

Unmet Capacity Underscores Emerging Market Woes

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An ongoing [Asian Development Bank](#)-led effort to loosen international regulatory capital requirements for trade finance doesn't stand much of a chance. How could it, given the recent economic meltdown and its lasting fallout?

But the push may shed light on whether existing rules for trade finance favor larger institutions over smaller, developed markets over emerging ones, and whether that means there are opportunity for deals out there that just aren't getting done.

The main complaint of the Asian Development Bank and its allies is that unmet loan capacity is lying fallow. They say this lack of lending is, in turn, a drag on international trade, and therefore on economic recovery. The nub lies in the rules treating trade finance under the international Basel II regulatory framework. The [ADB](#) says it requires banks to treat trade finance instruments and hold capital against them as one-year loans, when for the most part the financing is for three to six months.

It's actually a little more complex than that. The Basel committee responds by pointing out that there are a number of ways to treat trade finance: capital requirements can be set under a standardized approach, or receive a more favorable treatment using an advanced internal ratings-based approach, which is a function of a banks' own risk-assessment practices.

[John Ahearn](#), a managing director at [Citigroup](#) and the firm's global head of trade, says the advanced model allows for adjustments based on a bank's historical perspective - and that historical perspective requires 10 years of data to back it up. "Most banks don't have that," he says. As a result many institutions that would have had 20 percent risk weighting for trade finance deals under the Basel I code, now under Basel II would need to go to 100-percent risk weighting. "I don't think the crux of the issue is whether the treatment is for one-year loans or for shorter-term loans."

[Lawrence Remmel](#), a partner at the New York law firm Pryor Cashman, says that this adversely affects potential borrowers and institutions in emerging markets.

"If you are a more sophisticated financial institution and you have the intellectual and financial capital and data assets, you can do one of the more advanced treatments," he says. "This gives the advantage to larger, more sophisticated financial institutions over smaller ones. And it gives the advantage to financial institutions that work in developed markets as opposed to the ones in emerging markets."

On the client side, an unrated borrower will be very unlikely to get a credit higher than the sovereign rating of the country in which it operates. "If you deal with a smaller institution using the standard approach, you will be penalized. If you haven't done enough business, you won't have enough data to use one of the more favorable treatments. It increases the cost of doing business in emerging markets," [Remmel](#) says.

One might say this is well and good: you should have a longer track record in order to be able to take an advanced risk weighting, and that an unrated corporate in Nigeria or Indonesia does business in a volatile part of the world, and logically should be recognized as doing so in assessing risk. Then again, all the sophistication, ratings and history in the world didn't stop Wall Street and London from going up in flames last year.

Bank sources agree that there is unfilled capacity in trade finance. Whether capital treatment under Basel is holding back business, or more, dragging back recovery is much harder to say. The [International Chamber of Commerce](#) and ADB are teaming up to lobby the issue and were scheduled to meet in Brussels on Nov. 25 for further planning.

TRADE FLUTTERING TO LIFE - MAYBE

Global trade went off the tracks over the last year, and wasn't doing so hot before then.

According to the [Netherlands Bureau for Economic Policy Analysis](#), world trade in August was down 18 percent below its peak level in April of 2008. On the other hand, analysts say, trade transactions were up 2.6 percent above a trough hit last May. Trade growth is still on a sharp downward trend, the bureau says. This sober outlook builds on data collected by the International Chamber of Commerce at the start of the year, when a study found trade finance to and from emerging markets in Asia particularly hard hit. Overall, as of March, 47 percent of surveyed banks in the [ICC](#) study found a decrease in letter-of-credit volume, and 40 percent of respondents indicated a "significant" increase in fees. Interest rates on loans and advances soared.

But [Ahearn](#) tells a slightly different story, and he is moderately optimistic about the near term. He argues that the global SWIFT volumes for trade bottomed out, most likely, in June, and that there's uptick in volume. "The secondary markets are coming back. There seems to be plenty of capacity in the market - with the caveat that activity is relatively low compared with the historical highs of the business," he says. "Companies - in general - ran their inventories down to the lowest levels possible. They are starting to rebuild. You are seeing some demand come back."

Capital expenditure projects and long-term business like aircraft financing haven't moved so much with the meltdown - long-term contracts are locked in, and barring outright failure, these kinds of transactions can be counted on through the middle of next year. "Trade finance is a counter-cyclical business. Globally, trade banks did well during the last two years; demand may be down, but demand for our product is up because there's a feeling of trying to get to safety," Ahearn says.

The [HSBC](#) Trade Confidence Index, which surveys 3,500 small and mid-size businesses in 12 global markets, finds a positive outlook ahead, with China, Indonesia and the UAE expressing most confidence. According to HSBC, 59 percent of respondents globally expect good access to credit and a third expect access to increase; 44 percent expect trade volumes to grow.

THE UNKNOWNNS AHEAD

On its face, global capitalism is still extraordinarily fragile and in a volatile, forbidding environment. A jobless recovery is not going to do much for long-term consumer demand.

Scrutiny of trade finance rules, however, shows the industry itself is in a reflective mode. "Given the relatively low default-rate for this type of financing, there is insufficient data to statistically validate loss-given-default and exposure-at-default estimates," says [Craig Turrell](#), a senior executive and risk management expert at [Accenture](#). "A data-consortium approach across financial institutions with material exposure to this type of lending - similar to the approach already in use for other asset types such as project finance - may eventually be useful for the industry."

Given what's just happened in the global economy, sources do not expect the Basel committee to be so open to change.

But the industry's shifting anyway, Ahearn says. "In the trade finance world, a significant amount of capacity has been taken out of the market. It's been taken out from mergers and consolidation," he says. "Business is consolidating to bigger banks. With small and medium-size banks, trade is a product that they would like to have, but is not core to their business. As they retrench, they go back into their core business."

Citi itself is also retrenching, but it's not giving up on trade financing. Ahearn argues that Citi is still a global franchise, and notes that trade is a robust contributor to its [Global Transaction Services](#) business.

Meanwhile, smaller competitors are pondering their next moves, Ahearn says. "Do we want to be a cash management bank, or partner with somebody? A trust bank, or partner with somebody? Those conversations are happening at smaller and regional banks."