INTERNATIONAL MONETARY FUND

Survey of Private Sector Trade Credit Developments

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In response to the dearth of information on trade finance, the Fund has undertaken a survey of major advanced country and emerging market banks. The results suggest that the cost of trade finance is rising globally, but that provision is falling in emerging markets while staying stable in advanced countries, possibly reflecting structural differences in markets.

The startling plunge in global trade in recent months appears to partly reflect the global disruption of financial intermediation. The fall in trade appears faster than would be expected given data on activity, confirming widespread anecdotal evidence that the cost of trade finance has risen rapidly while many cases its availability has fallen. Unfortunately, there is little hard data on this area of financing, making it difficult to analyze underlying market conditions.

To fill this gap, the Fund (in conjunction with the Bankers Associations for Finance and Trade (BAFT)) initiated a survey of trade finance across major advanced and emerging market banks. More specifically, questionnaires were sent to advanced country and emerging market banks enquiring about current trade financing conditions compared to a year ago and expectations for the next year. As discussed in the Appendix, trade can be financed in a number of different ways. Cash-in-advance requirements or open account financing between importers and exporters, which involve direct loans to pay for imported goods, cannot be readily distinguished by banks from loans to pay for other expenses such as domestically produced intermediate products. The survey therefore centers on the bank-intermediated forms of international trade finance, such as letters of credit or trade lending.

The questionnaire was sent to a wide list of banks, of which some forty responded, evenly split between advanced countries and emerging markets.[1] Banks were asked about the situation with identifiable trade credit in October-November 2008 compared to the same

[1] BAFT sent questionnaires to their membership, but for confidentiality reasons could not share the list; additional surveys were sent out by the Latin American Federation of Banks (FELABAN). Accordingly, the response rate is not known.

period in 2007, as well as their expectations looking forward over the next year.[2] The survey focused on trends in the cost and provision of identified trade finance by banks, and the underlying reasons for these trends.

The cost of trade credit reflects the cost of finance, perceived increases in risk of such loans, and conditions in banks that provide such credit. Costs of finance vary over time depending on wholesale markets. Risks on trade loans come from events during shipping times. With global growth dropping rapidly, financial distress leading to banks closures and exchange rates fluctuating, counterparty risks have risen for importers, exporters, and financial intermediaries. To cover the potential costs of rising defaults, banks pricing margins have to increase. At the same time, the cost of trade finance also reflects conditions in banks. In particular, when banks are under pressure, the capital needed for trade finance may be allocated elsewhere on balance sheets. As a result, they may be less willing to offer trade finance to small or medium companies, or to companies with whom they do not have long-standing relationships, further raising the cost of finance.

The impact of rising uncertainty on the amount of trade finance provided by banks is ambiguous. As cash flow problems at importers and exporters become more severe, and they are less able to access cheap short-term finance to cover immediate needs, they may be less willing to extend trade credit to their partners, increasing the demand for bank-intermediated trade finance. On the other hand, rising costs of bank financing and reduced appetite for such lending by may lower the amounts extended by banks.

The net effect may depend upon types of trade and countries. For commodities, both effects are likely at work, with fluctuating prices and long shipping times raising the attractiveness of bank financing but banks themselves less willing to take the higher risk. For manufactured goods with low profit margins, the dampening effect from higher pricing is likely to dominate, as importers may not be able to afford more expensive letters of credit. For manufactured goods with higher margins, extra costs and higher risks are easier to absorb, but drops in demand may be disproportionately large for non-essential purchases. Countries that are perceived to be subject to more risk, either political or economic, will likely see higher demand for bank-intermediated trade finance.

Summary of Survey Results

There has been a widespread increase in the price of trade finance. More than 70 percent of respondents indicated that the pricing of various types of letters of credit increased, while close to 90 percent of respondents indicated that the pricing of both short-term and medium-

[2] As with all surveys, there is the risk of bias coming from self-selection. However, there is no particular reason to expect systemic biases in the underlying data.

term trade-related lending facilities increased (Figure 1).[3] As a result, spreads over LIBOR have increased by some 25 to 300 bps per annum, with some respondents reporting figures as high as 600 bps per annum (although this may reflect some respondents reporting levels, instead of increments, in spreads).

International financial strains have been a significant factor driving up the cost of trade finance. Some 80 percent of the respondents indicated that an increase in the cost of funds has been a factor driving up the cost of trade credit, while 60 percent indicated that higher capital requirements have played a part (Figure 2). The near universality of these strains is shown by the similarity of responses between banks in advanced economies and emerging markets (although it should also be noted that most of the emerging market banks that indicated that capital requirements were a factor are headquartered in advanced countries).

Banks in both advanced countries and emerging markets also indicated higher counterparty risk had affected lending. More than 90 percent of advanced economy money center banks and 70 percent of emerging market banks indicated a change in the counterparty criteria (Figure 3). Tightening lending guidelines based on specific counterparty banks seems to be a common response of banks in both advanced economies and emerging markets. Tighter lending guidelines were also reported for specific countries, including: Argentina, the Baltic Countries, Bolivia, Ecuador, Hungary, Iceland, Korea, Pakistan, Russia, Turkey, Ukraine, the UAE, Venezuela, and Vietnam.

In response to higher risks, a majority of banks have also adopted stricter risk management practices. For example, many banks are now adopting differentiated strategies based on the nature of the individual client, the client segment (trading, retail, commodities, etc), and country of origin. Banks underscored a greater focus on: (i) expanded insurance; (ii) shorter maturities and stronger covenants; (iii) higher cash deposits or other collateral from clients; and (iv) relationship deals. Evidence of higher counterparty risk is also a reason that many players are switching from open account terms to more traditional and secured instruments such as LCs, and cash-in-advance requirements.

A majority of banks anticipate current pricing trends to continue. This will involve more reliance on traditional finance instruments (such as letters of credit and guarantees) and greater focus on risk mitigation. Survey results indicate that emerging markets and commodities trade funding are likely to be hardest hit. However, a few banks note that spread increases may reverse once demand has picked up again. In addition, volumes may rise because of consolidation of the banking sector. When conditions normalize, the smaller

[3] Various types of letters of credit include documentary credit with and without postfinancing, guarantees, standby letters of credit, and confirmed letters of credit.

number of surviving global and super-regional banks will likely end up providing more trade financing than currently.

The volume of trade credit provided by banks is falling in emerging markets but not in advanced countries.[4] Advanced country banks reported roughly the same number of transactions of documentary credits, guarantees and letters of credit in October-November 2008 compared to the same period in 2007. By contrast, emerging market banks report a 6 percent fall in such transactions (Figure 4). Furthermore, both advanced country and emerging market banks expect current trends to continue over the next year: no significant change in the number of transactions for advanced country banks and a 10 percent decrease for emerging market banks. For the volume of short-term trade-related working capital lending, advanced country and emerging market banks indicate no significant effect so far but, while the former expect this to continue, the latter expect a drop by 8 percent. Both advanced country and emerging market banks provided the following reasons in written comments: less credit availability (35 percent of all banks), an increase in the price of trade finance (18 percent), a fall in demand (13 percent), and increased risk and a fall in commodity prices (10 percent each).

Trade finance to and from emerging Asia appears to have been particularly hard hit. Advanced economy banks were asked to distinguish transactions they financed by type of trade (export-/import-related) and also by region. Intraregional trade among advanced economies seem to have been unaffected by the current crisis. There is, however, evidence that financing of both exports to and imports from emerging and developing Asian economies are being hit. In particular, while more than 50 percent of respondents indicated that financing exports to Middle East and North Africa have *increased*, a similar preponderance of respondents indicated that financing of imports from South Asia, Korea, and China (including Hong Kong SAR and Taiwan Province of China) have decreased. On possible interpretation is that the collapse of trade in East Asia may also indicate that rising costs and increased risk perceptions are having a particularly severe impact on low-margin links in long global valued-added supply chains.

Lastly, all banks foresee a significant role for the official sector in easing the current conditions. In particular, respondents took the view that governments and multilateral institutions can help by: (i) providing more trade guarantees; (ii) increasing availability of financial resources; and (iii) improving export insurance processes. Programs such as the IFCs' Global Trade Finance Program (GTFP) were also seen as providing significant relief. In terms of regulatory changes, respondents indicated that authorities and international

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[4] Other data covering the entire fourth quarter as well as some early trade data suggest a continuing downward trend into December; for example, we understand that SWIFT messages related to documentary credit declined 27 percent in 2008 Q4 from the same quarter of 2007.

institutions should review Basel II trade capital requirements and discourage late payments and collusion in the trade finance market.

Interpretation

The increase in price across a spectrum of trade finance products is easy to explain. With increased costs of funds to banks, higher capital requirements, and rising default risk affecting most responding banks all pushing prices in the same direction, it would be surprising if there wasn't a clear trend toward increased costs during the October-November period. Looking forward, while cost of funds will likely come down at some point, increased capital requirements may have a longer lasting impact:

- The costs of funds pressures reflect extremely high TED spreads; CDS spreads for banks, and other indicators of banks' costs of funds. Against this are the sharp reductions in official target rates.
- The effect of increased capital requirements is likely to be more durable. Many banks expressed the view that excessively low capital backing for all bank products, including trade finance, had pushed spreads to unsustainably low levels, implying a semi-permanent increase in spreads as more capital is required to back risk.
- However, the price pressures from increased capital requirements are likely to be highest during the deleveraging process, and there may be some abatement of these price pressures once the new, higher-capital equilibrium is reached.
- Growth prospects also matter. With rapidly changing conditions and lower growth, defaults have risen. Pricing margins have to account for higher probabilities of default by importers and exporters.

The mixed impact of the current crisis on the volume of trade finance may well reflect different responses to heightened risk. Increasing use of bank trade finance in advanced economies could be the result of a shift by exporters from open account financing to use of letters of credit. At still higher levels of risk aversion, however, some exporters may be shifting from bank financing to cash-in-advance or other "low-trust" approaches to financing as difficulties emerge in some markets, reducing the volume of trade finance.

Finally, causality in the interaction between recent trade and trade finance shifts runs in both directions. The higher cost of trade finance will inevitably mean that some transactions that made economic sense earlier are no longer profitable, reducing both trade and demand for finance. At the same time, the global slowdown is resulting in a sharp drop in merchandise trade.

Next Steps

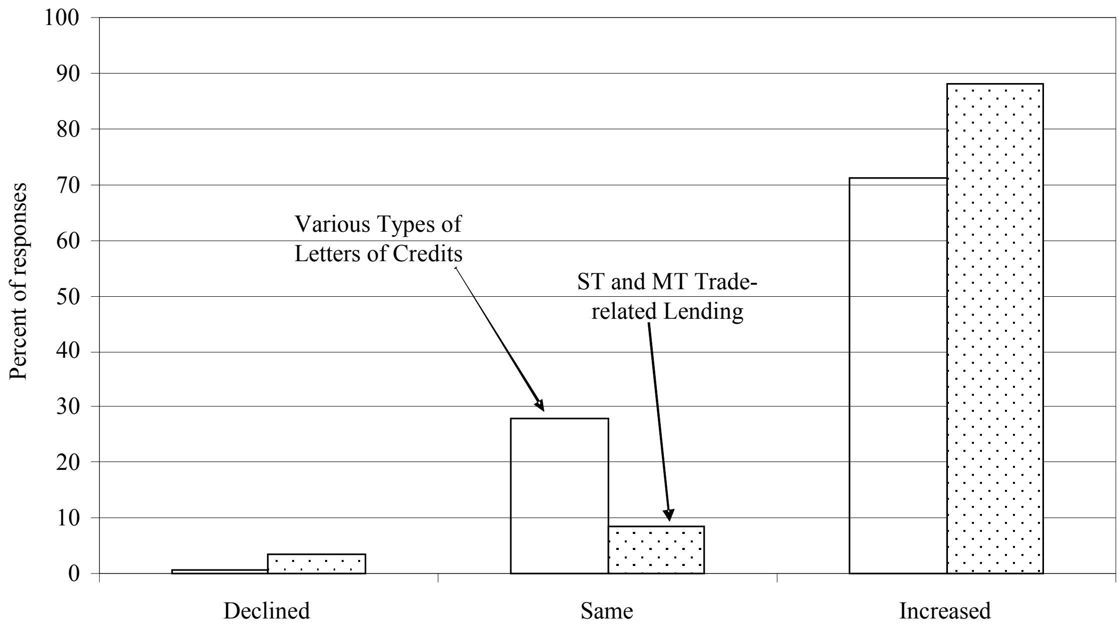
The Fund plans to make a summary of these data publicly available, taking into account feedback from this conference and other sources. In addition:

- Given the speed and which events are changing, we are considering a second survey of banks to capture more recent developments. We would encourage you to participate in the next survey and send any suggestions for modifications to survey design to us.

- Fund staff is also intending to collect information on official sector (e.g., export credit agency and multilateral development bank) activities in cooperation with other international organizations. The plan would be to also provide this information to the broader public.

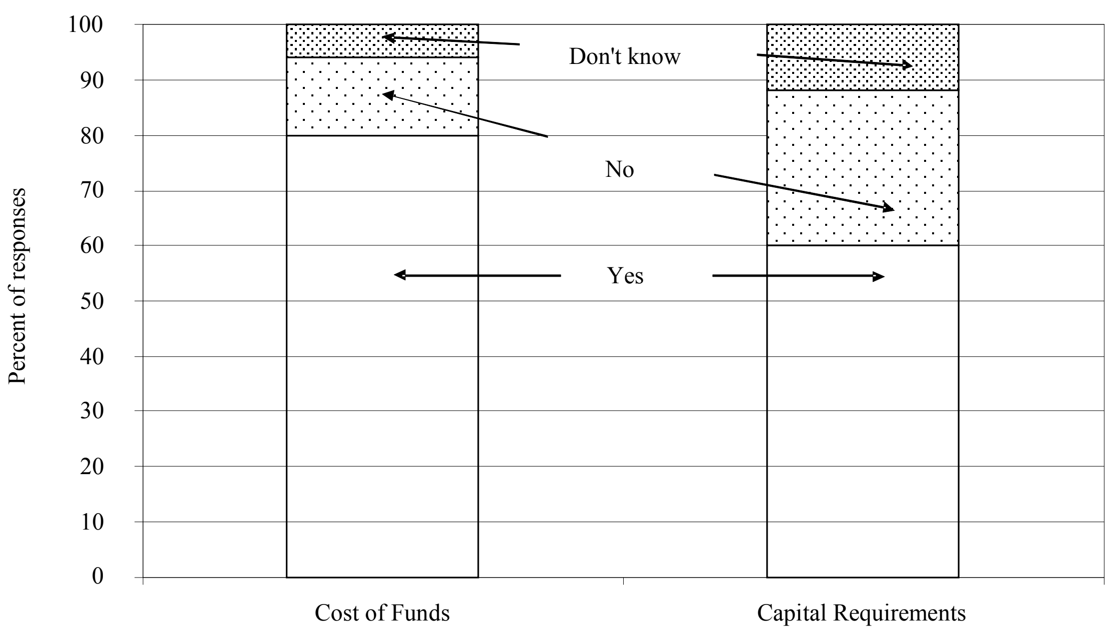
- Fund staff will also work with other public and private international organization that are also collecting information and assessing the circumstances in trade finance. For example, the World Bank is doing research on the effects of the current crisis on the non-financial private sector through country cases studies and other means, and expects to have results in the spring of this year.

Figure 1. Effects on the Pricing of the Trade Finance Instruments 1/



1/ Responses from advanced economy banks and emerging market banks are aggregated.

Figure 2. Source of Changes in the Pricing of Trade Finance 1/



1/ Responses from advanced economy banks and emerging market banks are aggregated.

Figure 3. Changes in Counterparty Criteria

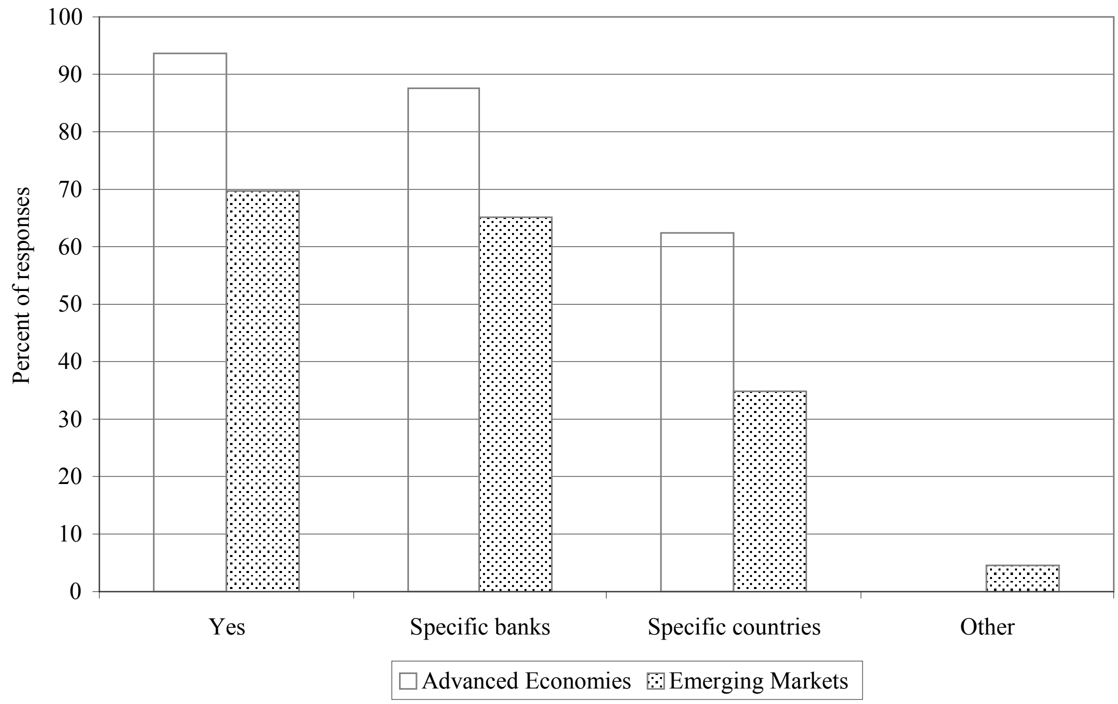
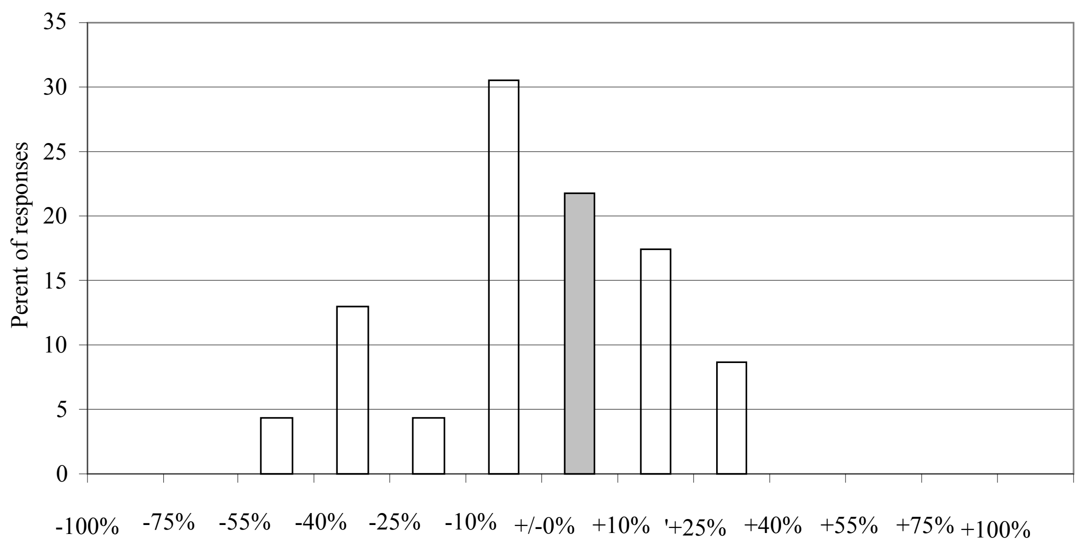


Figure 4. Volume Change: Emerging Market Banks 1/
During Oct-Nov 2008 (vs. Oct-Nov 2007)



1/ Changes in the volume (number of transactions) of documentary credits, guarantees, and letters of credit.

Appendix. Different Forms of Trade Finance

Trade finance can take many forms, depending on the level of trust between counterparties and the degree of financing needed from banks. If the transaction is purely between the importer and exporter, it can be done on a *cash-in-advance* basis (payment is received before goods are shipped), or an *open account* basis (shipment occurs before payment is received). Banks can also provide documentary services. Some, such as *document collection* (payment is made when title for the goods is received), do not necessarily involve financing in the form of credit. There are also options where banks provide some insurance against counterparty risk, and which do have balance sheet implications for banks. If the actual goods arrive before the documents arrive, the importer's bank can issue a *guarantee* of payment against a deposit (or credit facility), allowing the shipping company to release the goods before confirmation of payment occurs. An exporter *letter of credit* (LC, also sometimes referred to as a *documentary credit*) is where the importer gets their bank to certify that they will be able to pay for a shipment. When LCs are issued, the importer's bank may agree to offer *post-financing*, where the importer does not have to pay the bank back until the goods are sold. LCs can also be preapproved, and a *standby LC* can be offered before the transaction is agreed to. Or, if the exporter does not trust the importer's bank, the exporter's bank can provide *confirmation* of a LC. Finally, there are more standard forms of *trade lending*, where *short-term* (less than one year) or *medium-term* credit are offered by banks against the security of the actual goods or by discounting LCs.