Auboin, Marc

Article
Facilitating the Access of Trade Finance to Traders: The Role of the WTO

CESifo Forum

Provided in Cooperation with:
Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Auboin, Marc (2014) : Facilitating the Access of Trade Finance to Traders: The Role of the WTO, CESifo Forum, ISSN 2190-717X, ifo Institut - Leibniz-Institut für Wirtschaftsforschung an der Universität München, München, Vol. 15, Iss. 3, pp. 12-16

This Version is available at:
http://hdl.handle.net/10419/166570

Terms of use:
Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.
Facilitating the Access of Trade Finance to Traders: The Role of the WTO

Marc Auboin

Until the financial crises of the 1990s and that of 2008/09, trade finance had been taken for granted. However, the recent financial crisis revealed that trade finance markets can be subject to dislocation, making policy interventions necessary given the strong linkage between the availability of trade finance and trade flows. Following the G20 support ‘package’ implemented in 2009/10, conditions returned to normal in the main markets although not everywhere. The structural difficulties experienced by poor countries in accessing trade finance have been worsened by the banking crisis. In this context, it was important to foster dialogue with international prudential authorities to avoid ‘unintended consequences’ for trade finance. This article describes the efforts by the international community to support trade finance in difficult times, and the role of the WTO in this context.

The ‘big trade collapse’ and public support to trade finance in crisis

Finance is the lubricant of commerce. Most trade transactions are supported by a trade credit. A credit is required to bridge the gap between the time at which exporters wish to be paid (at dispatch, at the latest with the order, at the earliest), and the time at which importers will pay (at the earliest, on receipt of the merchandise). Hence, a large share (up to 80 percent) of the 18 trillion US dollars of annual trade revenue involves some form of finance (credit, insurance or guarantee). While the commercial risks involved in an international trade transaction seem, in principle, to be larger than in a domestic trade transaction (risk of non-payment, risk of loss or alteration of the merchandise during shipment, exchange rate risk), trade finance is actually considered to be a particularly safe form of finance, as it is underwritten by strong collateral and documented credit operations. According to the International Chamber of Commerce’s Trade Finance Loss Register, the average default rate on short-term international trade credit is no more than 0.02 percent, of which 60 percent is recovered though the sale of the underlying asset, the merchandise.

Despite trade finance being a routine task, at the same time it is universal and vital for trading activities. Until the financial crises of the 1990s and 2008/09, trade finance had become easy to take for granted; but the crises created distortions in the relevant markets that made policy interventions necessary. In the heat of the 2009 financial meltdown, the collapse of worldwide trade was accelerated by the shortage of trade finance, linked to the temporary inability of private sector banks to respond to their customers’ financing needs. Based on WTO proposals, the London G20 Summit took the initiative to muster 250 billion US dollars in additional short-term trade finance and guarantees. This was a most welcome development that helped restore confidence in the market. Large traders were able to benefit from rapid export credit support and risk-sharing mechanisms mobilised by international financial institutions: within a year of implementation, the initiative had helped to mobilise 170 billion US dollars in additional capacity, mainly from export credit agencies, of which 130 billion US dollars had been used. In the summer of 2009, it was felt that the outlook for global trade finance had improved, partly due to improvements in overall financial markets and partly to a recovery of trade.

During and after the financial crisis, academic work has highlighted the strong link between trade and trade finance. The ‘trade finance’ hypothesis has gained popularity among some economists in their search for plausible explanations for the ‘big trade collapse’ of late 2008 to late 2009, when global trade outpaced the drop in GDP by a factor that was much larger than anticipated under standard models. As summarised by Eichengreen and O’Rourke (2012), the roots of this collapse of trade remain to be fully un-
derstood, although recent research has begun to shed light on some of the causes – see, in particular, Baldwin (2009). While most authors agree that the fall in demand was largely responsible for the drop in trade flows, the debate focused on the extent to which other potential culprits like trade restrictions, a lack of trade finance, and vertical specialisation may have played a role. The trade finance hypothesis is sustained by several empirical papers analysing the effect of trade finance on trade during the recent financial crisis – see also Chor and Manova (2012); Amiti and Weinstein (2011); Felbermayr, Heiland and Yalcin (2012); Auboin and Engemann (2014).

Structural difficulties in low income countries

The problems faced by traders in low income countries (LICs) in accessing affordable trade finance are to a large extent structural, but have worsened since the 2009 crisis. A recent survey conducted by the Dutch Institute CBI (2012) revealed that a majority of SME exporters within Africa reported an increase in trade finance costs over the last three years, and that access to trade finance, one of the main obstacles to their trade, had become more difficult. A WTO-OECD also concluded that a lack of access to trade finance was a key element in the inability of low income countries to participate in global value chains.

The contraction of the global financial industry since 2009 has exacerbated the situation. Capital for lending in LICs has become scarcer and the selectivity of risks greater, so negative expectations regarding the cost of doing business in poorly (or non-)rated countries translate either into higher costs for traders locally, or simply in less finance available. For example, leading consulting firms active in trade finance have indicated that the regular import loans charged on non-sovereign African risks are still well over 10 percent per annum for at least a third of African countries, and for around a further 20 countries in the rest of the world.

The international response

In 2011, the Director-General of the WTO and President of the World Bank, with the support of the Heads of Multilateral Development Banks, drew the international community’s attention to this problem affecting specifically low income countries. The G20 Seoul Summit Document indicated that: “to support low income countries (LIC) capacity to trade […] we note our commitment to […] support measures to increase the availability of trade finance in developing countries, particularly LICs. In this respect, we also agree to monitor and to assess trade finance programs in support of developing countries, in particular their coverage and impact on LICs, and to evaluate the impact of regulatory regimes on trade finance” (Fighting Protectionism and Promoting Trade and Investment, paragraph 44).

The WTO reviewed the efforts already deployed by regional development banks and the World Bank Group – through the International Financial Corporation (IFC), its private sector arm – to support trade finance. This effort was not insignificant. Between 2008 and 2012, the total volume of trade supported by existing, so-called trade finance facilitation programmes increased by 150 percent, to a total of almost 25 billion US dollars. The support of multilateral development banks and that of the IFC is therefore very important for trade in developing and low income countries (see Box 1).

The G20 adopted the recommendations of the WTO Report asking regional development banks and the World Bank group, which have benefited from recent recapitalisations, to expand as a matter of priority their coverage of low-to-middle income countries (also including significant traders like Bangladesh, Pakistan, Nigeria, Sri Lanka, Kenya), and to further
Focus

Trade finance facilitation programs (TFFPs)

The expansion of trade finance facilitation programmes and similar schemes do not cost the taxpayer any money. These schemes are risk mitigation instruments that are run on a private-sector, demand-basis, with a focus on clients in developing countries, particularly the poorest. All institutions that operate such programmes are running net operating profits on them, while serving the wider purpose of facilitating trade in places of the word where private markets would not operate. These programmes strengthen financial and trade inclusion in low income countries. In effect, trade finance facilitation programmes provide risk mitigation capacity (guarantees) to both issuing and confirming banks, to allow for the rapid endorsement of letters of credit – a major instrument used to finance trade transactions between developing country players, and between developed and developing countries. The guarantee provided by the multilateral development bank ensures that the bank (typically the bank of the exporter) accepting to confirm a letter of credit (typically issued by the bank of the importer) will be paid even if the issuer fails to pay. The guarantee would ensure that the exporting bank is paid. Such guarantees are rarely called in, but reduce the risk aversion of conduction trade operation in low income countries – as they close part of the ‘confidence gap’ between the existing level of risk and its perception. Demand for these programmes increased during the 2009 financial crisis and has not fallen since. The Asian Development Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the Islamic Development Bank, and the IFC are operating relatively similar programmes. The African Development Bank opened a programme in early 2013, and has already financed over 600 million US dollars in trade transactions in Africa.

expanding the risk limits to allow for greater support to countries in which local financial institutions cannot support trade and traders cannot afford credit conditions. Two priority regions were clearly set out: Africa and Asia. With support from the WTO, Asian Development Bank and the IFC, the Executive Board of the African Development Bank approved the creation of a permanent facility for trade finance in February 2013, with a risk capacity of 1 billion US dollars. The first transactions were signed on the margin of the African Development Bank in May 2013. Other steps have been taken, such as expanding the EBRD’s trade finance facilitation program to countries in the middle-east (so-called MENA countries), and further extending the IFC’s own programme to cover other low-income countries. All in all, roughly 30 billion US dollars in trade transactions were supported by these programmes in 2013. Although this may not seem a large amount, the average transaction was of less than 350,000 US dollars, meaning that more than tens of thousands of trade transactions that would not have taken place otherwise were supported in that year.

Avoiding the unintended consequences of Basel III on trade finance

Traditionally, trade finance – mainly letters of credit and other self-liquidating instruments of payments for trade – has received preferred treatment on the part of national and international regulators on the grounds that trade finance was one of the safest, most collateralized, and self-liquidating forms of trade finance. This was reflected in the low credit conversion factor (CCF) determined under the Basel I framework for the capitalisation of these instruments, which was set at 20 percent, i.e. five times lower than any on-balance sheet loan.² However, as the banking and regulatory communities moved towards internal rating based and risk-weighted assets systems under the successor Basel II framework, issues regarding maturity structure and country risk emerged.

With the collapse of trade in late 2008 and early 2009, the regulatory treatment of trade credit under Basel II became an issue and was discussed by professional banking organisations, regulators and international financial institutions. A sentence made its headway into the communiqué of G20 Leaders in London in April 2009, calling upon regulators to exercise some flexibility in the application of Basel II rules, in support of trade finance. Moreover, in the context of prudential re-regulation under Basel III, there were calls for trade finance, which had suffered casualties by contagion from other segments of the financial industry, not to be penalised. The unintended consequences of increased prudential regulation were to be avoided, particularly with respect to the ability of developing countries to access trade finance at an affordable cost. The banking community was asked by the Director General of the WTO, Pascal Lamy, to provide evidence of the high level of safety and soundness of its activities by collecting statistical information.

In parallel, the G20 asked at the end of 2011 that the WTO and World Bank, on the one hand, and the Basel Committee on Banking Supervision (BCBS), on the other, engage in a dialogue with a view to improving the common understanding of trade finance, and

² The credit conversion factor (CCF) is the share of the asset’s face value taken into account for capitalisation purposes. A 20-percent CCF for letters of credit means that only one fifth of the letter of credit’s face value would be subject to the capital ratio.
identifying any possible unintended consequences of prudential regulation. This dialogue proved extremely useful. Prudential regulators have been able to improve their grasp of the workings of trade finance and to verify, thanks to the data collected by ICC under the ‘pilot’ trade finance register, the low-risk character and absence of leverage of the industry. The aggregate data delivered by ICC covered nine major international banks, over five million transactions, and revealed less than 1,150 defaults.\(^3\) ICC was able to participate in discussions with the Basel Committee alongside the WTO and the World Bank.

**Three positive modifications in favour of trade finance**

Since then, the BCBS has made three revisions reflecting the low level of risk of trade finance, and improving its regulatory treatment.

On 25 October 2011, the BCBS agreed to modify two of its Basel II rules as far as short-term, self-liquidating trade finance instruments were concerned, to reduce the excessive risk weighting on low-income countries (which proved to be no more risky than other countries), and to allow for capital requirements to be matched with the effective product maturity (hence waiving the one-year maturity floor applying to letters of credit and the like). Both measures are of great importance in removing obstacles to the provision of trade finance in low-income countries. This decision is explained in the document *Treatment of Trade Finance under the Basel Capital Framework* of the BCBS, available at http://www.bis.org/publ/bcbs205.pdf.

On 6 January 2013, the new Basel III guidelines on liquidity (concerning the liquidity coverage ratio, LCR) proved favourable to short-term, self-liquidating trade finance instruments. In its decision (http://www.bis.org/press/p140112a.htm), the LCR was defined as the ratio of the ‘stock of high-quality liquid assets’ to ‘total net cash outflows over the next 30 calendar days’. It is meant to ensure that banks have enough liquid assets (i.e. 100 percent of net cash outflows) for a 30-day liquidity stress period. Previously, the liquidity guidelines assumed that trade finance exposures experienced a run-off rate equivalent to corporate exposure (up to 50 percent) during a liquidity stress period and required a proportionate buffer of liquid assets. The revised LCR relaxes the outflow assumptions for a number of bank liabilities, including those arising from trade finance. The Committee allows national regulators to set very low outflow rates (between 0 and 5 percent) for contingent funding obligations from trade finance instruments – significantly below its previous level. This implies that banks will be allowed to hold fewer liquid assets against contingent liabilities and committed funded facilities arising from trade finance, thereby increasing the availability of trade finance.

On 12 January 2014, the BCBS modified its 2011 rule regarding the leverage ratio on trade letters of credit and other self-liquidating trade-related instruments, to reduce it from a 100-percent CCF to a 20-percent CCF (as for capital purposes). In its 2011 initial decision on the leverage ratio, the BCBS added a flat, non-risk weighted, 100-percent CCF for leverage on all off-balance sheet items regardless of their risk level – thereby also affecting trade letters of credit. One point made by the WTO has been the absence of leverage involved in trade finance transactions, due to the one-to-one relationship with merchandise trade. Moreover, contingent trade finance obligations, such as letters of credit, are off the balance sheet essentially for process reasons. This argument was accepted by several interlocutors, within and outside the BCBS. The 2014 modification was hailed by the Director-General of the WTO “as being of particular significance for the availability of trade finance in the developing world, where letters of credit are a key instrument of payment. This is good news for developing countries, for the expansion of their trade and for the continued growth of South-South trade flows”.\(^4\)

All in all, the situation on the regulatory front is looking better than it did a few years ago, thanks to the institutional dialogues initiated by the WTO and the Basel Committee, and the data support provided by ICC. There is no doubt that such initiatives contribute to improving the policy coherence between the prudential and central bank community on the one hand, and the trading community on the other.

**References**


\(^3\) Further details about the ICC trade finance register can be found in ICC Global Survey 2013: Rethinking Trade and Finance at www.iccwbo.org.

\(^4\) The entire quote can be found at: http://www.wto.org/english/news_e/news14_e/ldgra_17jan14_e.htm.


