Department of Policy and Business Practices

Trade Finance in the Current Financial Crisis: Preliminary Assessment of Key Issues

1. Introduction to this note

1.1. **The ICC Banking Commission:** This information has been prepared by the Secretariat of the ICC Banking Commission. The ICC Banking Commission is a leading global rule-making body for the trade finance industry as well as a worldwide forum of trade finance experts whose common aim is to facilitate international trade finance across the globe. The ICC Banking Commission has more than 500 members in 70 countries, many of them from emerging countries[1]. The Banking Commission is known for producing universally accepted rules and guidelines for documentary credits, bank-to-bank reimbursement and bank guarantees. ICC voluntary market-based approaches have often been praised for levelling the playing field in trade finance practices.

1.2. **The methodology for this note:** This note has been prepared by the ICC Secretariat following a consultation carried out with our members and ICC National Committees[2] on 6-11 November 2008. Due to time constraints, our analysis cannot be exhaustive and fully representative of all ICC Banking Commission members. Using the feedback received, we are able to provide some elements of consensus on key issues of the crisis.

2. Market gaps and the impact of the financial crisis on trade finance

2.1. **Adverse consequences of the crisis – an overview:** Our members have indicated the credit crunch is entering a new phase, where it is increasingly difficult to predict the timing and magnitude of events. What is clear is that we are now facing a period when it will be even more difficult to raise money. Our members believe that in the weeks to come, financial markets will continue to deteriorate due to continued deleveraging, lack of liquidity, etc., especially towards the end of the year when banks close their books.

[1] Each year the ICC Banking Commission brings together bankers, business leaders, finance experts, and government officials at Commission meetings to promote dialogue, recommend policies and develop rules to enhance trade finance practices throughout the world. Past meetings, held in India, Turkey, Russia, Italy, Greece, and most recently in Paris on 22-24 October 2008, have attracted wide audiences (usually over 300 delegates) and have been extremely useful vehicles for advancing trade finance and business interests across the globe.

[2] ICC's influence around the world is due in large part to its global network of national committees located in 90 countries.

38, Cours Albert 1er, 75008 Paris, France
Telephone +33 1 49 53 28 18   Fax +33 1 49 53 28 35
Website www.iccwbo.org   E-mail sg@iccwbo.org

The current environment is creating a risk-averse culture, both amongst banks and traders. With regard to the latter, banks report customers asking for confirmed letters of credit (LCs) where they previously dealt on CAD or open account. However, bank perception of risk is leading to tightening liquidity in some instances and therefore greater difficulty in getting bank confirmations. Our members have indicated this trend is accelerating and spreading to all continents. The logic of trade finance is to promote trade through accessible and affordable credit facilities. In general, because it is a relatively cheap and standardized funding instrument, trade-related companies make intensive use of trade finance to support their operational working capital. That said, in times of sudden credit constraint, like today, the demand for trade finance resources grows exponentially and the funding providers (i.e. private and public financial institutions) are insufficient and scattered.

Our members have also indicated only a few examples of trade transactions being stopped, although they expressed major concerns about the difficulty of obtaining liquidity.

2.2. **Evidence of trade contraction:** It is of course difficult to assess the magnitude of the current crisis. We would suggest, however, considering the recent fall in shipping rates as a general barometer of the extent of the problem particularly in relation to short term trade finance—although it is noted this may be also influenced by the slowing of demand for Asian goods. The tension in the market is reflected in the Baltic Exchange's Dry Index, a measure of the cost of moving raw materials by sea (more than 80 percent of international trade in goods is carried by sea), which fell to a nine-year low last 4 November, having plummeted 11-fold from its record high in May 2008. Furthermore, problems are seen in the credit default swap market, which has gone up 5-10 times compared to two months ago. It is suggested that this is less a sign of the increased credit risk, but rather a lack of appetite in the market.

At the last Banking Commission meeting of 22-24 October, conducted in partnership with IFC/World Bank, Andrew Burns, Senior Economist at the World Bank, indicated that global trade volumes are likely to contract in 2009, the first decline in volumes since 1982. We believe that a general distinction can be drawn between short term trade, say up to 6 months maturity, and longer term projects of a more capital nature. It is reported that the latter is more heavily affected at the current time, with large scale financing projects being deferred, particularly in the BRIC countries. This trend tends to impact most heavily on multinational enterprises.

2.3. **Is the market still open?** ICC Banking Commission members believe the trade finance market is still fairly open. However, global trade finance activity is beginning to be impacted by events in the financial markets over the past few months. This is due to several main contributing factors, inter alia:

- Slowing of demand from OECD buyers of Asian goods;
- Higher losses by trade banks due to deterioration in credit quality, fraud and commercial disputes;
- Rapid fluctuations in commodity prices;
- Foreign exchange rate volatility;
- Increased counterparty risk aversion which results in significantly higher risk pricing (conformation commission/discounting etc.); and
- Lack of US dollar liquidity which also results in significantly higher borrowing costs (resulting in high liquidity premiums as well as risk premiums).

3. Availability of trade financing

3.1. **Liquidity capacities challenged:** In the initial months of the crisis, companies were impacted by the general lending restraint showed by the banks. Companies quickly turned to trade financing to manage their working capital requirements. However, in recent months, banks have seen trade financing credit and liquidity capacities severely challenged. The effect of the squeeze in credit markets is now amplified by the "flight to quality," as investors withdraw capital from risky emerging markets. During a liquidity crisis, banks typically reduce their exposure as a defensive measure, which often results in a decrease in short-term trade lines.

3.2. **Some emerging countries hit first:** Most of our members pointed out to growing evidence of trade credit shortage being a threat to world trade as a whole and to emerging markets in particular. The global credit crunch, combined with the sharp decline in asset prices and the increase in the cost of trade credit on a sustained basis, is raising widespread concern about the availability of trade finance over the next few months. Buyer countries are witnessing a reduction in consumption. Supplier countries or raw material supplier countries have already been affected by the contraction in demand. This trend is spreading to finished product supplier countries.

According to our members, there is noticeable evidence that the weaker emerging economies are being hit first, e.g. Pakistan, Bangladesh, Vietnam, etc. Our members reported an important decline in the syndicated loan market targeting most emerging markets. They noted that such syndications are usually used to back international trade transactions of these countries. Fast growing developing economies (BRICs), except perhaps China and Brazil, are also suffering from the trade finance contraction. Countries like Argentina, Hungary, and Romania have become vulnerable. Whilst low-value trade LC business is currently relatively unaffected, problems are reported in some Central and Eastern European countries, and smaller, export-oriented economies in South East Asia. The acceptability of LCs from emerging and emerged markets is also being scrutinized carefully, which creates grit in the wheels of commerce.

3.3. **Deleveraging:** Across the banking market there is a lot of deleveraging taking place in the primary and secondary markets. The global financial system is getting rid of debt, so those who are holding debt face a situation where very few people want to take on debt. For institutions that need to refinance, the situation is becoming more difficult.

3.4. **Impact on open account and LC trading:** ICC Banking Commission members have noticed a shift from open account to traditional risk mitigation products. There is bound to be a contraction in open account trade, and more demand to buy protection. Demand for letters of credit is reported to have considerably increased. It should be noted that, from 2000 through last year, the use of letters of credit declined to about 10 percent of global trade transactions. When the economy was buoyant, the seller would collect payment directly from the buyer's open account when goods were delivered. But recently, even buyers and sellers with longstanding relationships have begun to question the financial health of counterparties. Traders now want their banks to guarantee each transaction. As a result, the LC sector may prove to be more resilient than other form of lending. Around 90 percent of the $13.6 trillion in world merchandise trade is funded by trade finance, with a large part financed through LCs.

3.5. **Court injunctions rising:** At a recent operational trade finance workshop held jointly by the ICC and the IFC, which included participants from more than 20 countries, some delegates reported an increase in the number of court injunctions barring payment under letters of credit on unsound technical grounds. Some of our members also reported intense scrutiny from some banks, eventually leading to higher rates of rejection of trade documents on the basis of minor discrepancies. The ICC Banking Commission is monitoring the situation closely, as this unjust mechanism has been used during challenging financial times in the past as a means of avoiding or delaying financial obligations.

4. Affordability of trade finance

4.1. **Increased cost of trade:** Another issue which raises serious concerns among our members is pricing, which has increased dramatically in some markets. According to our members, the tight credit conditions have allowed lenders to drive up interest rates for their loans in many countries, especially in emerging markets. The recent increase in trade pricing has also increased reluctance by some banks to take on new trade assets, lest they miss an opportunity to price higher in the months ahead. Add to the banks' constrained balance sheets, global currency volatility, and more rigorous risk assessment, and it is not surprising the cost of trade finance has shot through the roof.

We have received anecdotal evidence of trade finance deals offered at 300-400 basis points over interbank refinancing rates—two to three times more than the going rate a year earlier. In some cases, we have heard about the cost of a LC doubling or tripling for buyers in emerging countries, e.g. China, Turkey, Pakistan, Argentina, and Bangladesh.

Banks are now charging 1.5 percent of the value of the transaction for credit guarantees for some Chinese transactions, bankers say.

4.2. **Mitigation measures:** While interbank lending shows some signs of thawing because governments have stepped into the breach, banks are still wary of taking on counterparty risk from other banks outside of mainstream money markets. Some banks also report that they are now working with core clients to cushion price increases by focusing on longer term relationships, and cross selling risk mitigation solutions such as the hedging of their foreign exchange exposures.

5. Institutional and official measures

5.1. **Multilateral institutions and specialized agencies must help maintain a sound financial system:** Various strategies to support trade finance have been undertaken by the private sector, governments, multilateral financial institutions, and official bilateral credit agencies. ICC Banking Commission members underscore the importance of targeted temporary financing, and, in some cases, agreements with international banks, to address liquidity shortages and problems of risk perception. Business has greatly appreciated the measures taken in recent months by export credit agencies, regional development banks, and international banks.

5.2. **Trade facilitation programs play an increasing role:** Last October, the IFC approved a US$500 million increase to the IFC Global Trade Finance Program, raising the program's ceiling to US$1.5 billion. The expansion of this program enhances IFC's counter-cyclical role and its ability to respond to the global credit crisis, by supporting trade with emerging markets. Through the Global Trade Finance Program, IFC can guarantee the payment risk of issuing banks up to the full value of a transaction. This enables the continued flow of trade credit into the market, at a time when imports may be critical and the country's exports can generate much-needed foreign exchange. The EBRD provides a similar trade facilitation program to the IFC, but with a focus on supporting trade to and from the emerging markets of central Europe and central Asia. Our members say the current crisis has greatly increased demand for risk cover under such programs.

5.3. **Other initiatives:** It is also noted that various governments have responded domestically with financial as well as non-financial measures. For example:

- In Singapore, the Monetary Authority of Singapore has set up a swap facility to provide USD liquidity for banks operating in Singapore;

- Hong Kong has led those Asian countries which have guaranteed all bank deposits to boost confidence and set up a Credit Crisis Task Force consisting of industry leaders to recommend actions to manage the credit crisis;

- In last October, the Brazilian Central Bank announced it would use its foreign reserves to increase credit lines for exporters who have been finding it hard to reach trade finance instruments;

- In the latest and perhaps strongest intervention to date, China has announced a wide ranging economic stimulus package. Our members have also pointed out to the last October initiative of the Bank of China which entered into an agreement on trade finance facilitating with Inter-American Development Bank in order to provide financing and guaranties to Chinese companies operating in Latin America and the Caribbean; and

- In the UK, we are told that the Government is currently exploring how the UK Export Credits Guarantee Department can address the problems currently faced by some smaller exporters in obtaining trade finance. It would, however, be premature to speculate what—if any—measures will result from these discussions.

6. Conclusion and recommendations

6.1. **Conclusion:** It is recognized that this a challenging economic environment, and trade volumes may thus get further impacted in coming weeks. There is a concern that if the global recession deepens capital cost will increase further, thus exacerbating current trends. Banks remain focused on how to best structure and manage their working capital needs in this environment. This encompasses providing guidance around decisions on new ventures, knowledge of counter parties, structures of deals, and assessing cross border liquidity to get the best leverage possible.

Looking to the future, there is some evidence that various specialist trade finance firms including small hedge funds and boutique investment funds are partly filling the gap. However, without the participation of major banks and other financial institutions, their efforts are of necessity limited. A rapid and coordinated international response is viewed as imperative in the current circumstances.

6.2. **Recommendations:** In this context, the following policy prescriptions have been suggested:

- **Improve the resilience of emerging market economies:** Our members indicate that it is crucial to build trust in times of extreme uncertainty. Structural measures could include an expanded use of asset-backed securitization funding structures, risk-sharing, and greater risk differentiation by banks and public authorities. ICC and members of ICC's Banking Commission have already started working closely with development banks. Our goal is to create a network of skilled trade finance professionals in emerging markets—something that must be accelerated not only in emerging markets but in developed markets as well.

- **Rely more on multilateral agency and export credit agency (ECA) programs:** Short-term guaranteeing of trade finance facilities by governments and multilaterals is seen as a priority. If the crisis worsens, ICC suggests that in cases where solvent enterprises and exporters in a crisis country are unable to access trade finance, and/or the relevant sovereign's ability to provide credible guarantees required by external trade finance providers is limited, targeted support should be made available from multilateral agencies to facilitate a resumption of private sector financing. Our members suggest possible modification of the incentive structure governing official ECAs, to encourage counter-cyclical operations by these agencies. It is important for ECAs to resume the practice of providing short term cover. It will also be critical to ensure co-ordination of ECAs.

- **Maintain financing for SMEs:** Despite the serious impact of the financial crisis, countries must continue to trade. The availability of trade finance services is critical to the sustenance of emerging markets, but especially for small- to medium-sized enterprises relying on short-term trade finance to finance their trading activities. It has been an unfortunate development that many banks have in the last decade moved away from trade finance services, which are labor and skill intensive, to focus on investment banking, where greater rewards were available. This may have been a short-sighted approach, as many banks are now trying to return to trade finance with its inherent lower risk and transparent profile, but they are limited by a lack of skilled trade finance professionals.

6.3. It is suggested that these measures should be taken forward with the minimum of delay, preferably within the next six months. In the longer term, we believe that governments should explore how trade policy reforms can enable short-term finance to flow better, and create deeper and more liquid markets. We believe that this may be best achieved through the financial services negotiation under the Doha Round.