Shut out in the cold

Credit committees are turning away viable trade deals due to lack of understanding and inadequate risk modelling, argues ***Aidan Applegarth***.

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He has worked for Credit Lyonnais, UBS, ABN Amro and, more recently, Barclays, where he was global head of structured trade and commodity finance.
He holds an MBA with distinction from the Warwick Business School and is today providing specialist consulting services to banks and corporates.

Shoring up global trade has been a hot topic for 2009. Faced with a lack of liquidity, the IMF, World Bank, G-20 and national governments have been scrambling around to get trade moving again. Without commodities being traded, processing, manufacturing and their related service industries fall into decline, protectionism kicks in and economies destabilise. With this in mind, trade, and how to finance it, has shot up the global political agenda.

In contrast, for many commercial banks, trade finance has sunk to the bottom of their priorities. In a move that defies common sense, corporate credit managers prefer to back clean lending against historic balance sheets rather than support secured or structured lending against tangible and transparent trade flows.

Viable trade deals are being turned away and banks have and continue to downsize their trade teams as a consequence. Instead of creating value, this approach destroys it. But it needn't be this way.

There are two key problems. Global trade finance (being the composite of all the various trade products including commodity, export and structured trade finance) is seldom understood at executive board level in many banks and therefore lacks appropriate sponsorship. Secondly, trade is often bundled into corporate or commercial banking and forced to use risk models and tools which are not only inappropriate, but disadvantage it when competing for resources.

It doesn't help that credit managers are frequently ill-trained or ill-prepared to take decisions based on transactional risk.

They fall back on what they know – and that's the historic numbers in the spreadsheets and the outputs from the risk models.

For the vast majority of trade practitioners this is the biggest single cause of conflict for trade lending today: a corporate risk model that emphasises turnover, interest cover and EBITDA [earnings before interest, taxes, depreciation, and amortisation] for annual facilities is at odds with a trade exposure that is short-term and transactionally self-liquidating.

The risk models that trade is being forced to use within a corporate banking world are unsuitable. This needs to change, because there has seldom been a better time to invest in a global trade finance offering.

Trade's selling points

The potential for a bank to capitalise on trade finance is huge. Around 80% to 90% of world trade relies on trade finance, equating to a US$10tn per year market with bankable revenues estimated at US$150bn or 1.5% per year.

There is also a market financing gap of around US$25bn among the largest suppliers of trade finance – largely because of issues with their non-trade lending book.

It has even been argued that throughout the crisis those banks that have weathered the storm better than most have been the banks with a strong trade presence.

Why should this be? To trade practitioners the answer is obvious: trade finance deals with the short-term day-to-day running of a business. It is a far more transparent form of financing.

Even where a customer's balance sheet may be relied upon for providing a trade facility, often the financing of individual transactions within the facility will still be at the bank's discretion, based on the viability of the transaction as presented. This transparency differs from typical corporate lending in offering protection to the lender as it can avoid engaging in deals that may involve markets, counterparties or products the bank does not wish to support.

Trade finance should also be beneficial due to the fact that fee income should be a driver over interest income, making it far more attractive than straight corporate lending.

However, typically trade products do not get adequately measured against other bank products, and trade's inherent benefits are overlooked. There is now a real need to start challenging prevailing corporate risk models.

The challenge

The first step in challenging risk models is to critique the way default grade (DG) is calculated. This rating drives the probability of default rating (PD), which also affects the loss-given default (LGD) as well as risk-weighted assets.

For a start, most corporate risk models that determine DG, use as key indicators items such as turnover, interest cover and EBITDA, which are of little relevance for short-term self-liquidating trade finance transactions (many traders won't even disclose turnover as they see it as a distortion and some analysts simply enter the gross profit where turnover should be).

Secondly, a typical trader's balance sheet has a completely different make-up and weighting compared to a general corporate, yet this is not acknowledged by most corporate risk models. Until corporate credit analysis recognises these idiosyncrasies and adapts to accommodate

Top five benefits of trade finance:

- A flow of transparent, short-term self-liquidating transactions (with clear cash flows).
- Relatively low risk weighted assets leading to potentially higher returns on capital.
- Trade debts tend to get prioritised in the event of a moratorium.
- An effective 'foot in the door' to emerging markets.
- Strong cross-sell potential along the supply chain.

them, the inaccurate calculation of DG will distort every other calculation that depends on it.

A new risk model

There is a need to recognise that trade finance tools are themselves risk mitigants. This should particularly be kept in mind at the more credit challenged end of the client spectrum.

Through the use of risk-mitigating trade finance instruments, sub-investment grade exposure can be improved to reflect a DG-equivalent of an investment grade client.

For example, a corporate model based on turnover, EBITDA and interest might produce a DG rating of 11.

In comparison, if you take a deal where the balance sheet assessment produces a DG rating of 14, you can lower this to potentially a DG of 11 by applying a trade model that takes into account a range of monitoring and control mitigants.

Essentially, trade exposure to sub-investment grade can be as good a risk as corporate exposure to investment grade, and potentially better if comparing real-time operationalisation to historic balance sheets.

The rewards

Comparing like risk for like will ultimately ensure the best use of capital – and that will ultimately strengthen global trade finance's competitiveness.

A sound and profitable trade portfolio is typically built on a mix of clients with a larger weighting of sub-investment grade (ie to those clients who need to structure/collateralise to compensate for weaker balance sheets).

The risk:reward:effort ratio tends to be better at this end of the scale as structuring improves risk and affords additional fee reward, whilst repeating successful deals reduces the effort for each dollar earned.

However, without fail, those financial institutions that have insisted on an investment grade weighting being the largest have only ever produced mediocre returns.

Posing a particular problem for current risk models are those clients who fall a few DG points into sub-investment grade. Current models are just not sophisticated enough to make a value judgment. Either a manual override is needed to engage with the client or the bank forfeits the opportunity.

> "There is now a serious need to start challenging prevailing corporate risk models."
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Basel II distortions

Global trade finance reputedly benefits from a low loss legacy. However, risk modelers need lots of data in order to develop models that fairly reflect reality, and in the absence of such data they turn to less robust resources and provide risk models that instead distort reality.

In one such instance, the only source of default data open to a modeler was the trade activity which found itself into a workout group – and the question posed to the workout team was "what percentage of trade LCs that you see actually fail"?

The answer was a lot higher than expected default rate. But, of course, the workout group only dealt with credits already on the watch-list. Had the question been, "what percentage of all LCs that we issue end up in workout and eventually fail"? the answer would have been more realistically a mere fraction of the earlier response.

This was confirmed by responses to a questionnaire distributed during late 2008 prompted by concerns raised to central banks by the WTO. As a result, various trade bodies and banking associations are gathering trade data that can be used to develop more robust and relevant trade risk models. This should further improve the attractiveness of trade as an asset class and improve liquidity. **GTR**

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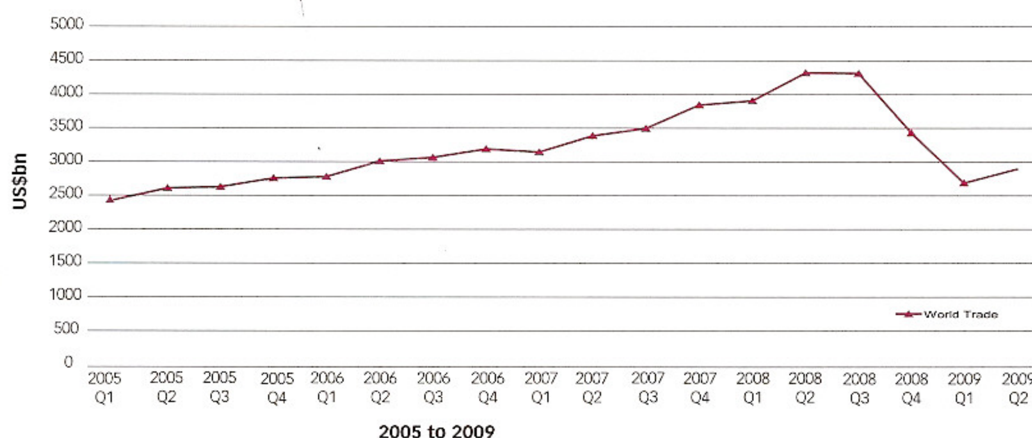

Source: WTO

WTO data on quarterly world trade volumes since 2005 clearly show a collapse in trade from a peak in Q2 and Q3 in 2008. However, more importantly, it provides evidence of signs of recovery in mid-2009.