time, since the fact that goods may transit from one country to another will have a strong impact on the risk calculation and







evaluation. *Market risk or Price risk:* monitoring such risk is fundamental; since goods are the only collateral for the bank, it becomes necessary to follow the price change of commodities. The more volatile the price of a Commodity is, the higher the risk becomes. *Counterpart risk:* banks need to evaluate the risk on counterparts of transactions they are financing; indeed, the second step of a transaction involves a counterpart to which the goods will be sold, and whose payment will serve to reimburse the amount initially financed. *Operational risk:* the bank ought to put in place very strict internal procedures for this activity and make sure their employees follow them rigorously. The set up of such procedures must be accompanied by the implementation of IT solutions designed to apply these procedures in a secure manner, but also to help bankers make quick and rational decisions based on valid data updated in real time.

Basel II and auditors pressure

As a matter of fact, Banks are currently evaluating whether their existing Trade Finance systems are still in phase with today's market standards and with the evolving prerequisites of auditors. In today's current Crisis Climate, one major topic remains on the lips of bankers and software vendors: "How can we improve Risk Management?" And Trade Finance and Commodities financing does not escape from such debate. Furthermore, Basel II regulations oblige banks to look more in-depth at how they evaluate their risks with regards to Trade Finance, since it has repercussions on capital requirements for this activity. If it is true that banks nowadays are more or less well equipped with systems capable of supporting their back-office operations with regards to financial instruments such as *Letters of Credits, Guarantees* and *Collections*, it is not as obviously the case for more complex financing and the monitoring of its allocated credit limits, as well as the management of Collaterals. In this case, the most frequently used tool is an Excel spreadsheet.

The spreadsheet offers great flexibility for relationship managers to follow the evolution of their transactions, and establish the global economic position of a customer at a given time. The position is calculated on the spreadsheet by consolidating data manually coming from heterogeneous sources. *The global economic position* supports the decision making process of a relationship manager or a credit committee, when deciding whether or not to finance. Despite its proven flexibility, a spreadsheet is not sufficiently secure as far as the reliability of the data presented is concerned. On the other hand, this information supports the decision-making process for financing amounts up to seven or eight digits. Therefore, there is an increasing market demand for innovative dashboard tools that can be easily integrated into a bank's IT infrastructure, and that is capable of automating the extraction of data coming from various systems in order synthesise it in a tool capable of presenting a reliable view of a customer's global economic position in real time. This was our goal when we created our new product TRAC-Trade Risk Active Control. ■

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