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FINANCE FOR TRADE: EFFORT TO RESTART THE ENGINE
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What is trade financing?

1. This note deals with trade financing and its role in the current crisis. But what do we talk about when we talk about trade financing?
2. Of course, if all buyers were paying cash in advance there would be not much need for trade finance. More often exporters extend commercial credit terms to buyers, taking the risk on their book. This is estimated to represent about 40-45% of financing for trade. Exporters are more likely to do so if they have a sound and large liquid position, a sufficiently diversified client base, and especially good knowledge of the credit risk of their counterparts.
3. To extend commercial credit, exporters must have access to credit lines from banks; insure their risks with credit insurers; discount them with banks and forfeiters. This, indirectly, brings in other players.
4. In all other instances, banks play a major role by providing short term lending facilities for working capital; medium to long term financing, especially for large exports, often acting in syndication with other banks or with Export Credit Agencies (ECAs). Letters of credit are also a very common tool.
5. Finally, capital markets have played an increasing role in providing a source of funding for portfolios of receivables through the securitization process. The word “securitization” today is an anathema. However, (like derivatives) it can be a useful tool if sensibly used. Re-securitization of already secured assets in a CDO can be less of a good idea; funding long-term illiquid CDOs with short term papers (ASCP) is a recipe for disaster as it creates both liquidity and mis-matching risks.

6. Thus, in talking about trade financing we talk about a host of tools and actors: buyers paying cash in advance; sellers extending commercial credit with and without insurance or discount of receivables; banks providing credit or payment commitments; factoring; credit insurers; capital markets. This market is so complex that, in my view, no clear definition of trade finance can be given and the precise observation of its dynamics is almost impossible.

Where are we in the crisis?

7. At the cost of being over simplistic, let me summarize the key ingredients of this crisis:
 - a. The deepest roots lie in the global imbalances in consumption and savings, with emerging countries like China running large current account surpluses and accumulating foreign reserves invested in securities from industrialized countries, and especially the US. In a nutshell, the Chinese farmer has been lending at subsidized interest rates to American house owners.
 - b. Expanding global financial markets have allowed the distortions to last for a very long period, creating the sort of products that a world flush with liquidity and low or even negative interest rates craved for, not to mention the bubbles in many financial and real estate markets.
 - c. This global world lacked an adequate system of supervision, control and policies and the capacity to deal with supranational issues.
 - d. The collapse of the financial systems, especially after the demise of Lehman Brothers, has caused a collapse in confidence, which in turn had provoked a collapse of investment demand (with furious de-stocking in all major countries) and consumption.
8. How are we getting out of this crisis? Again in very simple terms:
 - a. Confidence is being rebuilt in the financial system through State participation in the capital of banks; public guarantees on their assets; public guarantees on their deposits; low rate refinancing windows; low or negative reference rates. All those measures are boosting profits and creating an impression that the worst is over;
 - b. Re-stocking is slowly back after inventories had been almost completely depleted;

- c. Public expenditure funded through lease and growing fiscal deficits, is replacing private demand.
9. In summary if the worst seems over it is because the crisis in the financial system has been addressed by moving actual and contingent liabilities from private players to the State. The banking crisis in being translated into a public debt crisis.
10. Public policies have been effective in stabilizing financial markets; and recovery is taking hold in the manufacturing sector, driven in part by a rebound in inventories and consumption. Many believe that a new cycle is on the making. Are we so sure? Many of the problems that caused the crisis are still there. Some are on the mend but will take a long time: global macroeconomic imbalances for example is one of the key issues of the G20 agenda. Either it will be a long process gradually corrected or it will be a sudden adjustment involving a lot of pain. Other fundamental issues have not really improved. The new regulatory system for financial institutions is nowhere to be seen; the key priority for banks is to get the States out after being rescued at the 11th hundred hour. This is done by increasing profits (however temporary they may be) and raising new capital. This is fine: but what about leverage? And what about implicit State guarantee? And what about being so big that no single State can cope with their demise? If more capital means same leverage and more absolute risk for higher profits and higher contingent risk for States: good luck!

How is the banking industry reacting?

11. It is undeniable that profound changes are taking place in the banking industry: in the structure, conduct and governance, as we have come to appreciate over the recent past. But like the old adagio the impression is that “everything must change for everything to remain the same”:
- a. The number of global banks has been decreasing as the industry is consolidating. This is especially the case in the export credit business where we are close to having an oligopoly.

- b. The investment banking industry has all but disappeared; the few remaining survivors have sought licences as commercial banks to benefit from central banking interventions (a form of hidden subsidy);
- c. The shareholding of several commercial banks has changed and the presence of the state, direct or indirect, has expanded providing a life-saving line;
- d. The cost at which banks borrow on the market has (permanently) increased, due to higher counterparty and liquidity risk while forms of funding backed by the States are (temporarily) extremely cheap;
- e. The economics of several lines of business and entire segments of the industry have dramatically deteriorated raising doubt on their long term viability.

12. Individual banks are in a process of de-leveraging to improve capital ratios, re-pricing risks to better reflect both liquidity and credit risk; changing risk models and policies. These actions are affecting all forms of lending, from corporate loans, to working capital, to export credit, etc. No doubt they are causing a serious credit crunch that is not sparing trade financing, irrespective of what the surveys tell or do not tell. Everyday we run a survey by listening to our customers, we recognize a credit crunch when we see one.
13. Yet the profits of the banks are booming again. How come? The spreads at which they lend to each other have become very expensive as credit and liquidity risk premia have increased. Before the crisis, it was not unusual for banks to borrow at or around Libor flat; the spread they charged on other borrowers was exclusively the remuneration for the credit risk. Built in the final “all in” interest rate there was no liquidity risk as the market was functioning pretty smoothly.
14. Today on top of the Libor banks charge a hefty liquidity spread to each other. And this is then passed on to final borrowers. How justified is the amount of this “pass on”? To understand this we need to answer the following question: what is the real cost of bank borrowing today?
15. Let us look at the sources of funding for the banks: deposit are currently remunerated at negligible (often negative) interest rates. Because they benefit from the explicit and implicit State guarantee, depositors are prepared to accept low rates deposit; this clearly implies a disguised State subsidy to banks. Refinancing facilities at central banks are also priced at

very low rates (possibly negative). Only when banks borrow on the market do they pay hefty spreads. What is the weighted average cost of banks borrowing then? And how does it compare with the cost at which they lend? In other words, do banks charge borrowers their average cost of borrowing or the marginal cost of borrowing?

16. In the context of the de-leveraging effort, banks are reluctant to lend. The supply is scarce, competition is non-existent except for the few best risks and banks lend at a rate of their own choosing. In the overall lending decline, trade financing is especially hit. It is one of the least profitable lines of business; short term trade facilities can be cut simply by not rolling over. In one survey banks acknowledge (62% of the respondent) a drop in trade financing between Q4/08 and Q2/09 but 86% blames it on the fall on demand. Another survey reports that 67% of the respondent indicated that trade transactions volume have remained the same or increased. Credit insurers, on their part, state that “the problem is the stagnating bank lending to companies” And companies state that neither banks nor credit insurers are doing their part: “I blame you, you blame me”.
17. Particularly penalized in the current environment are long term loans and big - ticket items; project financing counterparts, as they do not offer the same opportunities for selling other banking products, are also crowded out. But also SMEs are also heavily affected in most industrialized countries. Particularly penalized is also short term trade financing, a low return business undertaken mostly as a “loss leader product” that opens the way to clients for other more profitable transactions.
18. The transactions that have been completed in the last months (at least in the business segment I know better of the Medium Long Term export credit) have taken place at high spreads, at the marginal cost of borrowing. In the current environment commercial policies are dictated by treasury departments more than commercial functions, and for many borrowers there is no credit at any price. Only the capital market has somewhat mitigated this spell of dry season.
19. Since the summer, we have seen a normalization in market conditions and liquidity spreads starting to steady or even reduce. However, there will no going back to the world of Libor flat and sooner or later, as monetary authorities will drain liquidity, reference rates will start to increase making the “all in cost” of borrowing more expensive.

20. In summary, for the time being banks are doing just fine. They are making a lot of money especially from the trading book (that consumes less capital) rather than from the banking book. As a result, believe it or not, the VaR of the major US banks is even higher today than in the pre-Lehman world. In a market rebound like the current one, this is boosting short term profit growth and the stock value of the bank. This is a proof that current macro policies are working: they are stabilizing financial markets allowing banks profits to increase; which creates the impression that the worst is over with a rally in stock markets and positive effects on consumer and investors expectations. Notice however, as far as the banks profits are concerned, that they are generated by the same traders and managers who got us into this mess in the first place and that they are underpinned by a contingent liability on taxpayers. The FED is starting to look at whether those profits are real or on paper (i.e. unrealized). But even if they were real, will we be surprised if this bonanza will end in tears again?

Public intervention: macro strategy and micro actions. The case of export credit

21. There is no doubt that financial markets at large, and trade financing in particular, are facing a credit crunch. The question that is more interesting is why? There is an apparent contradiction: the financial world is flush with liquidity, thanks to the huge monetary stimulus provided by central banks, targeting very low (negative real) interest rates, and relaying on unorthodox measures to further improve liquidity. These macro measures have saved the world so far. Unfortunately this liquidity does not get fully into the circle, as banks continue to be afraid of the risk of their peers and their clients; try to reduce their assets; prefer to allocate their assets in the trading portfolio.
22. To make sure liquidity reaches the real economy, governments support their macroeconomic policies through micro interventions: direct lending and bank refinancing. I will not dwell on the many examples, but focus on the area I know better: public intervention in export credit. In this industry public players tend to be direct lenders, pure cover (insurers), or a combination of the two. Today they play a key industrial policy role.

- a. ECAs that can already do direct lending have stepped up their facility to provide a direct source of funding to buyers; to refinance banks that are willing to provide export credit loans; to guarantee refinancing in case the market dries up again;
- b. Pure cover players are trying to cooperate with other public lenders in their countries to offer a combined facility of loan and cover;
- c. In order to make big projects financially viable, all public players have stepped up their participation by increasing the value of the loans or the covers they offer (risk sharing on the project);
- d. Pure cover players have increased the share of loan cover up to 100% to help banks reduce their capital allocation charges (risk sharing on the loan);
- e. ECAs have expanded into other products from working capital facilities to short term credit insurance (as we shall see below).

Market failures of yesterday and State failures of tomorrow?

23. In summary, governments on top of the macroeconomic policies have intervened directly to support the functioning of the export credit markets. Never has there been a capacity constraint in the ECA world. All ECAs have always had headroom for expanding their activities; in the cases where the limits were close, the guardian authorities promptly broadened them. The issue, since the inception of the crisis, has been bank lending. Without a bank loan, the ECA is a “lame duck”.
24. Today there is no major project finance undertaken without ECAs involvement. Large ticket items like aircrafts and ships that used to be market funded or relied upon a combination of market and ECA sources, are today largely dependent on export credit. Large capital investments in critical sectors (steel, petrochemical, etc) even in industrialized countries, have come to depend on export credit. The only exceptions are solid corporates that are liquid or have access to capital markets that have so far partially filled the space left empty by the banks.
25. The enhanced role of the Governments, while justified in the short term, raises issues and concerns for the future:

- a. Disguised in government actions are further subsidies to banks, that through direct State support can maximize the return on their activities. The result, as we see currently, is that banks always make profits, in good times and in bad time, except when they go bust;
- b. The increased presence in the export credit market, if not at market terms, will create a barrier to re-entry to banks once the current crisis will be definitely over. History in the export credit market, shows that State failures can be as remarkable as markets failures;
- c. The emphasis on the role of government as a saviour will give ground to the “bureaucratic spirits” that have been subdued in the past years of unfettered private sector growth and create a new breed of “vested interest”;
- d. Different national support schemes and philosophies hamper the level playing field needed in this world industry, with the smaller and least advanced countries (with less resources to devote to the new competitive war) being the most damaged.

26. On this last issue we already see signs of the pendulum swinging too much: a larger involvement of ECAs in industrialized markets; the ridiculous prices for loans and covers in this new riskier environment; the increased competition among country-systems and the relaxing of credit standards. Let me indulge on two examples of how the level playing field is changing:

- a. the spreads that banks charge for liquidity risk has increased dramatically while public direct lenders, that piggy-back on the high quality rating of their State, can still enjoy low borrowing costs (effect of the flight to quality) and pass them on. This clearly puts a disadvantage on country systems that do not have direct lending schemes as well as countries with lower sovereign ratings. I have seen public loans priced at one tenth of what would be the market pricing level.
- b. as the crisis is affecting industrialized markets more than emerging markets, ECAs will become ever more present in this area (be mindful that today the USA is already the largest market for export credit!). Yet pricing policy by ECAs in industrialized countries *de facto* is not regulated by the OECD. The OECD agreement only states that premia should be in line with markets. It does not define nor monitors this benchmark. The market price is like beauty: it is in the eyes of the beholder. The

premium by an average ECA would be one fifth or less than what the market would charge, provided there was any availability on the market.

- c. the “bureaucratic spirits” take hold; the new mantra is to support exporters and employment (and in doing so banks) at any cost. This reminds me of the ECA “ATM machine model” of the seventies and eighties. Will history repeat itself?

27. There is no doubts in my view that these trends will weaken the fundamentals of an industry that in the past decade had achieved great improvements. Actions by ECAs in the credit insurance industry may also move along the same lines.

Another story: the credit insurance business

28. Credit insurance is a very esoteric industry. In simple terms, credit insurers and their reinsurers must be profitable over the business cycle; if losses increase premia are rapidly raised to bring back profitability. Until recently this model seemed to work fine. The booming world economy kept everything afloat: even when the crisis was looming insurers were still fighting a bloody price war to win market share.
29. The depth of this crisis has created losses that are wiping out the profits of many years. They will not be recovered over any definition of cycle. Further industry consolidation is not likely, as it is already an oligopoly of three major players. Re-insurers, surprised by the extent of their own losses, are scaling down their activities leaving credit insurers largely uncovered. Shareholders of credit insurers seem to be looking for ways out, while managers are desperately cutting on risks by cancelling policies, reducing limits, increasing deductibles, increasing premia. Customers are seriously thinking that buying a policy that does not effectively cover you is just not a good use of their money and prefer “self-insurance”. And the States are coming back to solve the problem, but “only for the time needed for market conditions to improve and credit insurers to come back”. I doubt it will be so clear cut!
30. Many countries are trying to mitigate the situation by introducing new schemes: within the European Union, they are applying for the “escape clause” that will allow ECAs or other public schemes to resume activities in the marketable risk area (i.e. industrialized countries). Each country with its own scheme; each country having in mind its own firms and

employees. Some of the schemes will be effective; others will fail. Some manufacturers will be more supported than their competitors. Public insurers will have a higher role and will be reluctant to give it away when (and if) markets stabilize. What kind of industry will emerge from the crisis?

31. Going back to the future: after having (in the European Union) prohibited the State from working in marketable risk countries, they are now allowed to play a key role in countries like Spain, Germany, Italy, the UK. But it will be temporary...

A few conclusions.

32. How to assess the role played by governments? We know from history of the State and private sector shifting involvements. This is the time for the State to muster a come back. However, it is exactly at these junctures, when markets are weak, that they need to be protected. Provided they accept and introduce the changes that are required. And it is also high time to put State intervention under close scrutiny, to look into the horse's mouth very carefully, to be aware of the "bureaucratic spirits". The actions of the State should be geared to three key principles (the 3Ts): i) be timely; ii) be targeted; iii) be temporary. And something more. I would add three more rules: first, do no harm (State failures, as we have seen in history, can be terrible); second, use public resources effectively (negative financial results can too easily be justified on the basis of hard to prove social goals); iii) third, for the specific ECA world, do not jeopardize the future of the company (financially, reputationally, politically).
33. What about international cooperation? The IFIs, after years of neglect, are also back at the centre stage. At desperate times, public (national and multilateral) saviours are in demand. Let's be realistic: despite the high calibre of their staff, the great reputation they still enjoy, the capacity of producing knowledge, they are and remain small and marginal compared with the dimension of the private markets. They can make a difference in the poorest countries where markets are not deep enough. IFIs are also "bureaucratic bodies". They must also be kept in check.