Emerging market volatility highlights the need for collaboration and digitalisation

Katharina Michael, UniCredit

Significant shifts in trade flows over the past few years have led to greater levels of volatility and risk for those trading with the emerging markets. As a result, corporates are looking for risk mitigation in these regions, but greater levels of digitalisation and collaboration are required to help banks provide trade finance safely and efficiently, says *Katharina Michael*, head of trade finance sales, Germany, at UniCredit.

Changes in trading activity from powerhouse economies such as China and the US have caused trade flows to change considerably over the last three to four years – stoking volatility and risk in the emerging markets. These developments have done little to dampen appetite for emerging market business, however, with corporates simply seeking risk mitigation from their banks to secure their dealings in affected regions.

At the same time, banks are facing their own challenges – with lingering paper-based processes and growing due diligence costs putting a strain on the provision of trade finance and limiting banks' capacity to provide cover for their clients.

These challenges must ultimately be tackled collaboratively – sharing risks, costs and workloads to maximise efficiency, and co-operating to create a comprehensive digital infrastructure for trade finance processes.

Shifting trade flows disturbing emerging markets

Certainly, these measures are vital to keep up with demand from corporates, who are increasingly seeking cover for their emerging market transactions. Indeed, considerable shifts in global trade flows have seen risk levels increase steadily in a number of developing regions – driven particularly by the activities of China and the US.

Africa, for instance – a former key beneficiary of China's rapid rise from producer to consumer – has suffered from the recent dip in the Chinese economy, which has seen major Chinese corporates withdraw funds from large-scale development and infrastructure projects as the economy as a whole scaled back its consumption of raw materials.

Meanwhile, the US, once a larger importer of fossil fuels, has re-emerged as an exporter – with the resultant glut of supply contributing to a dramatic slump in oil prices. This has had a knock-on effect for countries such as Venezuela and Saudi Arabia, where the economy is reliant on oil prices.

These are two of the more notable developments that have seen an increase in emerging market risk – leaving many local corporates with diminished access to finance and greater credit risk to their name.

Corporates seeking cover

This volatility equally poses a challenge for developed market corporates – especially those in countries such as Germany, where exports are the principal drivers of growth. Not only does it increase the chances of counterparty default when trading with emerging markets, it also becomes increasingly difficult to convert and transfer funds from local currencies due to tightening currency control regimes, with few banks prepared to take on the inherent transfer risk.

What's more, it is becoming increasingly difficult to carry out transactions in emerging markets using major freely convertible currencies. Take Nigeria, for example, where banks are allocated US dollars by the central bank. The country's dependence on commodities means that a significant drop in prices has a proportional effect on the dollar budget – with falling prices corresponding to a reduced supply of US dollars. Consequently, corporates often have no choice but to transact in the local currency.

In the face of these challenges, corporates are turning to their banks to provide coverage in volatile regions – mitigating counterparty and transfer risk through trade finance.

Banks facing challenges

Yet banks are now facing challenges of their own when it comes to providing this support. In part, this is due to mounting costs associated with the due diligence process – with banks having to collect thousands of data points on each of their counterparties and correspondent banks.

At the same time, they must also contend with a number of paper-based processes slowing down workflows and incurring further costs. For example, the trade of raw materials – which accounts for the majority of global trade – remains reliant on the bill of lading to assure access to and ownership of transported goods. Consequently, a huge proportion of trade finance activities are hampered by lingering paper documentation.

The same problem affects customs and exports documentation, which also remains paper-based. Even in instances where electronic documents can be generated, the final document must still be printed and sent in paper format – adding days to the processing time.

Eliminating paper-based processes

Certainly, the need for a comprehensive digital infrastructure for trade finance is clear. Yet the creation and implementation of such an infrastructure will, of course, require considerable time and resources, along with the co-operation of the entire industry. For the time being, therefore, this remains a long-term goal.

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In the short term, corporate uptake of digital tools such as the bank payment obligation (BPO), a digitally-compatible bank-mediated settlement method, and the electronic bill of lading (EBL) will be of great advantage to all involved – significantly increasing speed and efficiency in the financing process.

But corporate uptake must be supplemented by a robust offering from banks. UniCredit, for instance, has developed an award-winning digital platform, that enables the entire BPO process to be carried out electronically from baseline to settlement – and other banks must offer similar innovations if paper-based processes are to be eliminated.

Controlling due diligence costs

Digital processes such as the BPO can also help reduce the data-gathering demands of due diligence – consistently generating reliable, standardised data on transactions. Yet these tools have still to reach critical mass, and, in the meantime, banks must come up with other, more immediate solutions. The most effective strategy in this respect is for banks to be carefully selective in their choice of correspondent banks. With due diligence incurring hefty costs for every partner bank, it is critical that each one brings tangible value to clients.

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Though many banks are struggling in this respect, it is undoubtedly a viable task. UniCredit's correspondent network serves as proof of this – having expanded in key areas, including Africa and Southeast Asia, even as other banks have been scaling back their own correspondent operations.

Sustainable rewards

With all these barriers removed, there remains the matter of shouldering the growing risk of corporates' emerging markets business. Collaboration, once more, is the answer – with syndicated loans enabling banks to share the risk and free corporates to continue their operations, even in challenging conditions.

Certainly, today's challenges are necessitating new levels of co-operation in trade finance. Yet drawing together to surmount these challenges is not simply a matter of helping corporates negotiate the volatility of the emerging markets. It is also the blueprint for galvanising the whole trade finance industry – with greater speed and efficiency set to drive profitability and sustainability for years to come.