KEEP OUT!

Credit committees are still turning down viable trade deals due to a lack of understanding of trade finance and poor risk modelling. **GTR** talks to those market players prepared to speak out.

Participants:

Jane Belova-Barr: director, distribution, Rosemount Capital Management
Aidan Applegarth: banking consultant, Bankingwise
David Gustin: president, Global Business Intelligence
Banker X: anonymous participant from a major international bank

GTR: What impact has the 2008/9 market downturn had on your ability to get trade deals sanctioned?

Applegarth: Suffice to say that late 2008 through to 2009 ranks amongst one of the worst periods I've experienced in more than 25 years.

Belova-Barr: We are lucky in that we are a small team and can therefore approve transactions fairly quickly. We do have a pretty rigorous credit policy and we perform in-depth analyses of the risks for each transaction. Each analysis is taken on its own merits and can also incorporate a broader overview of risks and risk mitigation. We view risks relative to the bigger picture, rather than having to take a few aspects and fit them to a rigid risk model. We have therefore not had problems approving transactions for our own books. However, when selling transactions into the market, we have seen many other institutions retreat to familiar risks close to home and prefer more plain vanilla types of transactions.

Banker X: Credit sanctioners have generally become much more risk averse, focusing on investment grade names where credit analysis is considered to be easier and more transparent, and have ignored the benefits of trade transactions which are usually short-term, self-securing and self-liquidating, but most often used by sub-investment grade traders.

GTR: What specific problems regarding credit committees and risk assessment are you experiencing in your institution, and what impact are they having?

Belova-Barr: Again, this is not something we have experienced at Rosemount itself, but we have seen it happening in the institutions we are speaking to. Quite often the front office will be prevented from doing deals because of the credit sanctioners who have to follow strict and inflexible risk models which do not necessarily allow for the inherent liquidity of a trade transaction or supporting collateral.

More frustratingly, some sanctioners let subjective viewpoints sway them – they might have read a negative article about a particular market and immediately reject a transaction due to the the risk of a risky

neighbouring country in the region. They sometimes assume some contagion, which is not always justifiable.

Banker X: A lack of understanding of the intricacies of genuine trade transactions has definitely adversely impacted our ability to do business.

GTR: Does the idea of having a dedicated trade finance risk model for determining a client default grade have merit? How realistic would it be to develop one?

Banker X: Many banks have developed their own in-house risk models for determining client default grade, but none are perfect and many rely on criteria that take no account of the self-securing nature of trade finance. An independently developed model that could be used as a 'market norm' would undoubtedly be welcomed by trade finance bankers.

the system comes up with. However these models will not realistically quantify various structures, collateral and risk mitigants which would only improve the risk. It is difficult to create a system with the flexibility to take these elements into account.

Applegarth: Today banks are using a set of weighing scales to measure the length of a piece of string – yes, they're using a tool of measurement but where traders are concerned it's not calibrated for the job.

I guess the real issue here is whether banks are genuinely concerned to reduce risk weighted assets (RWA), and at what point they then see the trade-off to invest in a dedicated model. The larger the portfolio exposure, the greater the absolute saving – which could be as much as 30% to 50% on current RWAs. Developing a model is structurally simple but requires data – lots of it. I'm not sure the market is there yet.

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> **Aidan Applegarth, Bankingwise**

Gustin: Trade finance describes a broad range of activities covering many forms of commercial credit and credit to financial institutions. Before it was implemented, the Basel Committee sponsored research on the impact of changing to Basel II. These reports noted that banks that met the more rigorous detailed data and model driven standards were able to reduce their required capital. Bank business that was aligned with investment grade counterparty exposures also released capital overall.

The problem for banks is that trade finance is largely the domain of lower rated, middle market companies. These types of deals get hugely penalised. But what my company, Global Business Intelligence, found out by doing our recent benchmark [research released in January 2010] is that financial institution (FI) trade finance also gets penalised, as banks are using models not designed for self-liquidating transactions.

Belova-Barr: I can see that some institutions with a large deal flow of small, short transactions for their clients would like a neat system to plug in numbers and see if the transaction is 'doable' based on what result

Meanwhile I'd recommend constructive benchmarking to corporate grades where I'd expect to see a couple of notches improvement for many trader ratings.

GTR: Are bankers placing too much reliance on quantitative risk models and not enough on a qualitative understanding of the real economy?

Applegarth: I believe that we've lost sight of what models are intended for and don't critique them enough. A model is supposed to be a representation of reality to help inform a decision. Too often it's taken as reality itself and makes the decision. Anyway, it's only as good as the inputs and if they're flawed, so are the outputs.

Basel II is a case in point. Aimed at damage limitation in the virtual financial economy the regulations have been well-intentioned and a whole modelling industry has been built up around it – but it's disadvantaged the real economy through frustrating the availability of capital for trade finance. It's imposing a one-size fits all and only as an afterthought has bunged in specialised lending to try and compensate. If we had a more qualitative challenge of the quantitative tools maybe we

wouldn't have had the global credit crunch.

Gustin: Look, every trade salesman worth his or her salt is going to say "I've never lost a dollar in trade in the 10 years I've been dealing with emerging markets". The fact is we should not be driven by experience, but evidence. Given trade's centrality to the largely below investment grade counterparties, it is negatively affected by Basel II.

GTR: Basel II is arguably flawed for trade finance – what impact do you think the revision proposals will have if adopted?

Gustin: I think bankers feel more stress around the liquidity requirements and off-balance sheet issues. We've already shown in our benchmark the punitive effects of Basel II on a trade portfolio comprised of corporate and bank transactions. So if banks are required to increase reserves even more (and there may be a 'too big to fail' capital premium) smart banks will look to off-load trade assets to secondary market players that are not governed by capital restrictions.

Banker X: Banks will be required to allocate significantly more capital against trade finance transactions. Basel II is open to interpretation by different banks, such that banks that adopt the strictest guidelines will undoubtedly be disadvantaged in terms of return on risk weighted equity.

Applegarth: On the face of them, they further threaten the real economy landscape. Again, I see the proposals as well-intentioned but ill-thought through. Yes, there needs to be a tighter rein on bank finances and clarity on contingent liabilities and off-balance sheet items but, we need to avoid the sort of 'grey market' fiscal manipulation that crippled the economy and not frustrate the movement of physical goods that will help the economy recover.

GTR: Are the arguments in favour of trade finance (short-term, self liquidating, prioritised during moratoria, strong cross-sell, low RWA/high RoE) still valid?

Applegarth: Yes. Whilst there have been some doubters in recent years, the engagement of the G-20 in finding solutions to trade liquidity testifies to its continuing economic and therefore political importance. If there is any uncertainty, it's more to do with what constitutes genuine trade finance that should benefit from its preferential treatment.

Belova-Barr: Yes. I think institutions still believe in the value of trade finance – even though they have been tested with recent experiences. With all the overt political backing, ECA and multilateral agency support, trade finance should be high on the agenda for every internationally-focused financial institution.

Banker X: Yes. If transactions are well structured and correctly documented from a legal perspective, banks should be in a far better position than lending unsecured. This has always been and always should be the benefit of providing transactional trade finance

GTR: What more should trade bankers do to get support from executive boards?

Belova-Barr: I speak to front-office people who find themselves squeezed by management – on the one hand being told that they need to make money, but on the other hand not getting approvals for deals they put forward. As more transactions come onto the market, perhaps a strategic list of missed opportunities should be waved under the noses of the powers that be – especially if it includes a column for 'money we would have made for this deal', and particularly for names that perhaps were acceptable to them in the not too distant past.

Applegarth: The strategic and tactical role of trade isn't flagged up enough. Most executive board members will think of trade as a labour intensive, paper intensive and capital intensive necessary evil to move around the stuff that the investment bankers have created.

They don't see that trade greases the wheels for the arrival of the investment bandwagon and ticks over the engine when the investment bankers have had their fill. Trade practitioners can hold their heads up high while the investment bankers are still scratching theirs. It's one thing to have the argument, but another to get someone to listen to it. That time should be now – underpinned by more appropriate risk models to properly reflect trade's RWA and ROE advantage.

Gustin: We need to work with corporate risk distribution staff and the CFO to develop secondary market solutions.

Top five problems with credit committees

- Lack of understanding of trade finance at executive board level and credit managers with limited to no experience of trade finance.
- Inappropriate use of corporate risk models, with an over-reliance on turnover, interest cover and EBITDA.
- Miscalculation of default grade (DG) rating, due to using data that is irrelevant to short-term self-liquidating trade transactions. An inaccurate DG rating can distort the entire risk model.
- Inability of risk models to adapt to the different make-up of trading companies' balance sheets compared to those of a general corporate.
- The application of Basel II does not fully recognise the low loss legacy of trade finance assets.

Banker X: If it isn't happening already in a bank, then it's probably too late. Executive boards generally have fixed ideas about future strategies. Unfortunately, trade finance is plain and simple, and not particularly exciting or a means of making a quick buck. The best option is probably to find a bank that wants to develop trade finance from scratch and is willing to provide adequate resources (including experienced credit sanctioners) to fully support the business.

GTR: Credit sanctioners – friend or foe?

Applegarth: How long have we got? I've come across both kinds and guess what? The banks that had the open-minded, constructive challenge from sanctioners tend to be market leaders while those that suffer from blinkered negativity tend not to be around too long.

It doesn't help that there's an inherent conflict between sanctioners trained to analyse balance sheets, and practitioners trained to develop structures because of the weakness of balance sheets. At one bank I was with, the allocated sanctioner didn't have any trade finance training and over a six-month period managed to duck and dive from actually taking any decision himself. Elsewhere, we've grown very successfully off the back of lively debate where the best argument wins – but for that to happen, the sanctioner actually needs to have and articulate an opinion.

Banker X: The answer often depends on current market and economic conditions. In stable and upward trending market conditions it is always easier for credit sanctioners to make positive decisions. In more difficult times, less experienced sanctioners often take the easy option and say 'no'.

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GTR: If you could, what would you change in the way banks handle trade finance?

Banker X: I'd employ experienced credit sanctioners who understand trade finance structures and have a market standard risk model developed specifically for trade finance.

Applegarth: I'd separate the complementary components of trade into a global trade division with a dedicated balance sheet and carve-out of country limits.

We'd have bespoke risk models so that trade can be fairly measured alongside rival products, appropriately trained sanctioners and be properly linked into other business areas for mutual cross-sell. I'd cut off any cash management ties (the beneficial links are overrated and a distraction) and I'd tailor the operating model to be less about products and more about capabilities.

Gustin: Banks need to better understand how trade finance affects corporates at the procurement, logistics, payables, treasury, and sales areas, and the typical comfort zone is treasury and payables.

Corporates don't think in terms of open account, letters of credit, etc. Banks need to take more of a corporate perspective and less of a product perspective.

GTR: What does the future hold for trade finance risk management in the next two to three years?

Gustin: I believe the beginnings of a secondary market. We must start laying the foundation for capital market entrants like pension funds, insurers, and others to play in this asset class. These entrants do not have regulated capital issues like the banks. The trading mechanics for this asset class (whether a transparent exchange like NYSE or a private exchange between select parties or somewhere in between) will evolve over time.

Applegarth: I'm not sure whether we will see a genuine secondary market as such or a second-tier primary market. With the first option, the banks will still need to book deals firstly on their own balance sheets before selling down. For the second-tier primary market, risk transfer would take place earlier in the booking process so that the banks have less underwriting commitment. Much will depend on whether current risk tools can be enhanced to be more relevant for trade. I'm looking forward to the day when the collation of trade data coupled with more relevant risk models vindicates the low loss profile we claim for trade.

Belova-Barr: Banks might be conservative now, but they will soon realise that they need to make budget and become a little more adventurous again. Even now in India and China, for example, the few deals that make it into the open are fought over in a bidding frenzy which ends up with extremely thin pricing. If there were enough volume, then that would compensate somewhat for the smaller margins. But there isn't enough volume for everyone, so banks will need to stick their necks out again and go back into markets they might have pulled out of. When there's money to be made, it's surprising sometimes what short memories people have. **GTR**

The next step... Basel III

Consultation on new global capital requirements for banks closed in mid-April, provoking a backlash among some banks and industry bodies that the new rules could cost jobs and impede economic growth.

The new regulations were proposed by the Basel Committee on Banking Supervision last December in two consultative papers tackling liquidity and capital levels in the banking system.

The proposals, which have become known as Basel III, will require banks to raise the amount and the quality of capital they hold before the end of 2012. The aim of such measures is to fulfil pledges made by the G-20 countries that governments will not be called upon again to bail out failing banks with taxpayers' money.

Levels of required capital, liquidity and leverage ratios will be set by the end of the year.

There have already been calls from French banks for a new round of talks on Basel III proposals, as well as questions raised about the reality of banks hitting the 2012 deadline.

A letter from the French Banking Federation sent to the Basel Committee, dated April 16, commented that "excessive capital and liquidity requirements would bring the economic recovery to a screeching halt".

There have also been concerns about the implications of Basel II and now Basel III on trade finance.

Trade finance industry body BAFT-IFSA has submitted letters to the Basel Committee commenting that suggested regulations will cause further uncertainty among banks on how to apply Basel II to trade finance activities.

"Trade finance instruments have historically maintained a low risk profile in comparison with other financial instruments. We are concerned that the consultative document does not account for their intrinsically safe structure," says Donna Alexander, chief executive officer of BAFT-IFSA.

"We wish to ensure that unintended consequences are avoided, and any changes ultimately adopted do not result in reduced trade flows for trade-focused banks at a time when they are essential to continued economic recovery around the globe."

As an example of BAFT-IFSA's concerns, according to the committee's consultative paper on strengthening banks' capital requirements, off-balance sheet items are deemed sources of "potentially significant leverage". Trade instruments such as letters of credit and standby letters of credit are included in this category.

The Basel Committee has proposed to implement an increased leverage ratio constraint on these off-balance sheet items by increasing the credit conversion factor used to 100%. BAFT-IFSA believes this move unfairly penalises trade finance assets which are far more secure and safe than other off-balance sheet (OBS) items. Such measures, the group argues, could see banks slowing down their trade-related OBS business or end up passing on the cost to their clients, both of which would be detrimental to economic growth.

BAFT-IFSA comments: "The inclusion of trade in the generic description of OBS items is misleading given the way the products are used to support genuine underlying commercial trade transactions. As a general policy, banks do not enter into 'synthetic' trade transactions, where off-balance sheet trade structures could potentially be used to disguise on-balance sheet loans."

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