A HARVARD BUSINESS REVIEW ANALYTIC SERVICES REPORT

Harvard Business Review

TRADING BY THE RULES

Copyright © 2015 Harvard Business School Publishing.

sponsored by

Bring on tomorrow®

TRADING
BY THE RULES

Greater access to trade finance could speed the global economic recovery—if more stringent bank regulation doesn't get in the way.

The financial crisis of 2007-08 was a severe blow to global trade, as insolvencies, collapsing financial institutions, and constricted credit markets took their toll. Many European banks in particular stopped providing trade financing, while trade credit insurers absorbed high volumes of claims and retrenched their activities. Since then, the market has recovered considerable ground, and trade finance products such as letters of credit, bank guarantees, and bill collection and discounting are still considered some of the safest, most strongly collateralized forms of finance.

Indeed, trade finance remains a systemically critical area: The Asian Development Bank (ADB) calculates that a 15% increase in access to trade finance would increase production by 22%, for example. With global trade generating some $15 trillion a year in transaction volume, only a fraction of which is bank-funded, trade finance is also potentially one of the biggest asset classes in the world. figure 1

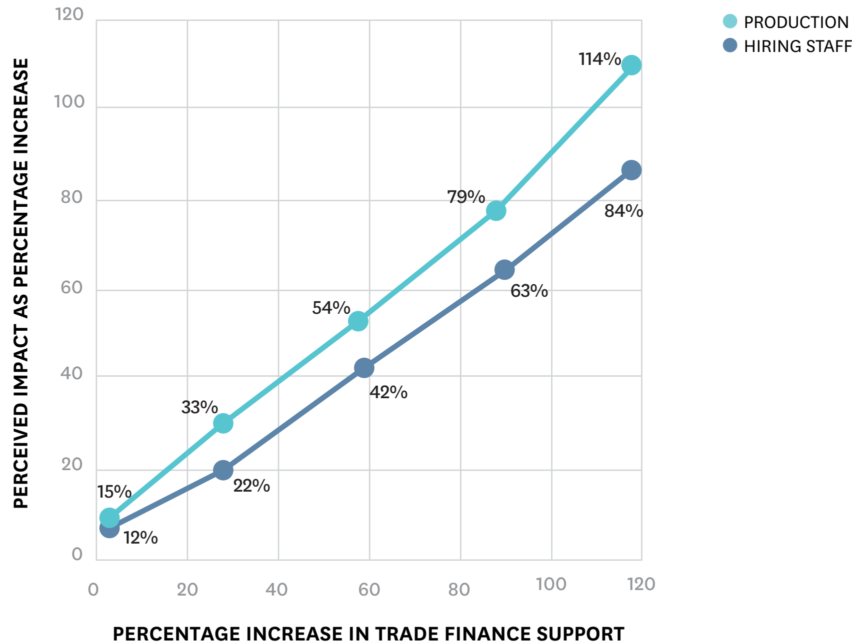
But there is still concern among banks and corporations that rely heavily on exports to emerging markets regarding whether trade finance can play its full part in boosting global trade—especially for small to medium-sized enterprises (SMEs) selling into developing markets. Despite the near-global recognition of SMEs as engines of growth and economic value creation, some international banks, still recovering from the financial crisis, have either withdrawn or curtailed financing and risk mitigation activities in this segment of the market. The ADB last year estimated a global trade finance gap of $1.9 trillion—up from $1 trillion at the low point of the global financial crisis in 2009—of which $1.1 trillion is in developing Asia.[1]

Overcoming this gap may be critical to achieving full worldwide economic recovery, says Krishnan Ramadurai, senior technical advisor to the International Chamber of Commerce (ICC) Banking Commission, given that the growth of global trade has lagged global GDP growth since 2011. What factors keep the trade finance gap from closing? The ICC singles out three:

- Differences in the way the new rules and regulations are interpreted and applied in diverse geographical markets make it challenging for banks to extend finance, despite recognition within the new rules that trade finance is different from other asset classes.
- Standards for risk tolerance lack clarity.
- Trade is not recognized as a unique asset class that serves to help SMEs access finance.

FIGURE 1

EXPECTED IMPACT OF MORE TRADE FINANCE SUPPORT ON PRODUCTION AND JOBS



SOURCE ADB TRADE AND FINANCE GAP, GROWTH, AND JOBS SURVEY, DECEMBER 2014

Together, these developments are affecting provision of trade finance to companies, placing a new emphasis on managing risk.

A TIGHTENING REGULATORY ENVIRONMENT

New international banking capital standards introduced in the wake of the crisis threaten to raise the cost of trade finance, especially where counterparty risk is unrated or below investment grade. This concern has been alleviated to some extent since the Basel Committee on Banking Supervision introduced its Basel III rules in 2010:

- A flat 100% credit conversion factor (CCF) for certain off-balance-sheet items was reduced last year to 20% for letters of credit and 50% for trade guarantees.
- A requirement that risk-weighted assets on banks' books must have maturities of at least 360 days was waived in 2011 for commercial letters of credit across all member states.
- For trade finance exposures, the Basel Committee in 2011 agreed to waive a requirement that banks treat a certain percentage of their off-balance-sheet items as on the balance sheet for regulatory capital purposes.

- However, banks must still assume that only 50% of their corporate exposures will mature over the next 30 days, even if they are guaranteed, and must buy high-quality instruments like Treasury bills to cover the remainder.

That last requirement could increase the cost of these loans by as much as 17 basis points and boost the cost of trade finance by as much as 50%—this despite the fact that trade finance was not a cause of the crisis and indeed is an important element of the continuing recovery. Research that the ICC consolidates in its annual Trade Register found that on over 8 million trade finance transactions between 2008 and 2011, the average default rate was roughly 0.21%, and the expected loss for trade finance products from 2008 to 2012 was at least 10 times lower than for the Moody's-rated universe.[2]

The European Parliament has eased the situation for European banks, allowing them to assume the full 100% availability of trade finance inflows—but not for non-European banks, unless their home-country regulators follow suit. And the EU rule is expected to benefit primarily larger corporate customers, meaning SMEs still face more limited access to trade finance. Last year, 42.5% of banks responding to an ICC survey said Basel III rules had affected their operations significantly.[3]

The Basel Committee will revisit its rules in 2018-19, and no doubt will take the historically low-risk nature of trade finance into consideration. Of at least equal importance, however, banks face stiffening know-your-customer (KYC) regulations and customer due diligence (CDD) rules in most jurisdictions, designed to prevent money laundering and hobble terrorist organizations. In 2013, 68% of companies globally said they had to decline a transaction due to money laundering or KYC issues, according to an ICC survey, while 69% had to terminate correspondent relationships because of the cost of compliance—including more stringent KYC rules.[4]

Together, these constraints represent a serious impediment to the trade finance market, which the International Monetary Fund in 2008 estimated as underpinning 35% to 40% of all global merchandise trade transactions.[5] figure 2 They raise the cost and lower the profitability of trade finance, possibly inducing some banks to shift their resources into more profitable but higher-risk businesses, resulting in a less competitive trade finance marketplace. That could create greater stress in a period of financial crisis, as fewer banks would be able to step in and supply credit should a major institution be forced to withdraw. For all companies, but especially SMEs, the cost of providing trade credit to their buyers would go up.

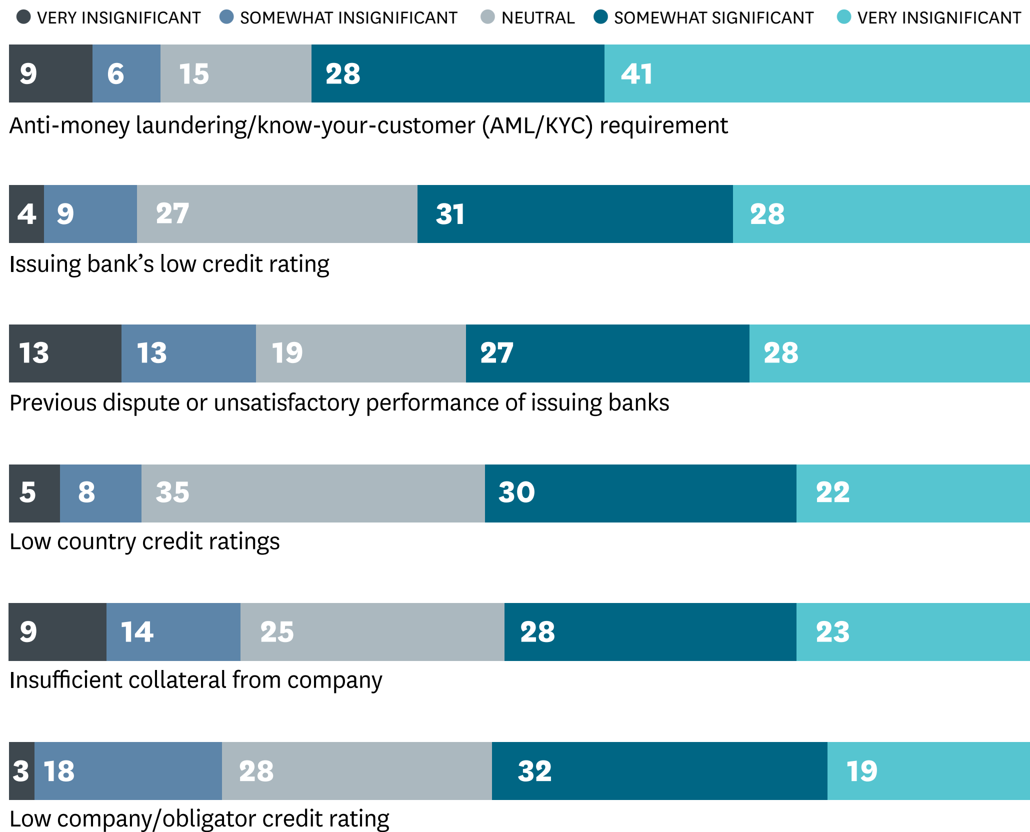
USING DATA AND TECHNOLOGY TO MANAGE RISK

Despite these threats, bank-intermediated trade finance remains a large and robust market, estimated at between $6.5 trillion and $8 trillion in 2011 by a study group of the Bank for International Settlements' Committee on the Global Financial System (CGFS),[6] and some experts argue that these products retain a relative advantage over other forms of credit. Nevertheless, financial institutions as well as corporate treasurers and CFOs will need to find ways to satisfy the new regulations without choking off credit to buyers. Improved risk management will play a critical part as companies adapt to the post-Basel III world.

Some banks that left the trade financing market after the crisis still have not returned, and more may exit as quantitative easing ends, pushing rates higher and putting more bite into the Basel capital requirements. For banks that want to take up the slack, the learning curve—especially the

FIGURE 2

TOP IMPEDIMENTS TO TRADE FINANCE



SOURCE "2014: RETHINKING TRADE AND FINANCE," INTERNATIONAL CHAMBER OF COMMERCE, JUNE 2014

ability to analyze credit risk in a vast and diverse global trade market—has steepened. Those that remain will have to better understand their credit exposures and become more efficient if they are to keep the cost of trade finance instruments low.

Large buyers are increasingly demanding their sellers move to open-account transactions in which the seller ships goods before payment is due. That means taking on higher levels of risk, particularly during financial crises or economic downturns.

These companies will have to enhance their ability to scrutinize proposed transactions, as well as their transactional partners. Further complicating this already thorny task is the lengthening of supply chains in a globalized economy.

Sellers, banks, and even regulators must learn to work more closely together as effectively as a risk management team in the trade credit arena. Technology will play a critical role, as it enables these organizations to share information that helps them make risk assessments more cheaply

> Technology will also be pivotal for banks and nonbanks seeking to create a market for securitized trade finance receivables, which requires deep and easily analyzed reservoirs of market data.

and efficiently. "Fraud, rather than true credit events, is where banks have the real exposure in this business," says John Ahearn, global head of trade, treasury, and trade solutions at Citigroup.

"If we can build the linkages between banks, insurers, and customers, it can help to deal with this," he noted—for example, by engaging big data solutions to red-flag suspicious transactions.

Last year, SWIFT launched a global Know Your Customer Registry, a centralized database that collects and distributes standard information that banks use for CDD . Such efforts help standardize and create a common language around KYC compliance, and help eliminate the need for banks to gather information that their counterparts already hold. Meanwhile, insurers are developing online tools that allow both the company and the financial institution to monitor exposure levels and manage buyer credit limits.

More complete and standardized information also enables banks and their corporate customers to take a more flexible approach to trade credit provision. While letters of credit and bank guarantees are likely to remain widely used, other trade finance instruments are assuming a higher profile.

- Rather than assuming all or none of the liability for a failed counterparty, companies can achieve financial and risk-sharing objectives by opting to share it. Insurers that offer noncancelable excess-of-loss products require the insured to take on a certain level of risk and responsibility for risk mitigation before the policy pays out. This requires the company to invest more in its own credit management capabilities, and results in greater flexibility in managing its risk profile.
- Bank payment obligations (BPOs) are similar to letters of credit but are transacted between the buyer's and seller's banks and are entirely paperless, rendering them cheaper and faster to process.
- As supply chains lengthen, companies are making greater use of products and services that help them manage the attendant risks, including receivables factoring, discounting of payables, and asset-based lending tied to inventory or capital equipment.
- Banks and alternative lenders are purchasing trade credit insurance as a risk mitigant, which enables them to retain less capital under the Basel standards. However, Basel III requires that the instrument be unconditional, which means insurance is irrevocable and under the direct control of the purchaser.

Greater use of technology to consolidate information about the trade finance market could open up further opportunities to make trade credit provision more flexible. Banks and insurers could more systematically make a case to regulators to substantially expand capital relief for trade credit

> Securitization could help banks economize on capital and liquidity, enabling them to keep more trade finance products available at lower prices.

insurance, for example, if institutions could consolidate data about these products and generate empirical evidence about how they perform, say, during financial crises. "There's evidence that it had a countercyclical effect in 2008-09," says Kai Preugschaft, secretary general of the Berne Union, "but we need more evidence from the market participants, that we can then get out to the regulators, to further validate the excellent work the ICC Banking Commission has already established with its Trade Register."

Technology will also be pivotal for banks and nonbanks seeking to create a market for securitized trade finance receivables, which requires deep and easily analyzed reservoirs of market data. The collapse of mortgage-backed securities and the low or negative interest rates on benchmark government bonds pose a continuing problem for investors that typically place some assets in low-risk investments with returns in the 1-2% range.

Banks and other institutions such as insurers, with expertise in analyzing credit, risk, and markets and the ability to hedge currencies and supply trade credit insurance, could structure or facilitate the structuring of securitized trade finance products for these investors, which include pension funds, corporate treasury departments, and sovereign wealth funds. Citi and Banco Santander launched one of the first trade finance securitizations, Trade MAPS, a three-year offering, in 2013. The $1 billion deal was oversubscribed 11 times, and Citi expects to do similar offerings in the future, says Ahearn.

"Information asymmetries" are one barrier to such deals, according to a CGFS report last year.[7] Another is the absence of a common terminology in a fragmented trade finance market. "What I call payables discounting, other people call reverse factoring. The institutional investor wants one name, and to understand the characteristics of that item," says Ahearn. Yet securitization could help banks economize on capital and liquidity, enabling them to keep more trade finance products available at lower prices.

A MORE ROBUST, INNOVATIVE MARKET

Improved data collection, analytics, and advocacy efforts by the ICC Banking Commission, together with other industry bodies, have combined to help alleviate some of the current challenges, says Ramadurai. The ICC Trade Register has demonstrated the low-risk nature of trade finance from a credit perspective, leading to more appropriate, risk-aligned treatment of trade finance. The industry has been working to raise awareness and increase technical competencies in trade finance as well, particularly in the post-crisis environment. The latest effort in this area is the launch of the Singapore-based ICC Academy. While the academy will eventually cover topics related to all major areas of the ICC's work, it began with the development of a suite of online courses and professional designations related to trade finance and international banking.

The second issue may be less tractable. "There's increasing concern around KYC and financial crimes issues, and a general concern about a scaling back of trade finance due to possible exposures to perceived risks. Prices can be expected to go up," says Ahearn, as quantitative easing ends, interest rates rise, and bank liquidity shrinks. The Basel capital rules will hit harder by 2019 as well, further raising costs.

Offsetting that, at least partially, Ahearn expects the market to become more efficient and uniform as data and analysis improve, driven in part by investors in trade finance securitizations. Consolidation will concentrate more of the market within the most knowledgeable and committed institutions. The result will be a more robust, innovative market for trade finance and stronger, more consistent growth in global trade in the long run.

ENDNOTES

1 Alisa DiCaprio, Steven Beck, and John Carlo Daquis, "ADB Trade Finance Gap, Growth, and Jobs Survey," Asian Development Bank, December 2014.

2 International Chamber of Commerce, "2014 ICC Trade Register Report Summary: Global Risks in Trade Finance."

3 "2014: Rethinking Trade and Finance," International Chamber of Commerce, June 2014.

4 Ibid.

5 Irena Asmundson, Thomas Dorsey, Armine Khachatryan, Ioana Niculcea, and Mika Saito, "Trade and Trade Finance in the 2008-09 Financial Crisis," IMF Working Paper, International Monetary Fund, January 2011.

6 Committee on the Global Financial System of the Bank for International Settlements, "CGFS Papers No. 50, Trade finance: developments and issues," January 2014.

7 Ibid.

ABOUT AIG

American International Group, Inc. (AIG) is a leading international insurance organization serving customers in more than 100 countries. AIG companies serve commercial, institutional, and individual customers through one of the most extensive worldwide property-casualty networks of any insurer. In addition, AIG companies are leading providers of life insurance and retirement services in the United States. AIG common stock is listed on the New York Stock Exchange and the Tokyo Stock Exchange.

Additional information about AIG can be found at:
www.aig.com | YouTube: www.youtube.com/aig | Twitter: @AIGinsurance | LinkedIn: www.linkedin.com/company/aig

AIG is the marketing name for the worldwide property-casualty, life and retirement, and general insurance operations of American International Group, Inc. For additional information, please visit our website at www.aig.com. All products and services are written or provided by subsidiaries or affiliates of American International Group, Inc. Products or services may not be available in all countries, and coverage is subject to actual policy language. Non-insurance products and services may be provided by independent third parties. Certain property-casualty coverages may be provided by a surplus lines insurer. Surplus lines insurers do not generally participate in state guaranty funds, and insureds are therefore not protected by such funds.

The data contained in this presentation are for general informational purposes only. The advice of a professional insurance broker and counsel should always be obtained before purchasing any insurance product or service. The information contained herein has been compiled from sources believed to be reliable. No warranty, guarantee, or representation, either expressed or implied, is made as to the correctness or sufficiency of any representation contained herein.

© 2015 American International Group, Inc. All rights reserved.

hbr.org/hbr-analytic-services