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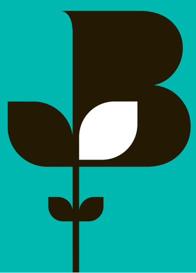

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Risk and risk mitigation in trade finance

Trade finance expert Geoffrey Wynne, of Sullivan & Worcester UK LLP, investigates the uses and risks of trade finance in global markets

Trade finance covers a multitude of transactions. At its simplest, it is the financing of the production, transportation, storage and sale of products. There are many ways to finance all or any part of this process. Sometimes the financing is structured (structured trade and commodity finance) and sometimes it is simply financing a part of the process (trade finance, or even plain vanilla trade finance). Different financial institutions participate in all or some of these areas, generically called trade finance.

There has been an ongoing debate for a number of years as to whether trade finance is relatively risk-free or inherently risky. Regulators have taken the latter view and most recently this was a conclusion of the Financial Conduct Authority (FCA) after its Thematic Review. However, the FCA in that case was looking at Letters of Credit and the practice and procedures of a number of banks. Even at that stage the information was historic since a number of banks had already tightened up their internal procedures. The advice to financial institutions in light of the FCA Guidelines that followed is that sound procedures need to be put in place, training of staff needs to be given and the procedures and the laws and regulations themselves to which they relate need to be fully observed. The failure to observe all of those can be expensive in relation to fines that have been levied recently against financial institutions, particularly in the US.

But this is only part of the story. In trade finance, practitioners think that their structures work well and that consequently trade finance transactions can be carried out in a relatively risk-free environment. However, compliance departments in financial institutions do not necessarily follow this and seem to be much more concerned about the reputation risk that a financial institution might suffer if it participates in transactions with parties and in geographical areas that are potentially subject to sanctions and general anti-money laundering regimes. This is the case even if the party concerned is not itself subject to any of these restrictions.

So what risks are being looked at?

In structuring trade and commodity finance transactions, there used to be two key risk areas that needed to be analysed and dealt with. These were "performance risk" in the emerging market of the prospective borrower who was producing a product that was to be sold; and the "payment risk" of the buyer not paying. There was a third, related risk named "country risk" where the obligors were. All of these risks could be assessed and eliminated, mitigated or transferred. However, following the changes that have come about recently in relation to anti-money laundering, other financial crimes and sanctions in particular, the key risk is now "reputation risk" followed closely by the "financial risk" of paying fines.

Risk analysis

There is no doubt that it is necessary to conduct a full risk analysis of any transaction and the parties directly involved in any transaction. That analysis should deal with the performance risk (or payment risk) for that particular party. Given the increased concerns of Know Your Customer (KYC), financial institutions may be put off with the risks in undertaking transactions in those circumstances. Furthermore, it is now clear that not only is it necessary to perform KYC in relation to the direct parties in a transaction that is being financed, but there is also a requirement to perform KYC on the financial institution's customer's customer. The good news is that the level of KYC in those circumstances is almost certainly not as stringent as for a financial institution's direct customer. However, an awareness of all the parties involved in the transaction is a requirement.

It is no longer the case that a financial institution can look at a transaction and the documents and say "I only need to concern myself with the documents that directly involve me". This used to be a safe harbour when looking at Letters of Credit. Indeed, UCP600 which governs the issuance and payments under Letters of Credit talks about not being concerned with the underlying transaction. It seems clear now that being involved to some extent with the underlying transaction is a requirement to satisfy regulators.

This is important not only for anti-money laundering, sanctions and financial crimes generally, but specifically in relation to the goods that are the subject of the financing. The fact is that there are risks involved in dealing in goods which might be determined to be of "dual use". There would be a perfectly safe use for such goods and a use of the same goods as, for example, explosives etc. However, mitigating that particular risk should not be too difficult in

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that by understanding the parties to the transaction, as well as matters such as quantity and price paid. From this it should be possible to establish whether that particular transaction involves goods being put to a benign rather than a malevolent use. As an extreme example, and given that sugar is a dual use good, it should be possible to work out whether the parties in the transaction are buying and selling sugar for culinary purposes rather than for use in explosives.

Risk mitigation

It is in fact good news to those involved in trade finance that there is a requirement for certain levels of due diligence. This means that those who are expert in assessing risk should be supported in their request for information to satisfy themselves about the legitimacy of a transaction.

By conducting risk analysis and then dealing with a particular risk in whatever way the financial institution sees fit, risks can be mitigated, transferred or indeed accepted. That depends on systems being put in place and having the ability to demonstrate both internally and externally (to the Regulator) that due diligence has indeed been conducted. Putting in the correct systems is part of this.

The real problem is that there appears to be no reward currently for having good systems. It is a fact that those who wish to mislead financial institutions are invariably astute enough to work their way round the systems. If a financial institution has set up the best system it can in the circumstances then certain things should result from that. One is that if the system is beaten by an astute party, any fines levelled against that institution should not be in any way disproportionate. Indeed, there is an argument that says there should not be fines but instead the financial institution should be invited to tighten up its systems still further.

Secondly, and in any event, a financial institution conducting itself with good systems should be given a reward in how it is treated during its business. There is a good way to measure that reward: where a financial institution has set up a strong risk mitigation system, there should be better treatment for its transactions by way of capital relief for its risk capital. It is arguably the most important aspect to address so as to encourage good housekeeping and good structuring. It would then be financially rewarding to structure transactions well and put in good monitoring systems.

The future

It is clear that trade finance is needed to meet the growing needs of the global markets and, in particular, emerging markets. There needs to be an incentive to financial institutions to embark upon trade finance where the parties likely to be involved are legitimate parties. This does mean having a "reward culture" as mentioned above. There should also be a basis where a financial institution can develop a good reputation for its procedures. This reputation needs to be sufficiently well protected that the compliance department of such a financial institution can then safely confirm participation in transactions without the concern about reputation risk. Thus, a transaction may yet go wrong but that should not affect the bank's reputation.

That equally requires the regulators to make positive statements about how they would view a financial institution's performance where it involved itself in trade finance transactions using good systems. The regulators would need to say that that was sufficient mitigation so that such an institution would not be penalised even if a recalcitrant party "slipped through the net".

Reputation is important to a financial institution and the risk of losing that reputation is clearly important. However, proportionality and encouragement need to go hand in hand with the encouragement to finance trade. For trade finance to have a strong future, there must be a sound reward for risk mitigation procedures that are put in place.

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