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Boosting the availability of trade finance in the current crisis: Background analysis for a substantial G20 package

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Some 80% to 90% of world trade relies on some form of trade finance. Since the first half of 2008, there has been evidence of tightening market conditions for trade finance. As expected by market participants, the situation worsened in the second half of the year and further in the first quarter of 2009. According to expectations revealed in market-based surveys, there is little doubt that the trade finance market will continue to experience difficult times throughout 2009. This situation is likely to contribute to deepening the global economic malaise. While public-backed institutions have responded rapidly in the course of 2008, it appeared that this has not been enough to bridge the gap between supply and demand of trade finance worldwide. This is why the G20 adopted a wider package for injecting some $250 billion in support of trade finance.

Why does trade finance matter?

Part of the collapse of world trade is due to problems with trade credit financing. The global market for trade finance (credit and insurance) is estimated to be from $10–12 trillion – that is roughly 80% of 2008 trade flows valued at $15 trillion. The World Bank estimates that 85–90% of the fall in world trade since the second half of 2008 is due to falling international demand, and 10–15% is attributable to a fall in the supply of trade finance. This *Policy Insight* lays out some recent facts and explains decisions made at the G20 London Summit regarding what is potentially one of the main sources of contagion of the financial crisis from a trade perspective – the supply of trade finance.

The potential damage to the real economy from shrinking trade finance is enormous. International supply chain arrangements have not only globalised production, but also trade finance. Sophisticated supply chain financing operations – including those for small and medium-size companies – rely on a high level of trust and confidence in global suppliers that they will deliver their share of the value-added, and have the necessary financial means to produce and export it in a timely manner. Any disruption in the ability of the financial sector to provide working capital, pre-shipment export finance, issue or endorse letters of credit or deliver export credit insurance, is likely to create a gap in complex outward-processing assembly operations. This can lead to a contraction in trade and output, and is particularly worry-some for the sustainability of global supply chain operations.

The WTO's involvement in trade finance issues

The *institutional case* for the WTO to be concerned about the scarcity of trade finance during periods of crisis is relatively clear. In situations of extreme financial crises, such as those experienced by emerging economies in the 1990's, credit crunch had reduced access to trade finance – already the short-term segment of the market – and hence trade, which would usually be the prime vector of balance of payments' recovery. The credit crunch had also affected some countries during the Asian financial crisis to the point of bringing them to a halt. In the immediate aftermath of the currency crisis, a large amount of outstanding credit lines for trade had to be rescheduled by creditors and debtors, to re-ignite trade flows – and hence the economy. Under the umbrella of the Marrakech Mandate on Coherence, the heads of the WTO, IMF and World Bank convened in 2003 an expert group of trade finance practitioners to examine what went wrong in the trade finance market and prepare contingencies.

Author's note: These views are not reflective of the official views of the WTO. They engage the author and only him.

Conclusions of the experts were summarised in IMF (2003) and WTO (2003).

The *economic case* for the involvement of international organisations, in particular the WTO, has been discussed in WTO (2003) and (2004). The main arguments are based on the idea that trade finance is to a large extent a very secure, short-term, self-liquidating form of finance. Even in some of the most acute periods of financial crises (1825, 1930), international credit lines have never been cut off. For centuries, the expansion of trade has depended on reliable and cost-effective sources of finance backed by a deep, global secondary market of fluid and secured financing instruments, and a wide range of credit insurance products, provided by private and public sector institutions (including national export credit agencies, regional development banks and the World Bank/IFC). Trade finance normally offers a high degree of security to the trade transaction and its payment. Such prime, secure corporate lending carries normally little risk and hence a small fee (typically, a few basis points over the LIBOR for a prime borrower).

However, since the Asian crisis the trade finance market has not been totally immune from general reassessments of risk, sharp squeezes in overall market liquidity, or herd behaviour in the case of runs on currencies or repatriation of foreign assets. This might happen again in this current turmoil. Commercial risk in trade finance normally stems from the risk of non-payment by the counterparty to the trade operation (either the client company or its bank). The perception of this risk obviously has changed with exchange rate fluctuations, the rise in political risk and bank failures, all of which may undermine the profitability of trade. Such rapid change in risk perception has happened again abruptly, for example lasting the fall of 2008, with respect to certain Eastern European countries. At the present moment, many lenders have adopted a wait-and-see attitude triggered by the doubts in the creditworthiness of banks in a number of regions in the world, including developing countries, as well as by the increase in the balance of payment risk. What aggravates the situation is that the secondary market has also dried up. As much as lending seems to be directly affected by the tight liquidity situation worldwide, the re-insurance market suffered from the difficulties faced by AIG and Lloyds.

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Of course, it can be argued that such 'exogenous' factors as liquidity squeeze, exchange rate fluctuations and other aspects impacting risk are not specific to trade finance. Any un-hedged cross-border flow would most likely be affected by them. Likewise, the supply of credit would be affected by the greater scarcity of liquidity available to some banks in the inter-bank market. Yet, since trade finance has to compete for an equal or reduced amount of liquidity like any other segment of the credit market the price of transactions has increased sharply under the combined effects of scarce liquidity to back-up loans and a re-assessment of customer and country risks. Spreads on 90-days letters of credit have gone through the roof in the course of 2008 (from 10 to 16 basis points on a normal basis, to 250 to 500 basis points for letters of credit issued by emerging and developing economies).

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Even under stress, it is hard to believe that the safest and most self-liquidating form of finance, with strong receivables and marketable collaterals, could see its price increase by a factor of 10 to 50. Indeed, this segment of the credit market has been by far one of the most resilient since the sub-prime crisis started in mid-2007, and that signs of market gaps at a global scale only appeared in the Fall of 2008, well after other segments of the credit market. This strong resilience can be partially attributed to facilitation devices developed by public-backed regional or multilateral financial institutions after the Asian financial crisis. Trade finance facilitation programmes which provide for risk mitigation between banks issuing and receiving trade finance instruments have been developed into a world-wide network, in which the IFC, the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB) and the Inter-American Development Bank (IADB) participate. Institutions such as the OPEC Fund, the Islamic Development Bank, and the African Development Bank have also developed or are developing similar instruments. In addition, national export credit agencies have expanded short-term trade finance operations, and added considerable liquidity to the markets in recent years according to Berne Union statistics. Both types of institutions have hence developed a unique *savoir-faire* in recent years, and are potentially ready to add further liquidity and expand the risk mitigation capacity should the need arise.

What is the situation now?

Despite the relatively strong resilience of the trade finance markets, the global liquidity situation has been a major constraint in 2008 for the largest suppliers, along with a general re-assessment of counterparty risk and an expected increase in payment defaults on trade operations. The market gap initially appeared on Wall Street and in London, as US and UK based global banks – particularly those with deteriorated balance sheets – could not off-load/refinance on the secondary market their excess exposure in trade credits. The situation spread to developing countries' markets in the second part of the year. As a result, some banks were unable to meet the demand from their customers for new trade operations, leaving a market gap estimated at around $25 billion in November 2008, out of the global market for trade finance estimated at some $10-12 trillion a year. Some very large banks used to roll-over up to $20 billion per month into the secondary market and this amount reaches $200 million or less right now due to lack of counterparty. Demand for trade credit is far from being satisfied, and the rise in prices for opening letters of credit by far outweighs the normal re-assessment of risk according to market specialists. More disturbing is the fact that large banks reported on several occasions that the lack of financing capacity has made them unable to finance trade operations. It has however been argued by relatively profitable banks that the situation, in particular in the secondary market has softened recently, although not for everyone.

The market gap could be well over the $25 billion estimate mentioned here, above $100 billion and up to $300 billion. Such scarcity of trade finance is very likely to accelerate the slowdown of world trade and output.

The liquidity problem has ever since spread other developing countries' money markets with the poorer countries in Asia, Latin America, and Africa being particularly affected. This adds to the specific problems faced by local banks in such developing countries in normal circumstances; relative lack of depth of money markets, lack of capacity to handle large volumes of trade credit, and the lack of reliable information on the creditworthiness of customers to name a few. In periods of crisis these issues lead to difficulties in finding partners in developed countries to accept the counterparty risk.

According to the joint IMF-Banker's Association for Trade and Finance (BAFT) survey[1] flows of trade finance from developing countries' banks seem to have fallen by some 6% or more year-on-year (end 3rd quarter 2007-end 3rd quarter 2008). This is more than the reduction in trade flows from and to developing countries during the same period, hence implying that the lack in supply of trade finance is indeed an issue for these countries. In late 2008 it was expected that trade finance flows for the same categories of banks would further fall by 10% in 2009 (IMF 2009). If such numbers were to be confirmed (at least local bankers seem to agree according to the survey), this would mean that the market gap could be well over the $25 billion estimate mentioned above, above $100 billion and up to $300 billion. Such scarcity of trade finance is very likely to accelerate the slowdown of world trade and output.

In advance of the G20 Summit in London, the IMF and the BAFT provided for an update of their survey, indicating that the decrease in the value of trade finance accelerated between October 2008 and January 2009 in almost all regions. While more than 70% of the respondents attributed this further decline to the fall in demand for trade activities, six-in-ten respondents attributed it to restrained credit availability, thereby pointing to increased difficulties of banks to supply trade credit due to the general liquidity squeeze and the increased risk aversion to finance cross-border trade operations (IMF and BAFT Trade Finance Survey (2009). Spreads (prices) on the opening up of letters of credit were up from 10 to 15 basis points above the London Inter-Bank Overnight Rate (LIBOR) up to 300 basis points in some emerging economies. Some banks even reported 600 basis points for particular destinations.

Results from the survey undertaken by the International Chamber of Commerce (ICC) broadly confirmed the conclusions drawn by the IMF-BAFT analysis, albeit relying on a wider panel of banks and countries (122 banks in 59 countries) (ICC 2009). The results were also released for the WTO Expert Group of March 18, 2009 and further updated before the G20 Summit in London. It is obvious that trade decreased as a result of the recession and due to tight credit conditions. About half of the banks had confirmed a decrease in volume and value in letters of credit, and the volume and value of aggregate transactions – a trend that was particularly clear when comparing data of 4th quarter 2007 and 4th quarter 2008. This was particularly true for developed countries' markets (and even more so for least developing countries), with large scale financing projects being deferred or having difficulty to obtain finance.[2] Apart for the reduction in the demand for trade, the main reasons provided by banks for the decrease in credit lines and increase in spreads[3] were the application of more stringent credit criteria, capital allocation restrictions, and reduced inter-bank lending. The ICC also pointed out that intense scrutiny of underlying guarantees by some banks led to higher rates of rejection of letters of credit. Prospects for trade finance in 2009 were negative, with the general view that 'tight credit conditions may further reduce access to trade finance'.

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Since the G20 meeting, the market has not gone back to normal. There is a great deal of lack of transparency on market conditions, in particular characterised by the lack of statistics on credit default – although the ICC global survey allowed for regional sub-surveys, in particular one conducted by the ICC and the Inter-American Development Bank (and presented at the 2009 Annual Meeting of the IADB), which indicated

1 Undertaken in the context of the WTO Expert Group Meeting on November 12, 2008 and presented at the Expert Group Meeting on March 18, 2009

2 SWIFT data pointed to a deterioration particularly visible in the Asian Pacific Area.

3 Some 40% of the respondent banks indicated that spreads had increased significantly over the past year, and were not expected to fall anytime soon.

that payment defaults were clearly on the rise. At the same time, statistics from the Berne Union on insured credit indicate since the end of 2008 a fall of such credit and a substantial increase in claims. These two sources seem to indicate that the rise in 'casualties' into what would normally be a relatively safe market is creating an abnormally high aversion to risk. This can be measured by the maintenance of high prices on the opening of new letters of credit for customers in developing countries – 150 basis points for some of the best counterparty risks at the present moment in India, for example. The perception of risk varies from country to country, depending on the evolving situation of its banking sector, the assessment of the sovereign risk, and the capitalisation required to finance such operations as a result of international regulatory frameworks such as Basel II, and of banks' own 'internal ratings system' (IRS). In this respect, the most recent information indicate that the situation seems to have eased a bit in Asia, particularly in China, although some countries see their access to finance still very restricted (Philippines, Vietnam). In Africa, the situation remains tense, and active banks are seeking support from international financial institutions. In Latin America, credit rates have somewhat eased up since the fall of 2008, but are still higher than usual both in small Latin American states, and increasingly in larger countries such as Mexico and Argentina.

The statistical difficulties

Why is the international community relying on surveys and not on a comprehensive set of international statistics for trade finance? Up until 2004, a series of trade finance statistics was derived from balance of payments and BIS banking statistics, under the combined efforts of four international agencies, i.e. the IMF, World Bank, BIS and OECD. Apparently the cost-to-quality ratio of these statistics led the agencies to discontinue this effort. At present the only available and reliable source of statistics concerning trade finance comes from the Berne Union database, which provides data on the amount of business of export credit agencies (mainly trade credit insurance). Survey-based data on banks activities provides great value at the moment, but is only of limited use for regular reporting. The reasons include the very large amount of transactions carried out by banks, the variability of trade finance instruments used by banks over time, and, more importantly, the difficulty to obtain from the largest banks commercially-sensitive data.

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The only way to obtain comprehensive information on an on-going basis would be through the balance of payments. Here, confidentiality is less of an issue as data is collected on an aggregate basis and according to the resident-non resident criterion of the balance of payments. Although short-term trade credit should be captured under the IMF's 5th Manual on Balance of Payment Statistics, it has always proven difficult to collect the information on a global basis due to the very high cost of information technology needed for statistical compilers to be able to do so. Even the richest countries find it difficult, with the highest level of reporting, to guarantee a high level of accuracy to very short term capital movements (in the form of short-term trade credit) which may cross the resident to non-resident border several times a year.

A mismatch between supply and demand during financial crises

As indicated above, while overall flows are not subject to comprehensive statistical compilation but only to measurement by surveys we are not able to appropriately gauge changes in trade finance flows. However, the overall increase in spreads requested for opening letters of credit is pointing to a shortage in supply despite the reduced demand due to the overall fall in trade transactions. Disagreement persists as to the causes of the shortage of trade finance. While the public sector in general maintains that trade finance gaps in extreme circumstances are a result of market failure, the private sector traditionally argues that they result from the cost of (new) rules, in this case the implementation of the Basel II Accord. These arguments have been developed in WTO (2003), and to some extent can be applied to the current circumstances (ICC 2009).

When market conditions tighten, capital requirements for trade finance instruments tend to increase more than proportionally to the risk when the counterparty is in a developing country.

The market failure argument rests on the inability of private sector operators to avoid herd behaviour, in particular when credit risk and country risk are being confounded (for example in cases of rumour of sovereign default). Also, non-cooperative games are played by global suppliers, with the best run institutions refusing to refinance on the secondary market letters of credit from banks in a less favourable liquidity situation.

On the regulatory side, commercial bankers have long complained about the implementation of Basel II rules, which are regarded as having a pro-cyclical effect on the supply of credit. When market conditions tighten, capital requirements for trade finance instruments tend to increase more than proportionally to the risk when the counterparty is in a developing country. Both western banks and developing countries have recently been complaining that ratings from international rating agencies maintain a bias against developing countries' risk.

Several developing countries have made that point in the WTO Working Group on Trade, Debt and Finance, among others. They argue that they neither have been involved in the elaboration of recommendations of Basel II rules by the Basel Committee on Banking Supervision, nor have they any control over ratings by international rating agencies. Before and during the G20 Summit in London, it was agreed that all G20 countries would become members of the Financial Stability Forum and its components, including the Basel Committee on Banking Supervision and various other coordinating bodies on financial regulation. Therefore, they would be able to participate in the review of Basel II rules.

Recommendations by business associations

In the context of the current financial crisis, the BAFT, ICC, Business Europe, as well as individual commercial banks have been making recommendations to the G20 Summit in London, in the following areas:

- **Reviewing Basel II rules.** Results from a survey conducted by the ICC UK in parallel with the ICC Global Survey (March 2009) indicate that the implementation of the Basel II framework has eroded the incentive of banks to lend short-term for trade because capital weightings are not fully reflective of the low risk level and short term character of the activity. In a risk-weighted asset system, increases in minimum capital requirements had particularly adverse consequences on trade lending to small and medium-size enterprises and counterparties in developing countries.
- **Creating a ring-fenced liquidity pool for trade finance.** The general proposal was to design a small and targeted liquidity fund run by international financial institutions and useful for smaller segments of the market or new countries, in particular those most likely to be hit by the contraction of trade credit supply.
- More co-sharing of risk with public sector-backed institutions. The idea would be to encourage co-finance between the various providers of trade finance. Public sector actors, such as export credit agencies and regional development banks, should be mobilised to shoulder some the private sector risk.

The efforts by public and private players to boost the supply of trade finance at the end of 2008

One clear lesson from the Asian financial crisis is that in periods prone to lack of trust and transparency as well as herd behaviour, all actors – including private banks (which account for some 80% of the trade finance market by way of lending), export credit agencies and regional development banks – should pool their resources to the extent this is practicable (IMF 2003). Cooperation among the various players is also important because of an absence of a comprehensive, continuous data set on trade finance flows. This means that the main channel for making a reasonable assessment of the market situation is via the collection of informed views and surveys from various institutions. This has been a key aspect of the activities of the WTO Expert Group chaired by the Director-General of the WTO, in particular after the November 12, 2008 meeting.

> **All regional development banks and the IFC have doubled on average capacity under trade facilitation programmes between November 2008 and the G20 Meeting.**

The response of public-sector-backed institutions since the fall of 2008 has been more than positive, actually of a magnitude unseen in recent history. Capacities in three types of activities were enhanced significantly:

- All regional development banks and the IFC have doubled on average capacity under trade facilitation programmes between November 2008 and the G20 Meeting. Further enhancements of these programmes were agreed at the G20 meeting, in particular the establishment by the IFC of a liquidity pool allowing co-financing operations with banks in developing countries, which would likely have a high leverage and multiplier effect on trade.
- Export credit agencies have also stepped in, essentially with programmes for short-term lending of working capital and credit guarantees aimed at SMEs. For certain countries, the commitment is very large (Germany, Japan). In other cases, very large lines of credit have been granted to secure supplies with key trading partners (the USA with Korea and China), while in some countries, cooperation has developed to support regional trade, in particular supply-chain- operations. To this effect, the APEC summit announced the establishment of an Asia-Pacific Trade Insurance Network to facilitate intra- and extra- regional flows and investment through reinsurance cooperation among export credit agencies in the region. Japan's NEXI is establishing itself as the leader and main underwriter of this collective re-insurance system.
- One problem often underestimated in developing countries is the difficulty for banks and importers to find foreign exchange, for example in cases where the main currency of transactions (say, the Euro or the US dollar) has become scarce because of the depreciation of the local currency, or because of the fall in receipts from remittances and exports. Central banks with large foreign exchange reserves have been able to supply foreign currency to local banks and importers generally through repurchase agreements. Since October 2008, Brazil's central bank has provided $10 billion to the local market. The Korean cen-

tral bank has pledged $10 billion of its foreign exchange reserves to do likewise. The central banks of South Africa, India, Indonesia, and Argentina are also engaged in similar operations. However, many developing countries lack foreign exchange reserves and are unfortunately unable to use similar facilities.

Why has the market not re-balanced itself?

The current effort aimed at mobilising public-sector institutions to shoulder some of the risk carried by private sector banks is to a certain extent a race against time. While more financing capacity is provided by public institutions, it seems that the private sector's ability to respond to importers' and exporters' demand for finance has been deteriorating even faster, particularly in developing countries in the last two quarters. Also, BAFT members (commercial banks) have complained that measures announced by Export Credit Agencies (ECA) and regional development banks were hard to track, which lack the information on who is providing what and under which conditions. To fill this information gap was of one of the highest priorities of the WTO Expert Group Meeting on March 18, 2009.

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In this context, it is important that implementation and design of ECA programs are carried out in a cooperative manner. The issue of financing both *exports and imports* has also been raised by bankers and traders, as the survival of supply chains partly depends on the financing of both sides. Perhaps, should the Asian example of ECAs supporting both intra- and extra-regional trade by working as a network be examined by other regions.

As a result of the above, policy-makers may find that there is no quick fix to the trade finance problem, but a need for quicker and more sequenced and cooperative implementation of a series of measures that are already underway. Hence, immediate recommendations would require to:

(i) accelerate the implementation of IFC's and regional development banks' programmes to enhance trade finance facilitation, which should open a liquidity window for co-financing;
(ii) fill the information gap as to what ECAs are doing by circulating a list of new programmes and open quick and user-friendly liquidity and re-insurance windows for both exporters and importers;
(iii) encourage coordinated actions by ECAs (possibly regionally);
(iv) encourage liquidity pools allowing rapid co-financing between banks, ECAs and IFIs (IFC proposal);
(v) review Basel II regulation to acknowledge the self-liquidating character of trade finance.

In the meantime, there should be no doubt that the trade finance market will experience difficult times throughout the first half of 2009 , and might get worse before it gets better. But efforts will continue to find durable solutions to what otherwise is yet another source of economic contraction (Auboin 2009), for example, through the WTO's advocacy and mobilisation work.

The G20 Summit in London: A trade finance 'package'

The above mentioned recommendations were to a large extend reflected in the 'trade finance package' of the G20 Summit's communiqué, on April 2, 2009. Under the heading 'Resisting Protectionism and promoting global trade and investment', the last two bullets points of paragraph 22 of the communiqué say:

> *'we will take, at the same time, whatever steps we can promote to facilitate trade and investment, and, we will ensure availability of at least $250 billion over the next two years to support trade finance through our export credit and investment agencies and through the MDBs (multilateral development banks). We ask our regulators to make use of available flexibility in capital requirements for trade finance.'*

The trade finance 'package' responds largely to the criteria developed by the WTO Expert Group on Trade Finance; strengthened public-private sector partnerships in the context of existing trade finance facilitation programmes, which will be further enhanced, not only on credit insurance, but also by opening and expanding liquidity windows of regional development banks to allow greater co-lending with banks. The IFC is showing the way by reinforcing its global trade finance facility through the introduction of a liquidity pool, allowing immediately to finance with commercial banks, on a 40-60% co-lending agreement, up to $50 billion of trade transactions in the next two years (Standard Chartered Bank and Standard Bank have already signed off on credit lines with several hundreds of millions of dollars for financing Africa's trade). While jump-starting the IFC's Global Trade Finance Liquidity Fund with $5 billion in IFC Funds (raised by both the IFC and several individual donors), to be matched by $7.5 billion in commercial banks funding according to the co-lending formula, the IFC Fund could further increase overtime by attracting more donors and hence more funding by banks. The objective of doubling the IFC's and donor funding overtime, from $5 to $10 billion is feasible, hence doubling the Fund's total capacity from $12.5 billion to $25 billion, which means financing over than $50 billion in trade transactions.

Another pillar in the package is the strengthening of existing capacities of ECAs in the OECD, allowing them to offer more finance and a wider spectrum of instruments. In particular, ECAs would be encouraged to provide more direct funding in the short-run (working capital lending and other forms of short-term direct support), that will be matched by a higher capacity on the insurance side, also in the short term.

Finally, several institutions, either IFIs, ECAs and other government agencies, will try to revive the secondary market by intervening directly into it.

All in all, the logic of acting by way of increasing co-financing and co-risk mitigation has been followed by the Heads of States and Governments. The logic implies more liquidity and re-insurance available from ECAs and IFIs. It is well indicated that the package is expected to be implemented over two years, hence some of the early comments by press and academics about the lack of new funding should be put into a longer time perspective, bearing in mind that most of such a package has been designed with the objective of raising additional, not re-hashed funds. However, it remains that the contraction of the trade credit is part of the broader liquidity and solvency crisis, and although progress has been made with significant input from the WTO, it is vital that we stay engaged to monitor the situation, along with WTO Members, our network of banks, governments and international institutions.

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