DIGITISATION
A BUSINESS CASE

MIDDLE EASTERN BANKS CAN TAKE THE LEAD IN TRANSACTION BANKING INNOVATION, SAYS SUMIT AGGARWAL

Transaction banking is experiencing unprecedented change, both in terms of transaction structures and technological innovation. The trade finance proposition of tomorrow will look very different to that of today. Having established itself at the centre of emerging-market trade, the Middle East is well-placed to spearhead the transaction banking industry's innovative future.

'Conventional' transaction banking offerings are gradually shifting towards customised solutions. Corporate treasurers demand structured solutions to their – and their suppliers' – unique problems, involving a variety of financing options that will evolve further as technologies such as blockchain redefine what's possible. Certainly, technology has the potential to fundamentally change how banks go about their role of satisfying corporates' needs.

Structured trade growth

In terms of shifting landscapes, the move towards open account trading from that based on traditional letters of credit has been under way over the past decade. Moreover, there is an increased focus on improving the efficiency of transactions conducted on an open account basis, with efforts under way to develop seamless processing and end-to-end financing for clients.

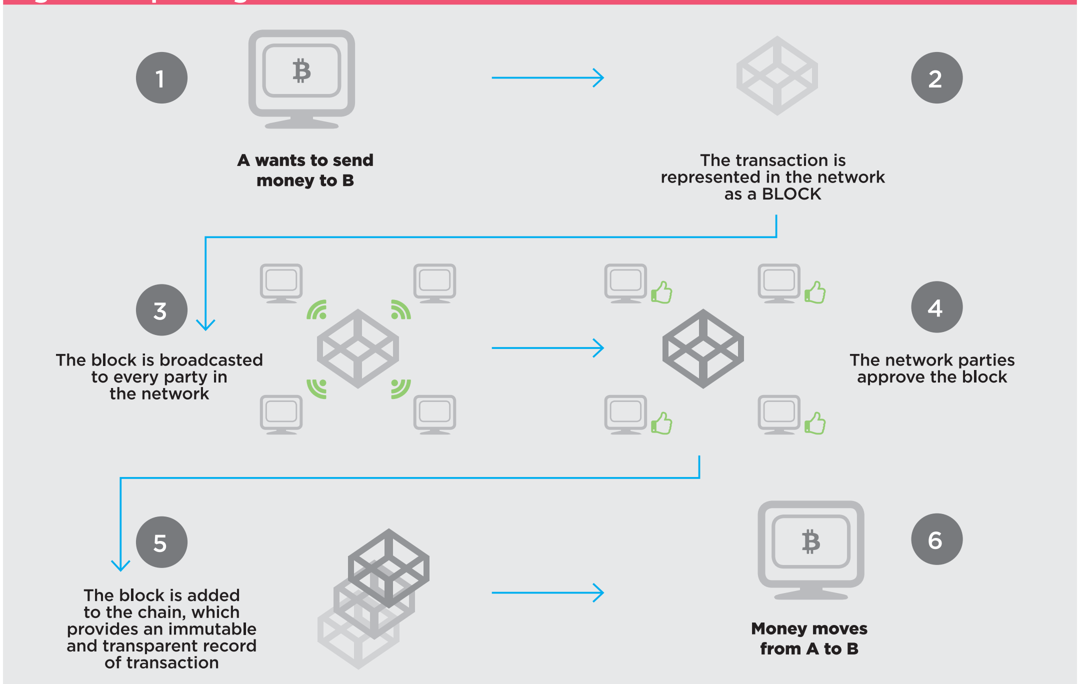
The types of financing solutions on offer are therefore evolving, with an increasing focus on 'off balance sheet' structured trade finance, ie financings based on the strength of the transaction rather than relying on the balance sheet strength of the customer. The move to structured trade finance is being driven by catalysts such as off-balance sheet funding, and even credit insurance-backed funding. Factoring, for instance, helps businesses grow by speeding up cash flow and by freeing up liquidity, as well as by mitigating against the risk of bad debts. Indeed, all types of receivables financing and non-recourse financing are also increasing in popularity.

Digitisation a key focus

Digitisation in trade finance has lagged behind the advancements made in retail banking, and even that witnessed in the payments industry. Yet we expect it to pick up considerably in coming years, in large part due to the demand from more digitally aware clients, as well as the emergence of new technologies that can help facilitate the trade process.

We are witnessing several key trends in this area – with the emergence of blockchain, the development of smart contracts and the Internet of Things all facilitating faster and more efficient transaction execution. At its core, a blockchain allows multiple parties to transact through a single, shared, decentralised ledger – which no party can independently control. Today, several types of blockchain exist: private (limited to one organisation), consortium (shared between organisations) and public (for example, Bitcoin) – but all are underpinned by a combination of cryptography and the timestamping of every action, logged independently of other parties.

Figure 1: Explaining the blockchain



Blockchain can provide the ability and choice to protect sensitive information and also improve transparency – allowing greater data security and faster execution and turnaround time as information for each cycle is updated on the distributed ledger by each market participant. Driving unique and seamless experiences for customers across all interactions and channels – and available real time for others to view – blockchain also has the potential to transform various industries to deliver an improved customer experience and loyalty.

We see blockchain as a particularly significant enabler of the future – replacing the manual effort of moving trade documents. In fact, it is this game-changing potential that convinced us to begin exploring blockchain last year, joining an expansive research and information-sharing effort.

Banks need dedication to innovation – both in terms of financial solutions and digitisation. For instance, at Emirates NBD, we run innovation labs – hosting innovation days inviting ideas from all internal stakeholders and employees, as well as partner and mentor fintechs. These keep our thinking fresh, and help demonstrate that the challenges we face are in fact opportunities – an ethos we are keen to uphold.

Additionally, Emirates NBD has been part of a trade network collaboration. Comprising Dubai trade, Dubai customs, Aramex, Banco Santander, IBM and du, the collaboration is focused on exploring how blockchain can be employed as part of a trade finance and logistics solution for the import and re-export process of goods in and out of Dubai. In addition, we have conducted a cross-border open account trade proof of concept on blockchain with ICICI Bank in India, enabling the client to execute end-to-end trade using the technology: all the way from the raising of a purchase order to providing the final confirmation of payment to the beneficiary's bank.

We also understand the challenges inherent in adopting blockchain – including initial costs, an unclear legal and regulatory environment, user readiness, interoperability and the potential losses if even one stakeholder doesn't deliver. Ultimately, however, the most successful offerings will be those that demonstrate a clear business case to corporates, while providing them with the full digital experience they crave. This is a positive for the industry, as is the fact the costs of digitisation, which have earlier been prohibitive for smaller businesses, should increasingly fall – driving adoption and in turn helping ensure that all participants are increasingly operating on a level playing field.

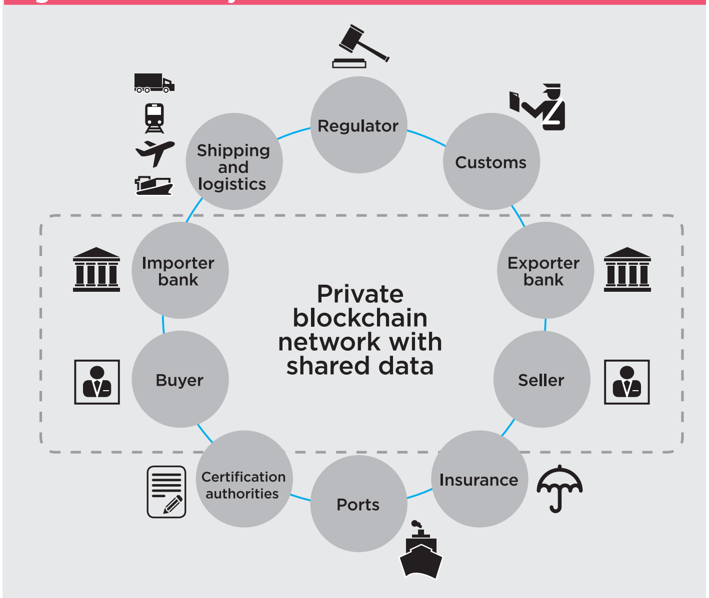
Artificial intelligence and machine learning have also emerged as key to automating trade processes.

In the face of headwinds

One of the most pressing challenges directly affecting Middle Eastern banks in the transaction banking space is that of regulation. In particular, we have seen rising compliance costs for banks, often caused by heightened requirements around their level of knowledge concerning counterparties with which they interact and conduct business – including correspondent banks. Indeed, the cost of maintaining a basic correspondent relationship is estimated to have risen by up to 20% in recent years[1].

Internally, banks are dealing with the ongoing challenge of complying with the now finalised Basel III regulation, in addition to IFRS 9, which, again, became effective from January 2018. This changes banks' capital requirements as well as specifies the classification and measurement of financial assets, financial liabilities and some contracts to buy or sell non-financial items[2]. In preparation for IFRS 9, many banks have set up appropriate frameworks representing all business lines, while some are even developing integrated reporting systems. Certainly, IFRS 9 is changing the way banks arrange loans, sell investments and manage financial assets, although approaching this challenge positively – through integrated reporting solutions – will pay off in the long run.

Figure 2: Summary of blockchain benefits



Turning vision into reality

One less tangible challenge is the disadvantage facing the 'first movers' in a banking industry that often waits for others to test new solutions before becoming adopters of innovation. This may seem sensible, but it slows down innovation, as well as harmonisation, in an industry noted for players that move forwards at a similar pace. The banks that lead take some risks – including reputational. But the rewards are there for those that get it right.

In light of these challenges, United Arab Emirates banks need to remain customer focused despite the pressures from regulators. Clearly, a focus on the customer experience will be important in this respect. While regulations cannot be ignored, banks can still view their clients as partners in need of solutions for their trading or transactional problems.

Also, having effective systems in place will be crucial when managing the changes. Banks with robust compliance departments are, in fact, more likely to be able to assist their clients, as they will be better informed and more aware of potential solutions, which they can then offer with confidence.

1 ICC Banking Commission's *Rethinking Trade & Finance* report: iccwbo.org/publication/2017-rethinking-trade-finance
2 ifrs.org/issued-standards/list-of-standards/ifrs-9-financial-instruments

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