BREAKING THE COMMODITY TRAP IN TRADE FINANCE

By Sumitra Karthikeyan, Jacopo Meneguzzo, Ian Wachters, Tushar Agarwal, Martin Van den Heuvel, and Frederik Wirtz-Peitz

Trade finance—despite its role as a vital lubricant of the world economy—rarely plays a key role in the profitability of the financial institutions that provide it. More often than not, the banks perceive it as a means to open doors or sweeten deals in order to help them sell more lucrative products.

Shrinking Margins Call for a New Trade Strategy

That image and subordinated role for trade finance needs to evolve quickly. Several trends, including tighter regulation and more intense competition, have pressured the margins of financial institutions to such an extent that only half of the commercial banks BCG tracks globally have returns above 16%, which is the minimum acceptable rate of return (the hurdle rate). This pressure is forcing financial institutions to reexamine the margins that their products and services generate. In their efforts to shore up profitability, banks can no longer afford to use low prices on trade finance as a lever to win deals.

The low-price strategy banks have historically used for trade finance rests on three beliefs:

- Clients perceive trade finance as a commodity, with price as the only differentiator.
- Low prices make cross-selling easier.
- Higher margins from areas such as core lending and cash management will more than offset any margin sacrificed on the cross-selling.

Relatively stable competitive and regulatory environments entrenched these beliefs and reinforced an illusion of success, because the banks had no impetus to change. A low-price strategy makes sense if the "margin math" really works and if prices indeed align with an overall market standard and do not vary based on the nature of the transaction or the customer.

But in today's environment, for most commercial banks, none of those beliefs is jus-

tified anymore. First, our surveys of trade finance clients suggest that trade finance is not a commodity at all. It is a differentiated, value-added product. Clients place value on factors such as the stability of a bank, the extent of its global network, the terms of the trade finance instrument, the service levels of the bank (including response time), and the quality of advice provided by the relationship managers (RMs). These factors are usually compelling enough for clients to pay a fair price for better performance.

Second, the other two beliefs are unsubstantiated. Most banks are unable to track activity dynamically and determine whether their cross-selling efforts are achieving the desired margins. In many cases, banks end up saddled with highly discounted prices on trade finance but only promises from clients and no material business from them to offset the lower margins. Finally, the competitive and regulatory environments have changed significantly. For example, the Basel III declarations from the Bank for International Settlements have both tightened and diversified the capital requirements for banks, relative to their risk-weighted assets.

Transforming trade finance into a profit driver will require a new pricing logic backed by a data-driven and disciplined approach. Such a logic can yield revenue improvements of between 10% and 12% if banks can overcome their entrenched behaviors and realize that their previous beliefs about trade finance are either unproven or outdated. Deep analytics of historical pricing can convince banks that their current behaviors undermine their margins, and that a robust set of pricing tools, incentives, and coaching can change those behaviors, help clients accept the new logic, and improve the banks' financial performance.

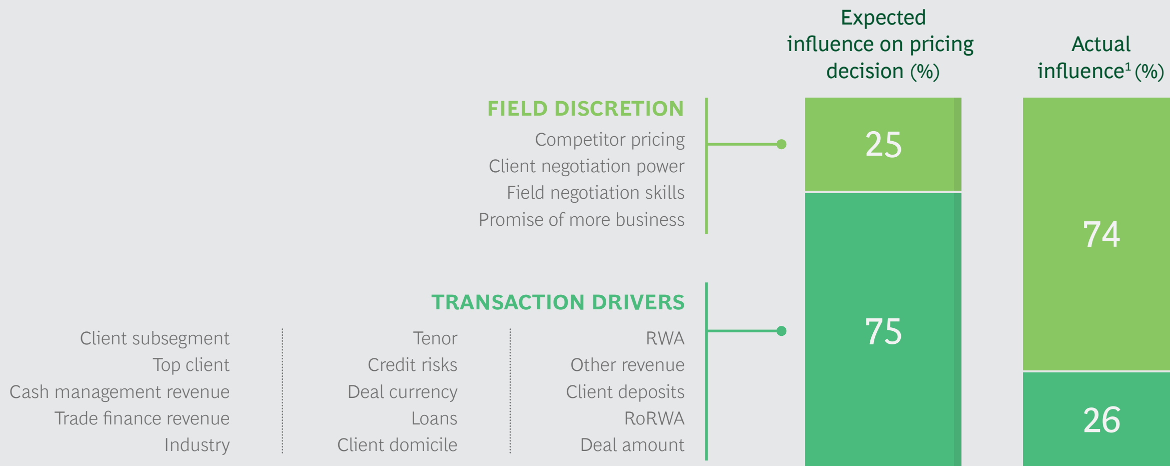
Change Starts with the Pricing Logic

It is logical to expect the price for trade finance instruments to have a strong relationship to the amount of risk involved. The higher the bank's target return is on risk-weighted assets or a similar metric, the higher the price for a trade finance instrument should be. It follows that two seemingly identical transactions—deals with the same trade volume, currency, trade corridors, terms, risk, credit rating, collateralization, and industry—should have very similar prices. But that logic breaks down in practice.

Our quantitative analysis of thousands of existing trade finance deals revealed that the prices for seemingly identical transactions can vary by a factor of three or four. In one case, we analyzed prices along a range of more than 15 risk-related and non-risk-related drivers such as size of deal, total value of the relationship, tenor, and type of collateral. We observed that the drivers explained only about 26% of the discount offered on standard prices. The remaining 74% of the price dispersion resulted from the influence of "field discretion," an amalgamation of clients' negotiating leverage, perceived competitive prices, reactive price-taking behavior on the part of the RMs, and clients' promises of additional business that rarely materialized. In other words, the influence of field (RM) discretion on trade finance prices far outweighs other key factors that should drive pricing decisions (See Exhibit 1.)

The analysis validated the hypothesis that the RMs were applying their own intuition to set prices, almost entirely uncoupled from the underlying risk and other key factors. The primary reason that RMs rely on gut feeling is that they do not trust the risk-based pricing models most banks use. Instead, the RMs establish their own market rates, because they perceive the models to be black boxes whose complexity makes it hard to understand how the inputs affect risk and prices. This mistrust is partially justified. The models usually take only a few variables into account, such as obligor and facility risk and collateral, even though many more variables—such as country risk, currency risk, and tenor—exert a strong influence on the value of a trade finance instrument. Also, the operational cost allocation incorporated into the models often deviates sharply from what is ob-

EXHIBIT 1 | High Field Discretion Limits Banks' Ability to Manage Pricing Effectively



Source: BCG analysis.
Note: RWA = Risk-weighted assets; RoRWA = Return on risk-weighted assets.
[1]Based on regression analyses of trade finance transactions across financial institutions in multiple countries/regions.

served in practice. This means that even when the RMs try to use these tools, they receive ambiguous guidance or outputs that are open to misinterpretation.

In the absence of more rigorous guidance, the banks grant RMs a high level of discretion to set rates. They encourage lower prices by incentivizing the RMs on the volume of business, rather than on the margins the business generates. In some cases, banks also place too much emphasis on rates—reflecting the "risk" part of trade finance instruments—and too little emphasis on fees. RMs frequently discount or even waive fees, surcharges, and similar price elements, either because the fees are not well constructed or because RMs are not sufficiently trained to explain the rationale behind them. Preferential pricing becomes the norm, and clients expect to receive such perks on every deal.

A Robust Toolkit Changes Pricing Behavior

The silver lining is that this problem—the extreme price dispersion caused by RMs acting mostly on their gut feeling—is solvable. Most companies in B2B industries with historically stable markets, a large number of customers, and a large number of transactions show the same kind of pricing dispersion we observe in trade finance.

To change established behaviors and avoid putting their margins at severe risk, commercial banks need to manage the dispersion by implementing a combination of new pricing models and guidance that is much more closely aligned with evolving market conditions and the risks involved. The outputs of the new models are prices that reflect risk and relationship, weighed against the bank's internal hurdles. The new models also provide guidance on client-specific variables that impact pricing, as well as standardized discounts that are relevant to the bank's terms of business and based on individual client profitability. The most effective pricing models are based on detailed analyses, but they also allow for the experience and insights of RMs, especially with respect to factors that affect pricing but are hard to quantify.

For a change in pricing discipline to be effective, RMs need robust pricing tools, as well as the coaching and training necessary to execute against them. One financial institution implemented a list-and-discount system built on a set of risk-weighted price targets for each country-product combination. Those targets effectively serve as client-in-

dependent list prices, in the spirit of a more advanced approach to pricing logic. The client-specific discounts depend on several drivers, similar to the ones noted earlier.

This new system also defines RM discretion in a standardized way. Each RM retains the latitude to discount prices by up to a certain percentage beyond the standard discounts. But any request for a discount in excess of these limits is now subject to a set of escalation procedures. The RMs still maintain some personal control over pricing, but within ranges that protect the overall goals of the institution. To prevent the RMs from defaulting to the lowest allowable prices under the new model, the bank also changed its incentives. By rewarding the RMs for price realization—a proxy for higher margins—and not solely for the amount of business they write, the bank gives RMs an incentive to trust and implement the guidance from the new tools.

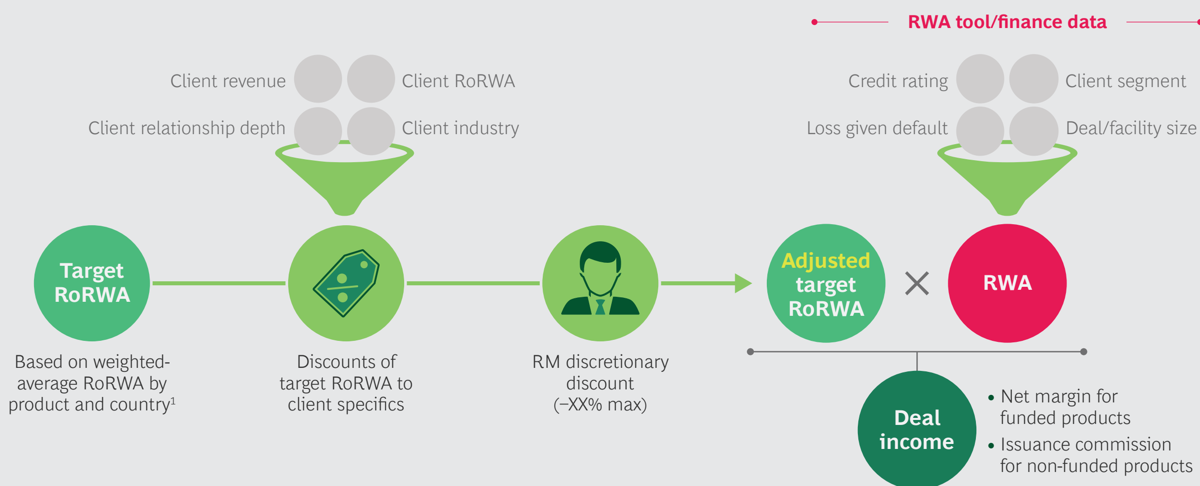
This approach shifts the emphasis toward what clients are willing to pay and away from field discretion that is informed in large part by competitors' prices or by perceived price elasticity. (See Exhibit 2.) The tool that supports this approach allows the RMs to set prices dynamically. Similar clients in similar situations pay similar prices, and each client's price point has a clear and defensible rationale.

The implementation of a more data-driven pricing system thus makes pricing fairer and more transparent, but not necessarily higher. In general, the vast majority of prices move higher after implementation of the new tool, but some prices stay the same, either for strategic reasons or because the prices were already fair. The few cases in which clients' previous prices were too high helped expose situations where the bank faced potential challenges with client retention. The new system also offers banks a better mechanism to raise prices. Rather than pursuing an across-the-board price increase, institutions can now optimize prices client by client.

Logic and Transparency Overcome Resistance

The three beliefs noted at the outset are universal, not specific to any country or region. With one client based in Asia, we observed a strong belief that midsize and large companies in its region are so price sensitive that any attempts to change or raise prices would cause substantial attrition. Our analysis and field observation revealed that this insecurity among RMs was unfounded and that the resulting steep discounts were unnecessary. Given the volatility of rates in the region, the bank's clients were well aware that they had received bargain rates. Modest, well-communicated rate

EXHIBIT 2 | The Pricing Tool's Logic Is Based on RoRWA Plus Adjustments



Source: BCG analysis.
Note: RWA = Risk-weighted assets; RoRWA = Return on risk-weighted assets.
[1]Adjusted for client and RM discretionary discounts.

increases encountered little or no resistance. In a region focused on aggressive growth, the value of an existing banking relationship trumps marginal price differences.

For a client in another country, the tool and the new procedures initially met internal resistance. In this case, the bank overcame that resistance by involving the RMs in the development stage, providing hands-on coaching, conducting live pilots, and implementing rigorous tracking. These measures helped the RMs understand that the new prices have a strong rationale and are transparent. They also reinforced the fact that the RMs still maintain meaningful, material discretion in setting prices.

RMs eventually welcomed the tool and guidance, because they no longer needed to rely on guesswork. When they explained the logic of the new rates to clients, most accepted them. The tool enabled RMs to shift the pricing discussion to a more objective and logical basis. Many of this bank's clients were not surprised to hear that they had been receiving extremely low prices relative to the volume of business they generated. Those that resisted the new prices were often open to broader conversations that led either to a partial price increase or to other cross-sell opportunities.

Ultimately, the new tools reinforce a fundamental and necessary change in perception regarding the pricing of trade finance instruments. Challenged by changes in their customer, competitive, and regulatory landscapes, banks are moving away from the old view of trade finance as a loss leader and are now treating trade finance as a strategic product and valuable contributor to the bank's profitability.

Long thought of as a commodity to build relationships, trade finance has significant, latent profit potential that commercial banks are now unlocking with a new, balanced approach to pricing. They are implementing tools and guidance that enable better pricing decisions, without marginalizing the role of their RMs.

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