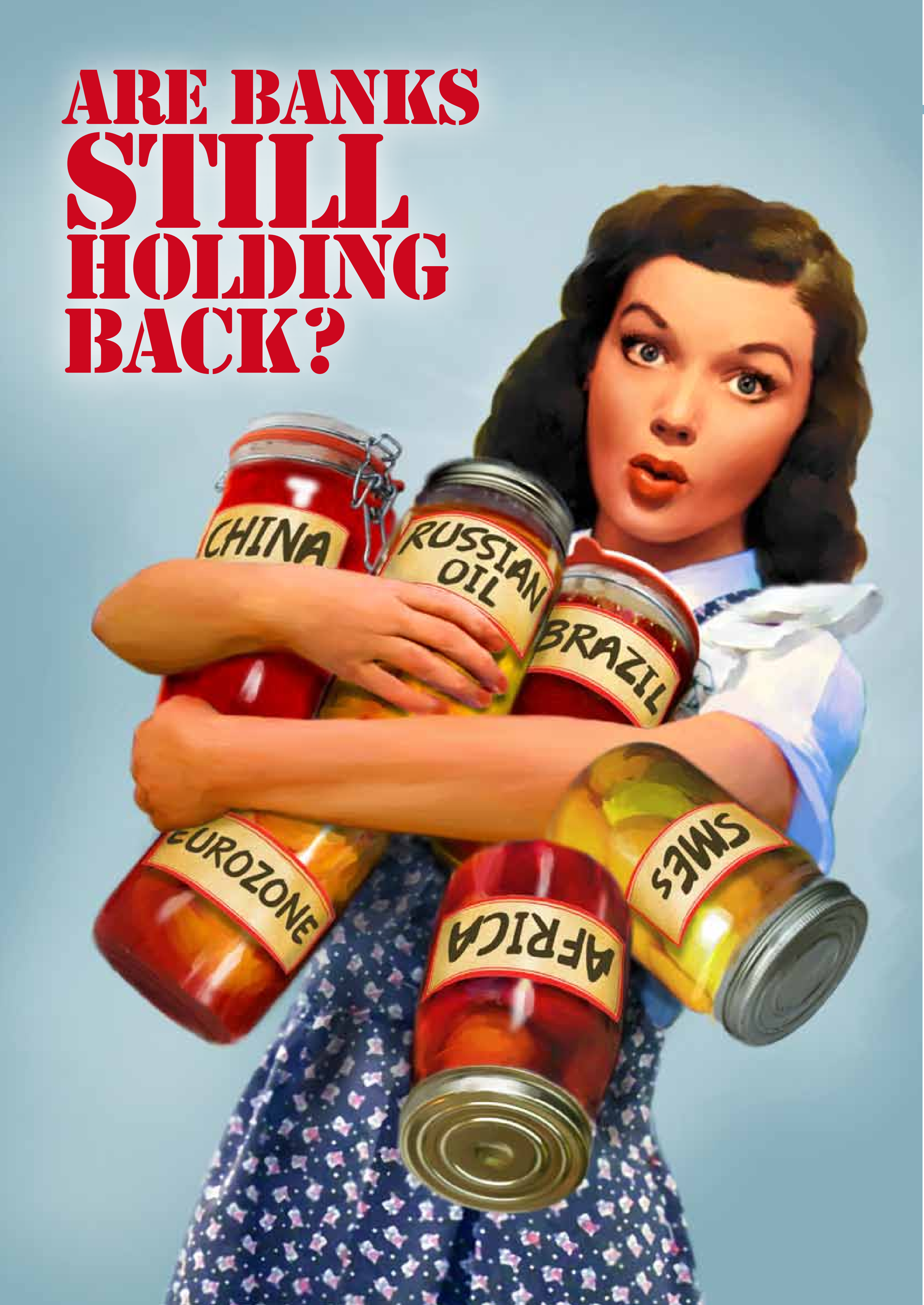
ARE BANKS STILL HOLDING BACK?



Banks face new obstacles preventing them from lending trade finance, writes ***Rebecca Spong***.

Ahead of the G-20 meetings held in Toronto in June, the ICC Banking Commission called upon world leaders to take action to support international trade.

Central to the commission's argument was the need to restore trade finance levels, as it is thought that the shortage of finance provided by banks was in part responsible for the 12.2% contraction in world trade volumes seen last year.

The ICC argued that although its recent survey highlighted some positive signs of recovery in the trade market, many borrowers are not able to access affordable finance. It reports that most banks are still holding back trade finance from certain types of borrower, such as small and medium-sized businesses or low-income countries.

To improve access to trade finance, the ICC proposes that there needs to be continued support at both a national and multilateral level to underpin commercial banks' lending capacity for trade.

In an official release, it stated: "ICC believes it important to further enlarge multilateral trade finance programmes in order to expand both capacity and coverage, especially for low-income and export-dependent countries.

"At the same time, national programmes should be reinforced to guarantee the flow of trade in times of economic stress and to provide refinancing options – in particular through export credit agencies (ECAs)."

The ICC's comments suggest that the risk appetite in the commercial bank market hasn't fully recovered, and indeed, where it has, it tends to be reserved for top-tier, well-known corporates or certain regions.

With such a fragile recovery in lending capability, the market is potentially vulnerable to any bumps in the economy, as well as legislative changes made by governments or regulatory bodies.

Thierry Senechal, policy manager, banking commission, executive secretary, corporate economists advisory group, at the ICC, tells **GTR** that the trade finance market should avoid being overly optimistic, commenting that: "Advanced indicators of trade developments underscore the fragility of the current recovery.

"Looking ahead, problems are still expected to hamper the availability of trade finance."

And with this in mind he calls for "sustained attention to be given to the implementation of the G-20 trade finance agenda, with a view to fostering further improvements in bank finance capacity".

> "Looking ahead, problems are still expected to hamper the availability of trade finance." **Thierry Senechal**, ICC

G-20 response

Trade finance was thrown into the spotlight during the high-profile G-20 talks in April 2009. With falling trade volumes, the members pledged to pump liquidity back into the trade finance market, promising US$250bn over the subsequent two years.

The financial aid was to be provided through various multilateral-led schemes and through increasing the role of national export credit agencies.

One year on, economists at the World Trade Organisation (WTO) predicted that world trade will rebound in 2010, growing at 9.5%. This rebound is perhaps partly due to new availability of trade finance, but probably owes more to increased demand across the globe as countries emerge from recession.

Despite this growth, if trade volumes continue to grow at the current pace, it will take another year

> "Clearly there will be more concern about counterparties within Europe, particularly the banks." **Jeremy Shaw**, JP Morgan

Top obstacles for trade

- Growing demand for trade finance – can banks meet this?
- Providing accessible finance to all sectors, including smaller companies
- Prospect of facing tougher capital requirements
- Correctly pricing risk – not pushing pricing too low again
- The potential impact of the eurozone debt problems on counterparties in Europe

before volumes exceed the peaks seen in 2008. And as consumption grows, the trade finance market needs to be ready to provide the necessary financing; otherwise exporters and importers will be left facing bottlenecks in their supply chains.

Looking at Q1 activity, most trade banks posted encouraging results, and anecdotally trade finance bankers reported that they were seeing more deals in the pipeline.

The market was encouraged by the various large-scale restructurings that were successfully completed at the beginning of the year, such as that of the Russian metals producer Rusal. High-profile trading companies also managed to secure oversubscribed facilities in the first half of this year.

The industry body Baft-IFSA commissioned a global survey in April to examine the state of trade finance, and one of its key findings was that market activities are stabilising, and that the outlook for the rest of the year is improving, particularly in emerging Asia.

At the time, Howard Bascom, chairman of Baft-IFSA, said: "The signs of recovery in trade finance that we saw in September [2009] have not only been maintained, but improved, and we are pleased to see further stabilisation."

But a lot has happened since the release of Baft's survey, with the financial landscape changing on an almost day-to-day basis.

The Greek effect

Although trade finance should not be directly affected by the downgrades of sovereign debt in Greece and other southern European markets, such events have certainly rattled markets.

There are concerns any loss of confidence in financial markets, or another decline in the real economy, could throw the fragile recovery they see in trade finance off course.

As one trade finance banker told **GTR** back in May, "another 'credit event' could be very damaging to the recovery in activity currently underway."

For those banks based in countries affected by sovereign downgrades, the concerns may well be more acute, with wholesale funding costs for those banks possibly increasing in the aftermath of downgrades.

Uncertainty over the full impact of the eurozone market reigns in the trade community.

As Jeremy Shaw, managing director, treasury services, at JP Morgan comments: "We as a bank are extremely liquid, and have not had a problem there.

"I think as we look at eurozone problems, it is not yet clear where the major exposures are, but as more information becomes available, banks and counterparties will form views about those banks which have more exposure than others."

However, he notes that such problems may indeed provide new business for large banks such as JP Morgan.

"Clearly there will be more concern about counterparties within Europe, particularly the banks.

"Will that create opportunities to provide trade finance to those banks? Probably, yes – as they may indeed have difficulty in financing trade transactions that they previously were able to do.

"The good thing about trade is that there are always opportunities in every event – but we don't know exactly where they are yet."

There are further concerns that the eurozone crisis will reduce the number of banks providing trade finance to the market, if banks in Spain or Portugal for example, reduce their lending capacity.

With reduced overall capacity in the trade finance market, banks with adequate liquidity will struggle to find partners for risk participations or to syndicate deals to.

One source that regularly works with Portuguese banks to fund its activities, tells **GTR**: "We are getting feedback that won't be good for us in terms of renewals. They have been happy with us – but it is a function of what is going on in the market – when countries or banks get their ratings changed, it alters their cost of

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> **Stuart Nivison**, HSBC

funds, and all of a sudden we can't even have a conversation about doing things at a certain level."

Stuart Nivison, head of trade and supply chain, Europe, at HSBC, echoes the theme of a reduced number of banks active in the trade market.

"There has certainly been a change in the landscape of trade finance in Europe. There are fewer banks involved."

However, he adds that the fallout from Europe will ultimately have a "minor" impact on trade finance, particularly when compared to the potential impact of regulatory changes.

Regulation problems

The reaction to the Eurozone crisis is mixed and mainly speculative, but the market seems to be united in its stance against regulatory interference in trade finance.

With governments and regulators trying to curb risky lending by increasing the level of capital banks are required to put aside, many in the market believe traditional trade finance assets are being treated unfairly.

The proposed capital adequacy framework, dubbed Basel III, has been heavily criticised.

"There is no need to change the treatment of trade finance from Basel II rules," says Emile Rummens, senior risk manager in the trade finance group at KBC.

"The losses in trade finance remained, even in the worst of the crisis, significantly lower in all respects than other financial techniques. It's unnecessary and unjustified to impose new burdens on trade finance."

Under the proposals, trade finance instruments such as letters of credit have been grouped together with other off-balance sheet (OBS) assets such as securitisations, as they are deemed as sources of "potentially significant leverage".

All such items could be subject to an increased leverage ratio constraint, raising the credit conversion factor used to 100%.

The market argument is that trade finance has a far lower risk profile than these other OBS vehicles, and therefore it is unfair to ask the market to put aside the same level of capital for trade.

JP Morgan's Shaw comments: "There is a lot of work to be done regarding Basel III and the impact of suggested treatment of trade."

He explains that banks active in trade finance in the emerging markets will be hit twice by heightened capital requirements. Firstly, those doing business in emerging markets will have to provide additional capital against the higher risks associated with those regions.

"Secondly, trade transactions usually benefit from some capital relief, versus 100% commitments made for loans. If trade is potentially to be treated the same as loans, banks will have to provide more capital against those transactions as well, so it is a double hit for banks."

The impact of providing this additional capital could be significant, potentially affecting both the pricing and availability of trade finance.

"Will all banks price the same way? Will the market sustain the required increases in pricing to achieve the necessary returns of the additional capital that is being required to be put aside?" questions Shaw.

Hubert Benoot, general manager, trade finance, at KBC points out further difficulties: "There are hidden costs involved in Basel III. If approved, all the rules will need to be implemented in the bank, explained to customers, and this could have an impact on pricing and availability of lines."

He adds that in the long-term, competition between trade finance products and other OBS products might increase, meaning that trade finance could potentially be pushed aside in favour of more profitable financing vehicles.

Benoot adds that it is not only the trade finance bankers who will lose out: "We are talking not just about the impact on us as bankers, but on real business; our customers; importers and exporters. If we have to charge them four times more for vanilla trade finance due to internal reasons, this will be detrimental to the economy."

Although it will be sometime before Basel III is approved and implemented (some US banks have only recently implemented Basel II), the impact of the legislation is already disturbing the market. "Most banks have not restarted trade finance lending because of regulatory uncertainty and a business model moving away from trade assets to focus on large corporates or consumer credit products," observes Michel Léonard at Blackstone Group's Alliant Insurance Services.

"This is not temporary. The gap in trade finance will remain and will have to be addressed elsewhere," he urges.

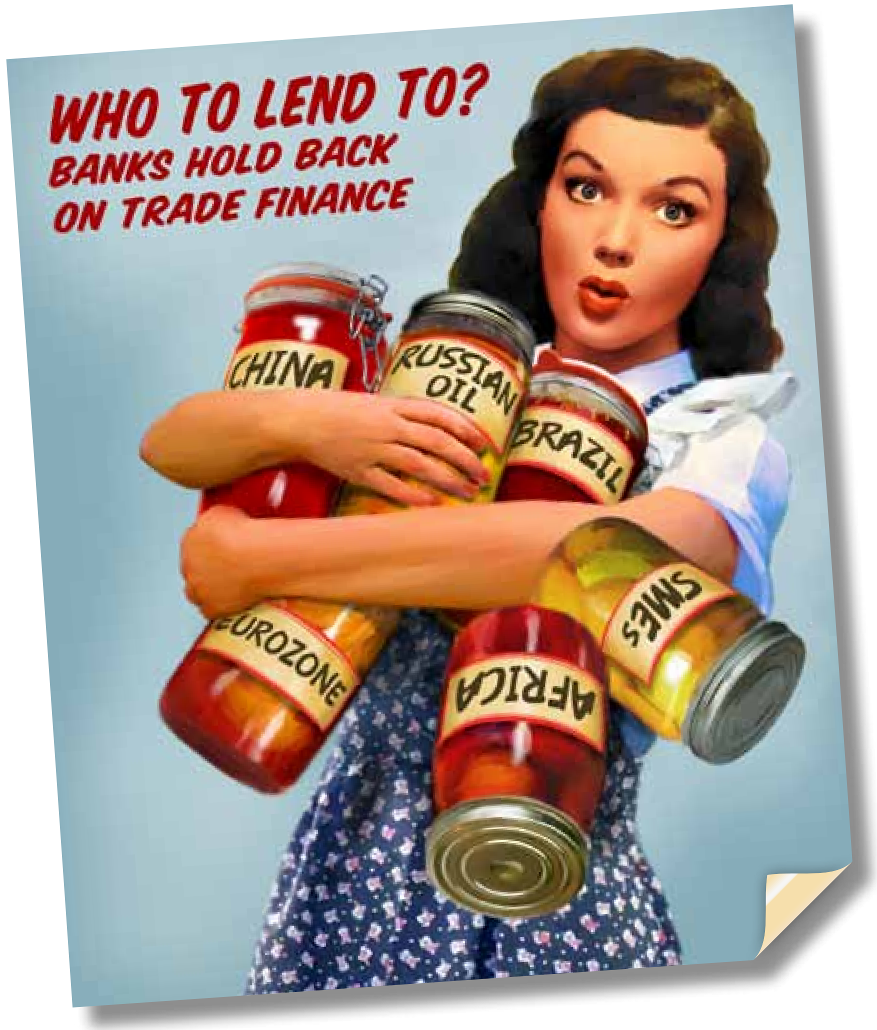
With this in mind, lobby groups are playing a key role in getting the voice of trade finance bankers heard at regulator and government level.

HSBC's Nivison comments: "The ICC and the WTO have done an excellent job of raising awareness at international level as was clear from the London summit of the G-20 last year. But it is critical that this stays high on the international agenda.

"We all know trade is an inherently low risk form of lending. It deserves and needs to be singled out for capital relief. Without this there is a very real risk that a lack of trade finance will stifle any recovery."

Baft-IFSA has submitted letters to the Basel committee during the consultation period on the regulations which closed in April.

In its letter, chief executive officer Donna Alexander comments:



"We are concerned that the consultative document does not account for their [trade finance assets] intrinsically safe structure."

Speaking to **GTR**, Alexander adds: "We are concerned about the potentially negative consequences on trade finance, so we are currently in education mode, letting decision-makers and stakeholders alike know what the impact could be."

"We have contacted the G-20 ministers and central bank governors to share our concerns and highlight what we think the impact could be on trade finance. We understand that what the Basel committee has proposed goes way beyond trade finance, but we believe it is important to show what the impact on our industry would be, as well as on global trade as a whole.""

Baft's recommendations to the regulators include a demand for the clarification of off-balance sheet assets as outlined in Basel's proposed new regulations, as well as a clarification of capital requirements for trade finance under the current Basel II rules.

Baft argues that the one-year maturity floor applied under Basel II to trade finance is excessive, as most transactions are short-term in nature (under 180 days or less) and self-liquidating.

The lobby group is also arguing to change the requirement under Basel II that asks for five to seven years of data to calculate default risk. Most banks lack this data for trade finance. It is suggested that available historical data or estimates based on this data be allowed to replace Basel's minimum data requirements. Indeed, the trade market is compiling its own trade debt registry to demonstrate to regulators the low default rate of trade finance.

Alexander is hopeful that the G-20 will listen given their response in April last year.

"We are pleased to hear that at least there is growing support amongst the G-20 and other leaders for phasing in the implementation of Basel recommendations.

"Rushing into some of the major changes recommended by the Basel Committee, without time and intent for closer review of the unintended consequences is short-sighted."

But looking ahead to the coming months, Alexander remains distinctly wary.

"We are not completely out of the danger zone and there are areas that need close attention. I am concerned that if there are heavier capital requirements for trade finance these problem areas will only get worse," she comments.

Banks to blame

As Alexander notes, there are "problem areas" where trade finance is not being provided.

To keep global trade moving, access to trade finance, lobby groups argue, can not be limited to certain borrowers, such as top-tier businesses. Yet, some in the market believe the finance is getting through. JP Morgan's Shaw comments: "The big headlines involve big deals and pricing falling, but my view is that there is still a lot of plain vanilla trade available for small and medium enterprises."

But, it is those headline trade deals that seem to be pushing pricing ever lower, with banks at risk of repeating history with pricing that is too low.

Remarking on pricing trends in the first quarter, Benoot at KBC tells **GTR**: "Pricing has dropped considerably since October and November last year, and in our opinion risk premiums dropped too fast."

Highly cautious banks are only happy to take on certain risks, an example being a top-tier Russian oil company. With a limited pool of acceptable borrowers, and a partially resumed appetite for risk, banks are competing heavily for deals. This inevitably drives down pricing on certain transactions, potentially leaving some borrowers out in the cold.

"The bulk of the G-20 trade facilitation support [is] going to large Fortune 500 rather than the small and medium-sized exporters providing the bulk of the new growth in trade finance, largely failing to address G-20 governments' goals," notes Léonard at Alliant.

The World Trade Organisation (WTO) has noted this trend.

Speaking at a conference in mid-June, WTO's director general Pascal Lamy commented: "While our experts tell us that there is a large appetite for risk and ample liquidity to finance trade from China, India, Brazil and Korea, at the lower end of the market, there continues to be strong constraints.

"This is particularly true for Sub-Saharan Africa where some financing capacity seems to have been lost. At this stage it is not possible to determine whether this is permanent or temporary.

"The explanation given by global commercial banks is that the cost of collecting information on counterparty risk is high and that coupled with the low profitability of small operations in the region, trade financing remains unattractive, particularly on the import side."

Lamy dismisses this explanation as short-sighted, explaining that import financing can lead to future export financing opportunities, and that banks should be looking to be long-term development partners with these regions.

He urges banks to "keep your lines of credit open, not just for the most profitable commodity deals".

Restructuring, not recovery

But nervous banks with reduced balance sheets and capital to preserve are going to need a helping hand to lend to such risky markets.

This is where multilaterals and ECAs step in, and in an address at the G-20 meetings Lamy noted: "For business in many low-income developing countries, the availability and affordability of trade finance remains a serious constraint."

He added that there should be "no rush" to exit the G-20 trade finance support package, arguing for "targeted trade finance" for more needy borrowers.

Lamy's comments fall in line with the ICC's recommendations for the enlargement of trade finance facilitation schemes, and that multilateral and public support is still needed to underpin confidence in trade finance.

Such developments herald a new era for doing trade business, and Léonard at Alliant notes that 2010 is not about recovery, but rather about "restructuring".

"A recovery implies a return to what was before. The investment landscape will be widely different, with growth not from old 'investment boxes', such as large caps or the BRICs, but rather small and mid caps with growth relying on domestic consumer demand within the emerging markets."

It is these smaller markets, he argues, that banks should be targeting to ensure long-term business flows. **GTR**

The To Do List

- Provide G-20 members and regulators with information on trade finance's business performance – demonstrating low loss history of different trade finance risk categories.
- Enlarge multilateral programmes in terms of both coverage and capacity – especially for low-income, export-dependent countries.
- National programmes to be reinforced, with ECAs to provide refinancing options, develop more direct lending schemes and engage in sub-participation in bank lending.
- Apply changes to Basel II framework to allow more proportionate capital weightings for tradition trade finance transactions.
- Continue lobby efforts to ensure trade finance interests are fully represented in the creation of new capital adequacy rules.

**Based on ICC's Rethinking Trade Global Survey*

GTR Obstacles to Trade Finance | **Cover Feature**