In this chapter, representatives of the Bankers’ Association for Finance and Trade—International Financial Services Association (BAFT-IFSA) and of three global banks—Standard Chartered Bank, Royal Bank of Scotland, and HSBC—present their assessment of how the 2008–09 crisis affected trade finance, their response to the crisis itself, and their concerns about the effect of the Basel Committee on Banking Supervision (BCBS) regulations on trade finance.

The authors agree that the global economic crisis seriously disrupted the trade finance market in 2008–09 and that the regulations under Basel II further constrained the supply of trade finance during the crisis. They echo the broader view of the banking and trade community (as expressed by 18 banking, services, and trade industry associations around the globe in a November 2010 letter to BCBS) about the unintentional consequences of the BCBS recommendations to increase capital requirements for trade finance. Although the signatories strongly support the BCBS’s stated goal to improve the resilience of the banking sector, they also

---

This chapter has been put together by the editors Jean-Pierre Chauffour and Mariem Malouche based on original material submitted by the authors.
believe that the proposed recommendations neither reflect the risk profile of trade finance assets nor take into account the adverse effects of the proposed changes on global trade and growth.

The BAFT-IFSA Response

BAFT-IFSA\(^1\) and the International Monetary Fund (IMF) were among the first institutions to join forces to help fill the information gap concerning trade finance developments during the 2008–09 financial crisis. BAFT-IFSA and the IMF collaborated on global trade finance surveys to gauge the magnitude of market dislocations around the globe and to benchmark key trends.\(^2\)

Global Trade Finance Surveys

The first survey, conducted in late 2008, found a drop in the banks’ ability to provide trade credit in fall 2008 (IMF 2009). The third survey conducted in July–August 2009 (IMF–BAFT 2009) showed that the capital and liquidity crisis mutually fueled the crisis in confidence and that the value of total trade finance activity dropped by 11 percent. Credit markets froze, transnational movement of goods fell, and protectionist measures gained footing, threatening to slow recovery. Banks also reported that the implementation of Basel II, concomitant with the global recession, added liquidity pressure because global risk deterioration had a dynamic effect on bank capital requirements. As global banks rushed to improve their capital positions to avoid losses in the crisis, trade finance credit lines suffered from heavy cuts. Global trade took a corresponding hit—hurting economic growth, triggering job losses, and depressing consumption.

The results of this joint survey served as an important reference, enabling all stakeholders to clearly understand the magnitude of the problem. Since then, BAFT-IFSA has conducted three more surveys with the IMF. The fourth, conducted in March–April 2010, found that the trade finance situation had started to stabilize (IMF and BAFT–IFSA 2010). Trade finance activities fell by 1 percent on average between the fourth quarter of 2008 and the fourth quarter of 2009—an improvement over the 11 percent decline noted above. Yet, given the global economic contraction, international banks continued to be exposed to heightened risks on a broad scale. Between the retrenchments in the markets and decreased access to private-sector risk mitigation providers, the effect was felt by both trade and non-trade-related clients.

These survey results have been regularly provided to Group of 20 (G-20) finance ministers, central bank governors, and other key regulators. The surveys and position papers gave policy makers tools for considering solutions to the crisis—including (a) a $250 billion pledge for multilateral development banks and export
credit agencies (ECAs) to launch programs addressing trade finance market dislocations and (b) G-20 recognition that waivers by national jurisdictions of Basel II’s one-year maturity floor for trade finance would help mitigate the crisis.

Other Collaborations
Throughout the crisis, BAFT-IFSA engaged on several fronts through its global convening power, its involvement in country-specific and regional matters, and its broad advocacy for fairer treatment of trade finance by the Basel Committee.

Global trade finance summits
BAFT-IFSA hosted the first of four global trade finance summits in London in January 2009. For the first time since the crisis hit, all major stakeholders in the trade finance crisis were gathered: banks from around the world, ECAs, public and private credit insurers, government officials responsible for trade and finance, the World Bank Group, the regional development banks, and other key multilateral institutions such as the World Trade Organization.

The first summit’s aim was to promote a common understanding of trade finance among the gathered experts and stakeholders, to highlight the impact of the crisis on each region of the world, and to agree on recommended solutions. In preparation, BAFT-IFSA circulated a position paper that highlighted the low-risk, short-term nature of trade finance; its long history as “the oil to the wheels of commerce”; and BAFT-IFSA’s recommended solutions to the crisis. Foremost was a warning against a retreat to protectionist measures. BAFT-IFSA recommended that governments form public-private partnerships to address the liquidity problems and revive the secondary markets for trade risk. It also advocated for ECA participation in, and creation of, short-term trade finance programs to ensure recovery.

Regional and country-specific efforts
A number of regional and country-specific trade finance difficulties had potentially broader systemic implications. BAFT-IFSA helped to address those difficulties—for instance, by collaborating with key banking associations, federations, and multilateral entities around the globe to ensure that Kazakhstan officials fully understood industry expectations of adherence to international practices for treatment of trade finance obligations during that country’s banking sector crisis. It sensitized key policy makers to the perils of ignoring such practices, given that trade finance remains an integral tool for global recovery. Although this particular advocacy effort was country specific, it was a useful precedent for influencing the treatment of trade finance liabilities in similar restructuring exercises worldwide.
Response to Basel requirements

BAFT-IFSA has also played a key role in informing policy makers and regulators about the unintended consequences that the capital and liquidity requirement proposed in BCBS’s consultative papers could have on trade finance. In BAFT-IFSA’s view, implementation of the BCBS recommendations could result in decreased trade flows for trade-focused banks at a time when such flows are essential to supporting global economic recovery. Among the key arguments, BAFT-IFSA emphasized that the Basel II requirements disproportionately affect trade instruments and do not take into account the inherently safe nature of trade. Because regulators have not fully addressed Basel II–related issues, BAFT-IFSA concerns are magnified by the pending BCBS capital and liquidity recommendations—collectively known as Basel III. These recommendations include proposals that could increase the risk weighting for trade finance instruments in a manner inconsistent with their short-term, low-risk nature. BAFT-IFSA is concerned that, given the crucial role of trade finance in global recovery, the Basel recommendations could ultimately limit trade activity. According to BAFT-IFSA, the BCBS recommendations fail to take into account that the movement of goods and services underpins trade finance, differentiating it from other forms of financial transaction in terms of lending security. In April 2010, BAFT-IFSA submitted comment letters to BCBS regarding these recommendations and their impact on trade and on transaction banking in general. It continues to work with other stakeholders in the international community to ensure that the Basel Committee and the G-20 are aware that, if adopted, the Basel Committee recommendations could ultimately result in decreased trade flows.

During the 2008–09 global economic crisis, BAFT-IFSA helped raise awareness about the key role of trade finance in sustaining the global trade recovery. It contends that a more appropriate treatment of trade finance under Basel II and III, alongside sustained public-private sector support and cooperation for trade finance, would help ensure the sustainability of the ongoing recovery.

Private Banks’ Response to the Proposed Basel Regulations

This section describes how three private banks—Standard Chartered Bank, Royal Bank of Scotland, and HSBC—responded to the proposed Basel regulations.

Standard Chartered Bank

As a result of the global economic crisis, global trade fell some 23 percent, or $3.5 trillion, in value. Of this sum, Standard Chartered Bank estimates that 10–15 percent stemmed from lower trade finance liquidity. It is estimated that banks slashed their trade finance loans by 10 percent to shore up their capital
positions. As a result, $350 billion to $525 billion of world trade, or up to 0.85 percent of global gross domestic product (GDP), may have been wiped out.

Financial support
Standard Chartered Bank took several steps to meet the markets’ constraints, including signing an innovative $1.25 billion Global Trade Liquidity Program (GLTP) partnership with the World Bank Group’s International Finance Corporation (IFC) to help support $50 billion of global trade. It also entered a $500 million risk-sharing program with the Organization of Petroleum Exporting Countries (OPEC) Fund for International Development to potentially fund more than $2 billion of trade.

Response to Basel requirements
In addition, Standard Chartered Bank actively helped foster sound banking regulation of trade finance activities. Although supportive of the Basel Committee’s overall proposals in December 2009 to strengthen the resilience of the banking sector, Standard Chartered Bank considered that the proposed changes could have disproportionately adverse effects on banks’ ability to provide trade financing at affordable costs to both importers and exporters.

In particular, the Basel proposals treat trade finance as a risky type of bank asset in the following ways:

- All trade contingents are subject to a 100 percent credit conversion factor (CCF) on the balance sheet in calculating the leverage ratio (compared with 10 percent for certain credit derivatives).
- Trade assets are not recognized as a high-quality liquid asset for the purpose of the liquid asset buffers.
- The proposed one-year maturity floor means that banks will have to hold more capital than is representative of the average trade tenor of 115 days.
- Basel makes no allowance for using real data to calculate the actual asset value correlation (AVC) and CCF of trade finance and instead imposes metrics that assume a much riskier profile than empirical evidence suggests is warranted.

As a result, the Basel proposals would lead to a significant increase in banks’ cost of providing trade finance in terms of both capital and liquidity, which will lead to a lower supply or higher prices or both. Standard Chartered has taken the lead in highlighting the potential adverse effects that some of the proposed Basel regulations could have on world trade, supply, and trade finance costs:

- **Further drop in world trade.** If banks do not raise new capital (and if the consultation document is approved as drafted), banks could slash trade finance
lending by as much as 6 percent a year, triggering a drop in international trade of up to $270 billion based on today’s trade value. That would represent 1.8 percent of world trade or 0.5 percent of global GDP.

- **Decreased supply of trade finance.** A 25 percent increase in the AVC factor will require banks to hold as much as 10 percent more capital for banking and trading book exposures to large financial institutions worth more than $100 billion in assets. This requirement will erode 50 basis points from banks’ capital adequacy ratio, limiting their ability to lend and negatively affecting their profile with investors and rating agencies. Banks will have two choices: raise more capital to preserve the market’s confidence in their capital levels or lower their capital adequacy ratio to comply with the fledgling regulations, for all their negative consequences.

- **Increased pricing of trade finance.** As trade finance becomes more capital-intensive, its availability will decline, spurring higher prices. Trade finance banks lend to importers and exporters with funds from either other banks or clients’ deposits. If a trade finance bank funds its lending through other banks, such borrowing will cost up to 37 percent more than it costs large financial institutions. These incremental costs may be passed on to the ultimate importers and exporters. If the trade finance bank’s funding is from its deposits, the cost of its lending will rise by 15–25 percent for mid- to lower-rated importers and exporters in the emerging markets, which usually need trade finance the most.

**Recommendations**

Given trade finance’s paramount importance in supporting international trade, Standard Chartered Bank recommends that the new regulations recognize that trade finance is different from the normal corporate or financial institution lending exposures. Standard Chartered has made concrete proposals to reduce the impact of the proposed Basel regulations on trade finance.

First, Standard Chartered proposes that the appropriate capital adequacy ratios be applied through the following means:

- **Mandatory extension of the maturity floor waiver to trade products** that are self-liquidating, short-term, nonrevolving, uncommitted, and do not form part of the ongoing financing of clients. BCBS should remove the national discretion given to regulators to waive the maturity floor rule and make it mandatory for banks to apply actual maturity tenor for trade finance and apply a minimum one-year tenor only on an exceptional basis.

- **Adoption of a separate AVC for trade finance** because trade finance is short-term and self-liquidating in nature, and such transactions are generally small, diverse, short-term, and self-liquidating—that is, inherently less risky.
• *Permission for banks to use industry data* such as the Trade Finance Default Register of the International Chamber of Commerce (ICC) and the Asian Development Bank (ADB) rather than simply relying on internal estimates. Recent survey results from the ICC-ADB Register show that trade off-balance-sheet items (letters of credit [LCs] and guarantees) have low conversion rates into on-balance-sheet items that in turn require funding from the banks (ICC-ADB 2010).

Second, Standard Chartered proposed recognizing the role of trade and financial institutions in providing liquidity through the following means:

• *Including trade of less than 30 days as a stable source of funding.* Short-term trade assets that will be paid off in less than 30 days should be considered as liquid assets. The attraction of trade finance as a class of assets is its ability to generate cash flow even during economic stress due to its self-liquidating nature.

• *Prescribing a required stable funding ratio for off-balance-sheet trade exposures.* Trade is an international, cross-border business, and hence, there should be greater harmonization in the treatment of global trade finance transactions. As such, leaving the required stable funding ratio for each national regulator to decide as trade business will run the risk that regulators, naturally inclined toward conservatism, would apply a 100 percent ratio, thus creating a complicating mix of rules for a global business. It is recommended that this required stable funding ratio be determined by calculating the probability of an off-balance-sheet trade exposure being converted into an on-balance-sheet asset.

**Royal Bank of Scotland**

The Royal Bank of Scotland (RBS) experienced the same trade finance developments as other institutions in 2008–09: business volumes declined, and the cost of trade finance increased. Exporters were hit by reduced order books, a demand for extended credit terms, and a greater propensity for their buyers to default. Importers were also hit by declining order books and destocked significantly.

The more successful companies paid down debt; reduced their levels of restocking; and adopted prudent, secure methods of settling export transactions. However, those that struggled did not respond quickly enough, finding themselves with too much stock and no demand. As a consequence, their credit ratings deteriorated—in some cases, quite dramatically. However, given the transparent nature of trade finance (whereby all parties involved have full control and visibility of transactions), trade finance should have been the least-affected method of financing during that turbulent period.
Three factors affected the reduced appetite for trade finance facilities and conspired to drive up prices:

- **Credit quality deteriorated, affecting price.** However, before the crisis, many trade finance professionals felt pricing had become too fine. Price increases were driven by an element of price correction as well as by the deteriorating credit quality of counterparties.
- **Capital availability became more constrained and much more expensive.** The Revised International Capital Framework (Basel II) played a role here: being highly risk-sensitive, a relatively small deterioration in credit quality results in a disproportionately large increase in the amount of capital required to support exposures.
- **The collapse of the interbank funding market led to a shortage of liquidity.** During the crisis, financial institutions found it difficult to fund their customers, but the downturn in demand mitigated this impact to an extent.

Notably, the impact on companies’ behavior varied. In the United Kingdom, for example, small and medium enterprises (SMEs) tend to use overdraft facilities to finance international trade. Such facilities until recently were relatively cheap and flexible and were typically supported by a tangible security (such as property or shares). During the crisis, the value of the security underpinning the overdraft diminished and was worth less relative to the level of exposure. As a result, lenders scaled back overdraft facilities. (Lending on this basis is never a good way of supporting international trade because it does not link the finance to the underlying trade cycle.)

**Financial support**

RBS continued to provide trade finance solutions to importers and exporters. In the United Kingdom, for example, the bank offers export finance support to companies through packaged solutions that include export LCs, invoice discounting, and guarantees and bonds. RBS also plays a role in encouraging companies, particularly SMEs that have not exported in the past, to consider new markets by offering financial tools that fund credit periods and mitigate risk. RBS has also entered into risk-sharing arrangements designed to encourage exports. The bank participates in the LC guarantee scheme operated by the United Kingdom’s official ECA, the Export Credits Guarantee Department (ECGD). Under the scheme, the ECGD shares the credit risks associated with confirmed LCs. The ECGD is also engaged in U.K. government schemes launched in 2011 to support exporters in accessing facilities for bonds, guarantees, or working capital related to export contracts.
For major importers in the North American and European markets, supply chain finance (SCF) open-account solutions—which introduce liquidity and security into the supply chain—have continued to grow. Before the crisis, many large importers believed the benefit of these solutions was all on the suppliers’ side; however, the downturn highlighted the risk to buyers of failures in their supply chain. Buyers now see SCF as a way to ensure certainty of supply. Suppliers can reduce their Days Sales Outstanding from 90-day credit periods to seven days or less, and buyers can improve Days Payable Outstanding, taking longer deferred credit while remaining on commercial terms.

The adoption of SCF is blurring the boundaries between traditional trade finance and international cash management. Further developments include initiatives such as the Society for Worldwide Interbank Financial Telecommunication (SWIFT) Trade Services Utility and related Bank Payment Obligation, which provide many of the risk and finance benefits of traditional trade instruments but in a digitized environment, using data from the trading partners’ supply chains.

Response to Basel requirements
As noted above, Basel II requirements contributed to capital constraints during the crisis. Under the Basel III proposals, measures such as the leverage ratio—aimed at preventing banks from using off-balance-sheet structures to leverage their balance sheets—will cause off-balance-sheet trade obligations to be treated in the same manner as on-balance-sheet items. LCs, bonds, and guarantees may therefore become less attractive options for banks that are capital constrained. Trade finance instruments, though off-balance-sheet in nature, directly reflect the value of customers’ underlying commercial transactions; they are not a method banks can use to leverage their balance sheets.

The financial crisis showed that trade finance, which links funding to a customer’s cash conversion cycle, is the most effective way of supporting international trade. A more prudent and risk-averse approach to trade finance will emerge as a result of the crisis. The trend toward open-account trade, in which export credit insurance and factoring were used to finance the trade, has been temporarily reversed in many cases. As the economic recovery takes hold, traditional LCs, which enable companies and their financial institutions to collaborate within a robust framework, will continue to play a role in risk mitigation, finance, and settlement of international trade.

HSBC
Trade has traditionally grown faster than GDP and, as such, is a key driving factor of the world economy. When the 2008–09 crisis hit, trade flows were rapidly
affected, and it became clear that one of the governments’ priorities was to foster trade to re-create the proper background for world growth to resume as early as possible. The 2009 G-20 London Summit was mainly dedicated to this subject. Then the availability of finance for trade activities became a key focus.

Trade finance became scarcer for a number of reasons, and, although none of those reasons can be held solely responsible for the overall squeeze, together they created the following significant negative impacts:

- **Increased distrust among banks.** Pursuant to Lehman Brothers’ demise, the general level of distrust in the bank-to-bank market gathered momentum, first in developed economies and then in some developing economies. Toxic assets were hard to locate, and the general suspicion surrounding the presence of such assets in banks’ balance sheets around the world triggered a general reassessment of risk among banks. Trade finance, being largely reliant on bank intermediation, was therefore gradually affected.

- **Scarcer liquidity.** Liquidity became scarce in developed countries. Banks, therefore, focused their support on their domestic markets. Gradually, this shift started to affect developing-market banks that received less hard-currency funding and, thus, faced growing difficulties in supporting their customers’ international trade requirements.

- **Higher capital requirements.** The reassessment of country risks (as the crisis spread) and of bank-to-bank risks led to higher capital requirements for banks, affecting all of their lending activities. This phenomenon was amplified by the concomitant implementation of Basel II regulations in most parts of the world, with the noteworthy exception of the United States. Basel II, by putting more emphasis on the counterparty risk than on the instrument of lending, created a more challenging environment for trade finance in the context of the spreading crisis than would have existed during the previous regulatory environment.

The rebound of trade since mid-2009 is an encouraging sign that the crisis has diminished in intensity. In HSBC’s May 2010 Trade Confidence Index, more than 50 percent of the respondents were bullish about trade outlooks, and they expected trade volumes to rise over the following six months. This optimism was confirmed in the September survey. However, the effect of the crisis on world economies was deep, hence recovery is still fragile. In this context, it is important that all pro-trade measures taken at the height of the crisis be maintained.

**Financial support**

HSBC has been an active provider of trade financing. It views international trade as a key driver of its development. Beyond its history, its raison d’être is its ability
to serve its customers’ businesses along their supply chains throughout the extensive HSBC global network. It takes a different view on trade risk than other financiers: because it has relationships on both sides of a global trade transaction, HSBC understands the business intimately and can weigh the risks associated with trade transactions accordingly.

During the crisis, HSBC continued to support its customers in financing their businesses for trade. Early on, decisions were made to direct financing to the corporate sector and notably to SMEs. HSBC announced a global $5 billion fund for the express purpose of lending to fundamentally sound SMEs and mid-market enterprises to supply working capital and to support businesses that trade or aspire to trade internationally. Furthermore, HSBC has been working closely with ECAs to help them devise financial packages to support trade finance, notably in the United Kingdom.

Recommendations
Trade finance never appeared more strategic than it did in the midst of the crisis. The 2008–09 financial crisis revealed that the trade finance industry was not organized and structured enough to assess its sheer weight and to face the challenges posed by the regulators. Banks have since taken measures to build a common base of information and organized dialogue.

In particular, the ICC-ADB Trade Finance Register represents a significant step forward because it will create a living database of the trade finance market that will help to demonstrate the resilience of this business (ICC-ADB 2010). The database will then enable the industry to objectively claim more favorable regulatory treatment of trade finance and thereby create the necessary incentive for banks to increase their commitment to international trade.

More generally, a closer dialogue between the banking industry and regulators over the treatment of trade finance in the Basel II and III frameworks is paramount to avoid unintended negative consequences over the financing of trade flows. HSBC welcomes the recent progress made in that respect.

HSBC has been closely involved in helping the industry to devise propositions to provide trade finance with a better regulatory environment and is committed to remaining at the forefront of such initiatives. HSBC obtained, together with other institutions, the lifting of the penalizing one-year maturity threshold by the U.K. Financial Services Authority. This action freed significant capital and created more space for banks to finance their customers’ trade requirements. HSBC would advocate that such simple yet effective measures be replicated in all jurisdictions.

Trade financing has evidenced its low-risk nature, thanks to its unique features (self-liquidating, fast-turning, and linked to trade of goods and services): At the
height of the biggest crisis since 1929 and as shown by the ICC-ADB Register, trade default rates remained at insignificant levels. The exchange of goods and services is the most powerful tool to create growth and prosperity. If there is one positive outcome the crisis has created, it is the awareness of the importance of trade and the availability of trade financing—a lesson that has resonated with HSBC’s culture since its founding in 1865.

Notes

1. BAFT-IFSA is an international financial services association formed by the 2010 merger of the Bankers’ Association for Finance and Trade and the International Financial Services Association, whose members include a broad range of financial institutions and suppliers around the globe.

2. Chapter 5 of this volume provides an in-depth discussion of the IMF and BAFT-IFSA global trade finance surveys.

3. For consumer banking, there is separate AVC for retail mortgage, credit cards, and other retail exposure because they vary in behavioral and payment factors and also react differently to macroeconomic factors. However, for corporate banking, there is only one AVC for all corporate products (lending, overdraft, derivatives, swaps and trade finance, and so forth).

4. We would recommend that the current CCF rule be refined such that off-balance-sheet trade will attract a CCF that matches its conversion level to on-balance-sheet items. Alternatively, BCBS could allow banks to adopt a CCF based on their internal methodology.

References


