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Research Report

The availability of trade finance: a challenge for global economic governance

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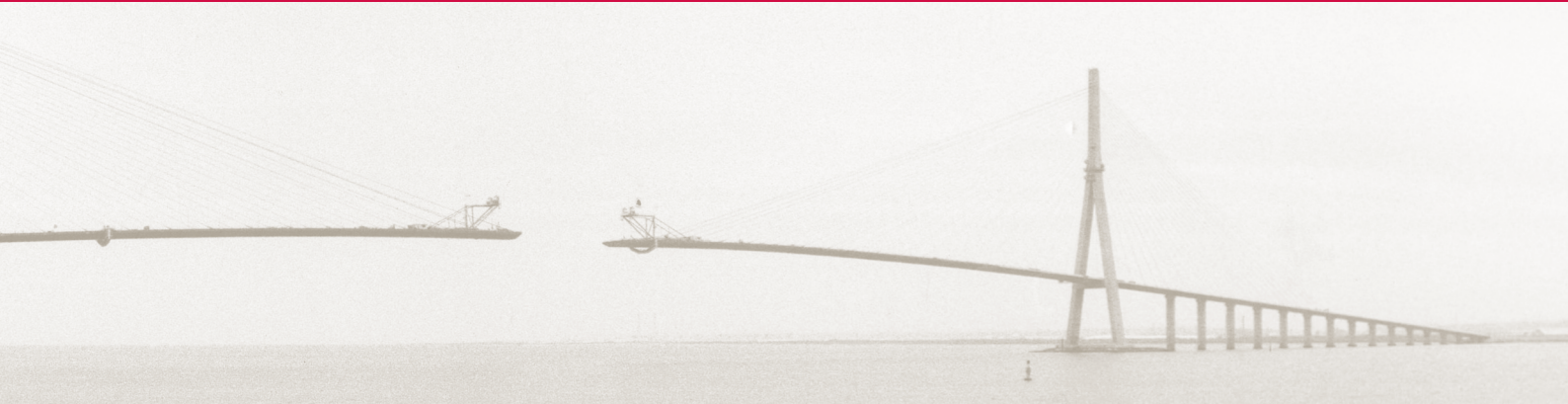
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The Availability of Trade Finance: A Challenge for Global Economic Governance

Global economic governance stands for the institutions, regulations and mechanisms that manage the increasing interdependency of global challenges in the world economy and forms the foundation of stable global economic development. However, global economic governance remains largely mired in “silo thinking”: it is broken down too distinctly into different subject areas, despite the fact that globalisation has led to an increasing overlap in policy areas, with political decisions in one area also affecting others.

For these close interrelations, the handling of trade finance and the parallel lack of coordinated and coherent global economic governance are important examples. Trade finance stands at the interface between trade policy and financial market regulation. Despite this, the relevant institutions, in particular the World Trade Organization (WTO) and the Bank for International Settlements (BIS), do not liaise with one another to an adequate extent.

During the financial and economic crisis, there was a dramatic slump in trade finance. The inadequate availability of trade finance has been a significant barrier to trade since then, and it may inhibit economic development in developing and emerging countries in particular. The G20 consequently saw the need to act promptly. In 2009 it organised support to the amount of US\$ 250 billion to reduce the gaps in trade financing opportunities that had emerged.

The global financial and economic crisis raised the need for a reform of the global banking regulation system. The Basel Committee on Banking Supervision of the BIS consequently initiated the Basel III reform package, designed to make the banking and finance systems more resilient. During the past months, there has been intense debate regarding the extent to which Basel III could inhibit trade finance, and therefore international trade flows.

Although financial regulation does not constitute a focal point of the mandate of the WTO, the organisation should nonetheless have an interest in closer cooperation with the BIS and the Basel Committee on Banking Supervision. The WTO does indeed serve as a discussion forum for relevant players in the field of trade finance; however, cooperation between the WTO and the BIS is not adequately institutionalised, and key actors such as developing countries are not sufficiently involved in the decision-making process.

The insufficiently coordinated and incoherent regulatory framework has resulted in a lack of uniformity in implementing Basel III in different regions. Such a fragmentation of banking regulations presents a problem, as it results in regulatory arbitrage and can serve to undermine the conditions for fair competition. Therefore, there is an urgent need for action, if the anticipated growth in world trade following the latest WTO conference in Bali is also to be financed.

The availability of trade finance – a challenge for developing country trade

Trade finance is the backbone of international trade. All trading transactions require financing to bridge the time between production, delivery and receipt of payment. This financing is either undertaken by the purchaser, the vendor or financial intermediaries. Compared to domestic trade, international trade has higher risks: firstly, higher transport risks and liquidity risks due to longer distances and, secondly, additional exchange rate and country risks. In order to cover these risks, close the financing gap and provide the companies with sufficient working capital, instruments such as loans, insurance cover and guarantees from commercial banks, export credit agencies, development banks or central banks are employed. These instruments are used in 40 per cent of all trading transactions, mostly on a short-term basis (approximately 115 days on average). The letter of credit – a traditional instrument of trade finance – is regarded as one of the safest forms of trade finance, with an average default rate of 0.02 per cent in the period from 2008 to 2011. In the case of private trade finance, which is the focus of this analysis, commercial banks are involved in the issuing of loans and guarantees. These are typically active in multiple regions of the world, with the focal point of business activity in the field of trade finance centred on emerging countries and developing countries of Asia and Latin America, in addition to the industrialised countries.

Figure 1: Transaction process of an import letter of credit

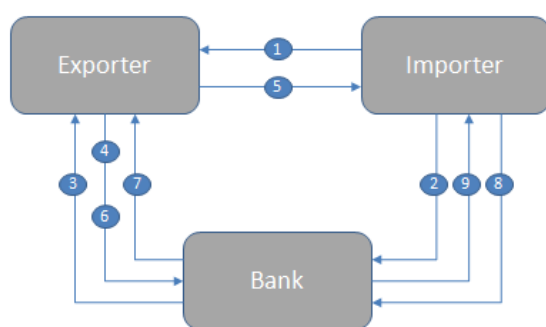


Figure 1 illustrates the transaction process flow for an import letter of credit. After importer and exporter have agreed upon a contract of sale (1), the importer requests a letter of credit (2), which the bank issues on behalf of the importer and in favour of the exporter (3). After the exporter has checked and accepted the letter of credit (4), the exporter ships the goods to the importer (5) and issues the documents required by the letter of credit to the bank (6). If compliant, the bank arranges payment to the exporter (7) and the importer pays the issuing bank (8). The issuing bank then releases the documents to the importer (9).

Source: ICC (2013b)

Financial crises such as the Asian financial crisis and the current global crisis have caused gaps in trade finance, which have in turn contributed to a significant fall in trade flows. According to a survey carried out by the International

Chamber of Commerce (ICC) in 2013, the banks responding identified the lack of trade finance as one of the key challenges for the economic development and recovery of a country. According to the survey, one consequence of the current financial crisis is an ongoing, significant gap in trade finance, which is hindering the trade of emerging and developing countries in particular.

The availability of trade finance is not only inhibited in the short term as a consequence of the current financial crisis, it could also be hindered in the long term by the new financial market regulations of Basel III. One fundamental factor of the crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while maintaining strong risk-based capital ratios. As a consequence of the current financial crisis, the Basel Committee not only decided to raise the risk-based capital requirements but also to introduce a leverage ratio, which, within the scope of Basel III, should serve to restrict the build-up of leverage in the banking sector in order to avoid destabilising deleveraging processes in the future. Moreover, the risk-based requirements in place thus far should be reinforced with a simple, non-risk-based measure. Until the end of 2013, the calculation of the leverage ratio required that off-balance sheet items were calculated with a credit conversion factor of 100 per cent and in future had to be backed by at least 3 per cent equity. Off-balance sheet items also include trade finance instruments. The risk-based capital ratio approach, used exclusively to date, required setting aside 1.6 per cent of capital for trade finance exposures. If the leverage ratio had become binding for financial intermediaries, then the equity requirements for trade finance would have increased substantially, with potentially negative consequences for trade finance. In addition to tariffs and non-tariff trade barriers, developing countries would have been therefore confronted with a new barrier to trade. The WTO serves as a forum for the removal of trade barriers. The WTO member states should therefore have an interest in participating in the drafting of the global regulatory framework for banks, as it has a direct influence on the availability of trade finance.

Trade finance – international cooperation?

The WTO is regarded as the initiator of international cooperation in the field of trade finance and serves as a discussion forum for relevant players.¹ Since the WTO Marrakech Agreement of 1994, global governance in the area of trade has been guided by a coherence mandate aimed at achieving improved cooperation between the WTO, the International Monetary Fund and the World Bank with regard to global economic policy.

1 The following analysis is based upon documents of the variously named committees, available on the WTO website.

As a consequence of the Asian financial crisis, a working group on trade, debt and finance was formed at the WTO ministerial conference in Doha in 2001. Members comprise all WTO member states and all organisations with observer status in the WTO general council. Both the coherence mandate and the establishment of a WTO working group served to strengthen cooperation between the WTO, the International Monetary Fund and the World Bank. For example, all actors took part in a series of meetings with the objective of mitigating the negative effects of the trade finance gap during the financial crisis. Since 2008 the working group has been the hub for WTO initiatives in support of trade finance, particularly in developing countries. In this, the group continuously interacts with the regional development banks, the International Finance Corporation (IFC) and the national export credit agencies.

In addition, 2003 also saw the formation of a WTO expert group on trade finance, initiated by the WTO and the International Monetary Fund, with the goal of improving access to trade finance. In contrast to the working group, the various WTO member states are not represented in the expert group, but rather representatives of regional development banks, the IFC, the Berne Union (International Union of Export Credit and Investment Insurers) and leading private banks. The expert group serves as a discussion forum and provides recommendations to relevant institutions. Since the onset of the current financial crisis, it has met twice a year, reporting to the WTO working group. Among other things, the US\$ 250 billion trade finance package agreed by the G20 in 2009 was based upon a proposal of the WTO expert group. In 2010 the G20 decided to improve the availability of trade finance and, in particular, also to investigate the effect that regulations had upon it.

However, the WTO is not in permanent contact with the key actor in international banking regulation, the BIS. The Basel Committee on Banking Supervision was created under the BIS in 1974. Members are primarily the central banks of industrialised and emerging countries. The goal of the Basel Committee is to establish and promote global standards for the regulation and supervision of banks as well as guidelines and sound practices in addition to contributing towards a "level playing field" among internationally active banks. The decisions do not have legal force, but the members are committed to implement and apply the standards in their domestic jurisdictions. Basel III, the new "regulatory framework for more resilient banks and banking systems", also includes rules regarding trade finance instruments, and is therefore able to influence the provision of trade finance and, subsequently, international trade flows. This underscores the need for the WTO to be interested in closer cooperation with the BIS – even though financial regulations are not the focal point of its mandate. 2010 did indeed see the beginning of a phase of inter-institutional dialogue between the Basel Committee, the WTO, the World Bank and the ICC – a dialogue that addressed the concerns regarding the effects of previous and future regulations on trade finance.

The cooperation between the WTO and the BIS is not adequately institutionalised, in particular due to the fact that there is a lack of mutual representation in the respective institutions. The BIS is not a permanent participant in the WTO working group on the identification of trade barriers as a consequence of new financial regulations, neither is the WTO involved in the drafting of these directives. This is problematic, particularly in view of the different national representations in both organisations. It is primarily industrialised countries, along with a few emerging countries, that draw up the regulatory framework for internationally active banks, guided by the Basel Committee. At the same time, it is primarily importers and exporters from developing and emerging countries that use trade finance instruments that are being newly regulated by Basel III, with the consequence that these countries are particularly affected by changes in the global banking regulation framework. In contrast, both industrialised and developing countries are represented in the WTO.

The regulations in Basel II and III regarding trade finance remain the subject of intense discussions. Consultations with the WTO, the World Bank and the ICC have indicated that four regulations in particular affect the availability of trade finance in the context of low-income countries. The Basel Committee evaluated the treatment of trade finance in the Basel II and III frameworks and decided in October 2011 to adopt two changes that have a disproportionately hindering effect on the issuing of letters of credit with developing countries. Firstly, the Basel Committee decided to waive the minimum maturity requirement of one year and instead take into account the effective, much briefer duration of trade finance products, such as letters of credit, when calculating credit exposures. Secondly, the Basel Committee altered a guideline that concerns exposures to another bank with no external rating. Basel II stipulated that claims on an unrated bank are subject to a risk weighting of 50 per cent or, in the case of short-term claims, 20 per cent. However, the risk weighting cannot be lower than the risk weighting of the sovereign in which the bank is incorporated. For low-income countries, this would typically be a risk weighting of 100 per cent. This "sovereign floor" has been waived so that banks with claims on low-income country banks can reduce the risk weights to 50 per cent or 20 per cent.

Implementation – regional fragmentation?

Despite the amendments to the Basel framework conditions in favour of trade finance, a series of financial sector actors remained dissatisfied. In a joint letter from the Bankers' Association for Finance and Trade and the International Financial Services Association (BAFT-IFSA) – with signatories including stakeholders from industrialised countries (e.g. the Association of German Banks and the European Banking Federation), as well as representatives of developing countries (e.g. the Corporate Council on Africa) – they made it clear that they considered the changes made thus far to the Basel framework conditions to be insufficient with regard to reducing the burden on trade finance. In particular, the uniform credit conver-

sion factor of 100 per cent when calculating the leverage ratio was heavily criticised. The authors called for more consideration to be paid to the short-term and low-risk nature of trade finance products – a position that was also supported by the International Chamber of Commerce.

Although not all regulations were conclusively debated and resolved, implementation of Basel III had already begun. So far 11 of the 27 members of the Basel Committee have accepted Basel III and began implementation in early 2013. Since Basel III does not have legal force but has to be implemented and applied by its members in their domestic jurisdiction, it may be implemented in different ways. The EU directive CRD IV/CRR on the implementation of Basel III, ratified by the European Parliament in 2013, deviated significantly from Basel III regarding the manner in which trade finance is treated. This was welcomed by both the ICC and BAFT-IFSA as well as the WTO expert group. A key modification in the implementation of Basel III within the EU was the introduction of a conversion factor for off-balance sheet items in the calculation of the leverage ratio. As mentioned previously, Basel III stipulated that off-balance sheet items are calculated with a uniform conversion factor of 100 per cent. In contrast to this, the EU differentiates between off-balance sheet items with low- and medium risk and all other off-balance sheet items. Off-balance sheet trade finance instruments with low- and medium risk are calculated with a respective conversion factor of 20 per cent and 50 per cent. Such a differentiation is not yet allowed for in the implementation of Basel III in the United States and a number of Asian countries. Here, a credit conversion factor of 100 per cent is adhered to, as stipulated in the Basel framework agreement. This could inhibit the availability of trade finance through US banks, and with it international trade. At the same time, the Basel Committee continued consultations until autumn 2013 and noted comments and proposals regarding

the definition and manner of calculating the leverage ratio. In January 2014, the Basel Committee decided to reduce the credit conversion factors for trade finance products from 100 per cent to 20 per cent, such that Basel III is now in line with the implementation in the EU, and additional pressures on trade finance – due to the introduction of the leverage ratio – will be avoided. It remains to be seen if these changes are sufficient with regard to reducing the burden on trade finance so that the availability of trade finance in developing countries is sustainably enhanced. A fragmentation of banking regulations would presumably have resulted in regulatory arbitrage and could have undermined the conditions for fair competition. Moreover, different implementations of Basel III could have altered the access of developing countries to trade finance in unpredictable ways, thus inhibiting international trade and economic development.

Outlook and recommendations

From a development policy perspective, it is possible to make the following recommendations in view of the analysis above:

- Developing countries should play a greater role in the ongoing discussions regarding trade finance.
- The BIS and the WTO, in particular, should intensify their cooperation with regard to more adequate global economic governance in the field of trade finance. Existing mechanisms for the exchange of information, analysis of risks and collection of data should be improved.
- The asymmetric implementation of financial market regulations should be avoided, as it leads to regulatory arbitrage and creates unfair competition.
- If Basel III does not reduce the burden on trade finance, the regulations should be re-examined and adapted for trade with developing countries in particular.

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