Trade Finance in East Asia – Potential Responses to the Shortfall

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The crisis of 2008 saw many European banks reduce their provision of trade finance in East Asia. Notwithstanding the actions of the G20 and other bodies to redress this, a substantial shortfall in trade finance facilities in the region remains. This article explores the development of this shortfall, and analyses potential responses to it. These responses range from some much-needed further revisions to the Basle III rules, to deepening of cross-border cooperation, creating a ring-fenced liquidity pool for trade finance, encouraging co-financing among the various providers of trade finance both private and public, and establishing a regional trade finance database. In addition, the article ponders the likelihood of China's banks beginning to take a substantial role in providing trade finance to the region. Trade finance offers China's banks a low risk means of expanding into international business, and offers China a way to provide the sort of important service to its region that regional leaders typically seek to provide.

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Trade finance is essential to support global trade, and the region that finances more trade transactions than any other is East Asia.[1] Historically trade has been important in the evolution and development of civilisations.[2] Today international trade enhances efficiency and competitiveness within economies and promotes their economic development.

Some 80-90 per cent of trade transactions are supported by some form of credit financing, making trade finance an integral part of the world economy.[3] Finance for international trade transactions is important for wealthy nations, and often critical for developing and emerging markets, where both exporters and importers may be severely constrained by limited working capital.

The global financial crisis that commenced in 2007-2008 sparked a substantial worldwide shortfall in trade finance in a global market then estimated at $10-12 trillion a year.[4] The effects of this contraction were markedly different in different regions.[5] South Asia, Korea and China were particularly affected, with China experiencing a double-digit decline in the

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[1] Thierry Senechal (ed), *Rethinking Trade & Finance 2013* (International Chamber of Commerce, June 2013), 13.

[2] K. N. Chaudhuri, *Trade and Civilisation in the Indian Ocean: an Economic History from the rise of Islam to 1750* (Cambridge University Press, 1985), 15-20; WTO Director-General Pascal Lamy, 'The role of trade in the rise of merchant cities' (Speech delivered at a seminar on the role of cities in trade, Shanghai, 22 July 2010) <http://www.wto.org/english/news_e/sppl_e/sppl163_e.htm>.

[3] Marc Auboin, 'Restoring Trade Finance During a Period if Financial Crisis: Stock-taking of Recent Initiative' (Working Paper ERSD-2009-16, World Trade Organisation, December 2009), 1.

[4] Marc Auboin, 'Boosting the availability of trade finance in the current crisis: Background analysis for a substantial G20 package', *Centre for Economic Policy Research*, Policy Insight No. 35, June 2009, 3; Marc Auboin and Martina Engemann, 'Trade finance in periods of crisis: what have we learned in recent years?' (Staff Working Paper ERSD-2013-01, World Trade Organization Economic Research and Statistics Division, January 2013), 14.

[5] Elizabeth Ho, 'The International Effects of the Credit Crisis' (2008) 28 *Review of Banking and Financial Law* 102.

availability of trade finance during 2008.[6] The G20 responded with its "trade finance package" in April 2009. In the words of the communiqué:

> "we will take, at the same time, whatever steps we can to facilitate trade and investment, and, we will ensure availability of at least $250 billion over the next two years to support trade finance through our export credit and investment agencies and through the MDBs (multilateral development banks). We ask our regulators to make use of available flexibility in capital requirements for trade finance."[7]

The package provided a much-needed boost, and financial agencies worldwide responded to the package by making substantially more finance available for trade.

Export credit agencies (ECAs) increased credit insurance and risk mitigation capacity by creating programs for short-term lending of working capital and credit guarantees aimed primarily at small and medium enterprises (SMEs).[8] Within our region, the leaders of eleven Asian ECAs formed the Asian Regional Cooperation Group (RCG) of the Berne Union, to meet annually to discuss responses to the global financial crisis.[9] The group responded to the crisis with new initiatives to help sustain the trade and investment flow in the region and worldwide.[10] In 2008, members of the RCG supported more than US$268 billion worth of international trade and investment.[11] Since this time, the RCG has met three times a year to exchange information and views and consider solutions for the unique challenges faced by

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[6] Wei Liu and Yann Duval, 'Trade finance in times of crisis and beyond' (April 2009) 3 *Asia-Pacific Research and Training Network Alerts* 1.

[7] The G20 London Summit Leaders' Statement, 2 April 2009, paragraph 22.

[8] Marc Auboin and Martina Engemann, above n 4, 17.

[9] Berne Union, *Asian ECAs Joint Statement* (13 August 2009) <http://www.berneunion.org/asian-ecas-joint-statement/>.

[10] Ibid.

[11] Ibid.

ECAs in East Asia.[12] Such challenges include the rise of trade protectionism in some countries, stricter foreign exchange restrictions, frequent cases of false trade documents, substantial fluctuations in the economy and local conflicts.[13]

Regional development banks (RDBs) and the International Finance Corporation (IFC) responded by significantly increasing the capacity of trade facilitation programs.[14] The Asian Development Bank (ADB) increased the capacity of their program to US$1 billion, from US$400 million.[15] The IFC also established a liquidity pool allowing co-financing operations with banks in developing countries, contributing $5 billion to jump-start the fund.[16] This amount was matched by $7.5 billion in commercial bank funding,[17] which has helped to support nearly $20 billion of trade transactions since its creation.[18]

Central Banks in nations with substantial foreign exchange reserves responded by making portions of those reserves available to finance trade.[19] Within East Asia, Korea pledged $10 billion of its foreign exchange reserve to supply foreign currency to local banks and importers through repurchase agreements.[20] Indonesia acted similarly.[21] The central bank in Japan

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[12] Berne Union, *Berne Union Yearbook 2013* (2013) <http://www.berneunion.org/news-publications/publications/>.

[13] Ibid.

[14] Marc Auboin and Martina Engemann, above n 4, 17.

[15] World Trade Organization, *The challenges of trade financing* (May 2012) <http://www.wto.org/english/thewto_e/coher_e/challenges_e.htm>; UNCTAD, *Trade financing and regional financial institutions from a South-South perspective*, (15 August 2012) <http://unctad.org/meetings/en/SessionalDocuments/ciimem2d11_en.pdf>.

[16] Marc Auboin and Martina Engemann, above n 4, 17.

[17] Ibid.

[18] International Finance Corporation, *Global Trade Liquidity Program* <http://www1.ifc.org/wps/wcm/connect/Industry_EXT_Content/IFC_External_Corporate_Site/Industries/Financial+Markets/Trade+and+Supply+Chain/GTLP/>.

[19] Marc Auboin and Martina Engemann, above n 4, 17.

[20] World Trade Organization, above n 15 and Marc Auboin, above n 4, 5-6.

opened temporary "discount windows" for local traders wanting to discount foreign trade receivables and other bills.[22] On a much smaller scale, Thailand injected US$140 million baht into the Thai EXIM Bank to increase export insurance and allocated a further US$85 million to the Small Business Credit Guarantee Corporation so it could increase credit guarantee funds and loans to SMEs.[23]

The G20 package ended in 2011. Trade finance availability and market conditions had improved continuously over the two-year period up to this time, with falling prices and increasing volumes of transactions, albeit with some volatility around an upward trend.[24] However, recovery has not been even across all countries and gaps in trade finance persist.

In 2010 the G20 Leaders in Seoul commissioned a report by the WTO on existing trade finance gaps and the effectiveness of programs aimed at addressing them.[25] The report was presented at the G20 Summit in Cannes in November 2011 and recommended that the MDBs and the World Bank Group expand the risk limits of their trade finance facilitation programs to allow for greater support to countries where local financial institutions cannot adequately support trade.[26] The Asian region was identified as a priority area.[27]

Europe's withdrawal of trade finance to Asia

Efforts to address the Asian trade finance gap have been hampered by the ongoing economic crisis in Europe. European banks traditionally provided substantial trade finance facilities in

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[21] Ibid.

[22] Marc Auboin, 'Use of Currencies in International Trade: Any Changes in the Picture?' (Staff working paper ERSD-2012-10, World Trade Organization Economic Research and Statistics Division, May 2012), 13.

[23] Wei Liu and Yann Duval, above n 6, 3.

[24] Marc Auboin and Martina Engemann, above n 4, 17.

[25] Marc Auboin and Martina Engemann, above n 4, 21.

[26] Ibid.

[27] Ibid.

East Asia and have severely limited their extensions of credit so as to improve their capital ratios.[28] Since 2008, the proportion of international credit provided by Eurozone and Swiss banks to emerging Asia-Pacific economies has fallen from 38 per cent to 19 per cent of the region's trade credit.[29] Eurozone banks (excluding German banks) reduced their share of large-ticket Asian trade finance from 43 per cent to just 3 per cent in the 18 months leading up to the first quarter of 2012.[30] French and Italian banks reportedly reduced their exposure to ASEAN countries by 50 per cent and 40 per cent respectively in this period.[31] The second half of 2011 saw a particularly rapid retreat, with European banks deleveraging their exposures to Asia by 18 per cent, a reduction of $89 billion.[32] This retreat has led to a dramatic increase in trade finance prices in Asian markets.[33] According to Barclays, "when European banks started to deleverage due to the Euro crisis [in 2011], trade finance pricing in Asian countries including India and China moved from 100 basis points to 200 basis points in three weeks."[34]

The reduction in trade finance by European banks has left a funding gap at a time of increasing demand for finance in Asia. In 2011, a $1 billion trade contract between the US

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[28] Aki Ito and Shamim Adam, 'European Retreat Squeezes Asia Trade Finance as ADB Sees Loan Demand Climb', *Bloomberg* (online), 6 December 2011 <http://www.bloomberg.com/news/2011-12-05/credit-squeeze-hits-asia-trade-finance-as-adb-loan-demand-soars.html>.

[29] Bank for International Settlements, 'Highlights of the BIS international statistics' (December 2012) *BIS Quarterly Review* 17-18.

[30] Morgan Stanley, *EU bank deleveraging and Asian trade finance* (1 May 2012) <http://pg.jrj.com.cn/acc/Res/CN_RES/INVEST/2012/6/1/8fa9fcad-09b7-4dc6-a05a-dcb2d692b442.pdf>.

[31] Takehiko Nakao, Vice Minister of Finance for International Affairs, Japan, 'International Regulatory Reform and New Financial Infrastructure in Asia' (Speech delivered at the Asian Financial Forum, Hong Kong, 14 January 2013) <http://www.mof.go.jp/english/international_policy/others/20130114.htm>. .

[32] Morgan Stanley, above n 30.

[33] Michael Bainbridge, 'Basel III threat to Asian trade finance', *Financial News* (online), 29 October 2012 <http://www.efinancialnews.com/story/2012-10-29/basel3-threat-to-asian-trade-finance>.

[34] Ibid, citing Kay Chye Tan of Barclays.

and China could not proceed due to the lack of trade finance.[35] Recent data shows that Chinese exports grew by 25 per cent in the year to January 2013 and imports climbed by 28.8 per cent in the same period.[36] In 2012, demand for trade finance products increased significantly.[37]

Fortunately, Japanese banks and some international banks such as HSBC and Standard Chartered have stepped in to cover much of the trade finance gap left by the European banks. In the past two years Japanese banks have dramatically increased their share of large-ticket, regional trade finance volumes, growing from 6 per cent in 2010 to an extraordinary 54 per cent in the first quarter of 2012.[38] As a result, Japan became the largest provider of trade finance globally in 2012, with reported trade finance volumes of $16.8 billion.[39] The Australian and New Zealand Bank (ANZ) has also capitalised on the European retreat, reporting a 29 per cent increase in trade finance revenue in 2011, and 58 per cent growth in Asia.[40]

Most trade is financed in US dollars, and the retreat of the European banks has been in part

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[35] UNCTAD, above n 15.

[36] Sarah Turner and V. Phani Kumar, 'China data helps lift most Asia stocks; Japan down', *MarketWatch*, *Wall Street Journal* (online), 8 February 2013 <http://articles.marketwatch.com/2013-02-08/markets/36970890_1_quarterly-net-loss-sony-corp-china-data>.

[37] World Trade Organisation, *WTO Report on G-20 Trade Measures: Mid-May to Mid-October 2012* (31 October 2012), <http://www.wto.org/english/news_e/news12_e/igo_31oct12_e.htm>.

[38] Morgan Stanley, above n 30.

[39] 'Japan tops trade finance charts', *Global Trade Review* (online), 25 January 2013 <http://www.gtreview.com/trade-finance/global-trade-review-news/2013/January/Japan-tops-trade-finance-charts_10637.shtml>.

[40] Steve Slater, 'Europe's banks leave room for rivals to fund world trade', *Reuters* (online), 16 April 2012, <http://www.reuters.com/article/2012/04/16/banks-trade-idUSL5E8E1B1P20120416>; Aki Ito and Shamim Adam, above n 28.

due to the rising cost of borrowing US dollars since the start of the Eurozone crisis.[41] Japanese banks, ANZ, HSBC and Standard Chartered have thus been in a position to benefit from the European retreat given their easy access to US dollars.[42]

Despite Japanese and other banks stepping in, there remains a shortfall of finance for trade in East Asia today. A survey conducted by the ADB in March 2013 identified a trade finance gap of $465 billion in developing Asia.[43] This finding is serious given the critical role finance plays in facilitating trade. The shortfall particularly affects our region as a higher proportion of trade is financed in East Asia than other regions. Notably, the majority of trade letters of credit issued globally are issued in Asia.[44]

As well as a simple shortfall of finance, Asian companies have complained that the cost of trade finance is rising, possibly due to the growing pricing power of the few banks in the region willing to extend trade credit.[45] While the top 40 institutions represented 95 per cent of the Asian trade finance market in 2011, only 20 remained in the market for Asian trade finance in 2012.[46]

Basel III

Apart from the retreat of European banks, the largest challenge on the horizon lies in the implementation of Basel III. While Basel III aims to establish a level playing field across

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[41] Francesco Guerrera, 'French Banks Say Adieu to Financing Asian Trade', *Wall Street Journal* (online), 3 September 2012, <http://online.wsj.com/article/SB10000872396390443571904577629250952177234.html>.

[42] Morgan Stanley, above n 30.

[43] Steven Beck et al., *Asian Development Bank Trade Finance Survey: Major Findings* (Asian Development Bank, March 2013), 1.

[44] Michael Bainbridge, above n 33.

[45] Francesco Guerrera, above n 34.

[46] Morgan Stanley, above n 30.

borders, its implementation will not have the same impact worldwide. In the words of Takehiko Nakao, Vice Minister of Finance for International Affairs in Japan:

> "[The] international standards of financial regulation [comprising Basel III] are based on the experiences of the financial crises in the US and Europe, and do not necessarily reflect the conditions of the financial sectors in Asian emerging countries."[47]

The implementation of Basel III, in requiring larger capital holdings against trade transactions, could slow trade financing in emerging and developing economies in the Asian region by substantially raising transaction costs and discouraging trade financing, thereby exacerbating the already precarious position of many nations in the region.[48] According to recent findings by the ADB, 79 per cent of banks surveyed stated that the Basel regulatory requirements had played a significant role in limiting trade finance.[49] 75 per cent of the banks surveyed indicated that they would reduce trade finance support by 5 per cent or more if Basel III were fully implemented.[50] Furthermore, 65 per cent of respondents to the ICC Global Trade and Finance Survey 2013 said that implementation of Basel III regulations is affecting the cost of funds and liquidity for trade finance to some, or a large, extent.[51]

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[47] Takehiko Nakao, above n 31.

[48] Elliot calls it a 'dangerous misconception' that raising capital requirements will ensure a safer banking requirement and believes considerably more debate is needed. See Douglas J. Elliot, *Higher Bank Capital Requirements Would come at a Price* (20 February 2013) The Brooking Institute <http://www.brookings.edu/research/papers/2013/02/20-bank-capital-requirements-elliott>; Shawn Baldwin, *Basel Barriers: How capital requirements would impede progress in the sovereign debt crisis* (15 October 2012) Forbes <http://www.forbes.com/sites/shawnbaldwin/2012/10/15/basel-barriers/>.

[49] Steven Beck et al., above n 43, 4.

[50] Steven Beck et al., above n 43, 5.

[51] Thierry Senechal (ed), above n 1, 13.

Most experts expected that Basel III would considerably increase trade finance pricing worldwide if implemented in its original form.[52] In January 2013, the Basel Committee on Banking Supervision bowed to longstanding pressure from the banking industry to modify the liquidity coverage ratio (LCR) for trade finance products.[53] The Basel Committee also delayed full implementation of the LCR requirements until 2019.[54]

The liquidity rule requires banks to hold enough liquid assets to be able to withstand a 30 day liquidity crisis. The original rule was drafted narrowly and limited what banks could count as liquid assets to money and government bonds. The Basel Committee has now extended the rule to include less traditional assets such as residential mortgage-backed securities to satisfy up to 15 per cent of the LCR.[55] Additionally, banks are now only required to hold 30 per cent of the funds they would theoretically lose access to in a crisis – a significant decrease from the 100 per cent originally required.[56] While the original rule assumed that banks would lose 5 per cent of their retail deposits during a theoretical 30-day crisis, the modified LCR assumes a loss of 3 per cent.[57] Furthermore, banks will now only have to be partly in compliance by 1 January 2015, the date upon which the original rule was supposed to be implemented.[58] The modified LCR will now be gradually phased-in over the further four years leading to 2019.[59]

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[52] Viren Vaghela, 'Basel III threatens to throttle trade finance', *Asia Risk* (online), 9 July 2012 <http://www.risk.net/asia-risk/feature/2190078/basel-iii-threatens-throttle-trade-finance> and Michael Bainbridge, above n 33.

[53] David Enrich, Geoffrey T. Smith and Andrew Morse, 'Rules for lenders relaxed', *Wall Street Journal* (online), 7 January 2013 <http://www.efinancialnews.com/story/2013-01-07/rules-for-lenders-relaxed>.

[54] Ibid.

[55] Ibid.

[56] Ibid.

[57] Ibid.

[58] Ibid.

[59] Ibid.

The decision to relax the LCR in January 2013 has generally been regarded by the industry as positive. However, some banks have criticised part of the amendment, which states that the LCR requirement should be based on collateral calls caused by market valuation changes, calculated by the highest collateral outflow during the preceding 24 months.[60] Critics argue that the amendment could significantly increase the volatility of bank liquidity requirements, and force banks to hold much higher levels of liquidity to ensure compliance.[61] This could affect banks' capacity to provide trade finance. Even if the amendment to the LCR eases pressure on trade finance, the longer-term impact of Basel III as a whole is still likely to increase the cost of financing trade.[62]

Potential Responses to These Challenges

Further adjustments to the Basel III rules

Trade finance rates of default and loss have historically been very low, even during crises. In 2009, the International Chamber of Commerce (ICC) and ADB initiated a trade finance default register to collect performance data on trade finance products.[63] The register collects data from 21 global banks that provide more than $2 trillion in short-term export-related credit, roughly 65 per cent of the world's total.[64] The data collected by the project supports the claim that trade finance is much less risky than other parts of banking. Between 2008 and

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[60] Michael Watt, 'Banks round on LCR approach to derivatives collateral flows', *Risk Magazine* (online), 27 June 2013 < http://www.risk.net/risk-magazine/feature/2277631/banks-round-on-lcr-approach-to-derivatives-collateral-flows>.

[61] Ibid.

[62] Thierry Senechal (ed), *Global Risks – Trade Finance 2013* (International Chamber of Commerce, 24 June 2013), 59.

[63] Thierry Senechal (ed), *Global Risks – Trade Finance 2011* (International Chamber of Commerce, 26 October 2011), 16.

[64] Brooke Masters, 'Push to cut trade finance from Basel III', *Financial Times* (online), 16 April 2013 <http://www.ft.com/intl/cms/s/0/5b8b9f1c-a678-11e2-885b-00144feabdc0.html#axzz2XU9DFw8g>.

2011 the ICC Trade Finance Register recorded fewer than 1800 defaults in a dataset of 8.1 million short-term trade finance transactions.[65] During the same period the rates of default for off-balance sheet trade products were particularly low, with only 947 defaults recorded in a sample of 5.2 million transactions.[66] The data collected determined the probability of loss as just 0.02 per cent.[67] Fewer than 500 losses were recorded out of more than 7.5 million transactions between 2008 and 2010.[68]

The proposed Basel III rules do not come close to reflecting this very low level of risk involved with trade finance. At present, there is no differentiation between trade finance and other forms of finance in credit conversion factors (CCFs) for calculating the leverage ratio.[69] Under the current rules, banks are required to apply a CCF of 100 per cent for all off-balance sheet items when calculating a leverage ratio.[70] This applies to all trade finance claims, unless the claim is unconditionally cancellable without prior notice to the beneficiary, in which case a CCF of 10 per cent is applied.[71]

Trade credit traditionally attracted a low risk weighting of 20 per cent under the first iteration of the Basel Accord because of these historically low default rates and because trade finance facilities are typically secured against the goods or commodities being financed. Under a

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[65] Thierry Senechal (ed), above n 62, 15.

[66] Viren Vaghela, above n 52.

[67] Thierry Senechal (ed), above n 62, 15.

[68] Thierry Senechal (ed), above n 63, 16.

[69] Garima Chitkara and Aaron Woolner, 'Revised LCR falls short on ending Basel III concerns over trade finance', *Asia Risk* (online), 6 February 2013 <http://www.risk.net/asia-risk/news/2242693/revised-lcr-falls-short-on-ending-basel-iii-concerns-over-trade-finance>.

[70] Laurence Neville, 'Euromoney Trade Finance survey 2012: Trade not getting the credit', *Euromoney* (online), January 2012 <http://www.euromoney.com/Article/2959489/Euromoney-Trade-Finance-survey-2012-Trade-not-getting-the-credit.html?Type=Article&ArticleID=2959489>.

[71] Garima Chitkara and Aaron Woolner, above n 69.

typical trade finance facility, the bank extending the credit has the bills of lading or other title documents to the goods or commodities pledged to it, and only releases this pledge when it is either paid, or another security interest is put in place.[72] Accordingly, if the bank is not paid it should be able to recover much of the credit it has extended by selling the goods or commodities.

The CCF of 20 per cent in the first Basel Accord remained largely unchanged under Basel II.[73] However, on 10 January 2010 the Basel Committee proposed the introduction of a flat 100 per cent CCF to certain off-balance sheet items in an attempt to reduce incentives for "leveraging".[74] This proposal included letters of credit and similar trade finance facilities.[75] Subjecting trade finance to a CCF of 100 per cent is utterly excessive given that the objective of the leverage ratio is to prevent the build-up of excessive leverage in the banking sector and yet, as trade finance underpins the movement of goods and commodities, it does not lead to the sort of leveraging that may endanger real economic activity.[76]

Data collected by the ICC and ADB supports the view that the leverage ratio in its current form does not reflect market realities and may significantly limit banks' ability to provide affordable financing to businesses in developing countries and SMEs in developed countries.[77] As indicated by the ICC in its report *Global Risks – Trade Finance 2011*, the leverage ratio proposed by Basel III could have adverse effects on global trade and growth by:

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[72] Carole Murray; David Holloway; Daren Timson Hunt and Clive Schmitthoff (1903-1990), *Schmitthoff: The Law and Practice of International Trade* (Sweet & Maxwell, 2012), 249-251.

[73] Marc Auboin, *The prudential treatment of trade finance under Basel III: For a fair treatment* (7 March 2010) Vox <http://www.voxeu.org/article/fair-treatment-trade-finance-under-basel-iii>.

[74] Ibid.

[75] Ibid.

[76] BAFT-IFSA, *Trade finance – key concerns and recommendations for the Basel framework* (1 December 2011) <http://www.esf.be/new/wp-content/uploads/2011/12/BAFT-IFSA-Basel-Talking-Points-2011-12-01-Final.pdf>.

[77] Thierry Senechal (ed), above n 63, 4.

“a) curtailing banks’ ability to provide affordable financing to businesses in developing and low-income countries and to SMEs in developed countries;

b) increasing the cost of trade, with banks raising their prices to pay the costs associated with the more stringent regulatory requirements;

c) encouraging banks to move high-quality trade assets and contingents into non-bank sectors and higher-risk, unregulated markets such as hedge funds, thereby defeating the purpose of strengthening the resilience of the banking sector; and

d) redefining the banking map because inconsistencies in the implementation of the regulatory regime at the national level can create competitive arbitrage opportunities in some financial markets and can have an impact on the domiciling of banks.”[78]

At present, Basel III also uses a standard asset value correlation (AVC) for corporate banking, imposing a treatment for trade finance that does not reflect its short-term, low risk nature.[79] The current rule requires the AVC to be multiplied by 1.25 in respect of exposures to financial institutions whose assets exceed 100 billion US dollars and to exposures to all unregulated financial institutions, regardless of size.[80] The increase in AVC applies to all sources of credit risk exposure.[81] The rule is based on the assumption that such exposures

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[78] Thierry Senechal (ed), above n 63, 7-8.

[79] Ibid; BAFT-IFSA, above n 76.

[80] Citibank, *Basel III – Sailing the trade winds of change* (October 2012) <http://www.transactionservices.citigroup.com/transactionservices/home/sa/b1/sibos_2012/docs/1015942_Impact_of_Basel_III.pdf>; Australian Prudential Regulation Authority (APRA), ‘Implementing Basel III capital reforms in Australia – counterparty credit risk and other measures’ (Discussion Paper, APRA, August 2012) <http://www.apra.gov.au/adi/PrudentialFramework/Documents/APRA_Discussionpaper_BASEL3_CCR_FINAL_2.pdf>.

[81] Australian Prudential Regulation Authority (APRA), above n 80.

present greater default correlations than others.[82] This assumption ignores the indisputable fact that trade finance rates of default are substantially lower than rates of default in other banking sectors.

While Basel III subjects corporate banking to a blanket AVC, consumer banking is granted several product specific default curves.[83] Under Basel III, separate AVCs are applied to retail mortgages, credit cards and other retail exposures.[84] Like retail banking, corporate banking products should be distinguished from one another to accurately reflect their level of risk. Applying a standard AVC is likely to increase the cost of providing trade finance, and may prompt smaller banks to pursue other, more profitable areas of banking.[85] In the words of the international banking industry association BAFT-IFSA:

> "The AVC proposals recommended by the Basel Committee could increase the cost of providing credit for trade transactions and limit their availability, particularly in emerging markets that rely on sustained and affordable access to trade finance to support commercial activities."[86]

Recent changes to the LCR under Basel III came about after sustained pressure from the trade finance industry.[87] At present, making further changes to the rules will be difficult for the Basel Committee given public sentiment towards banks.[88] While trade finance is crucial for world trade, it is currently seen as a minor issue in comparison to the ongoing Eurozone crisis

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[82] Garima Chitkara and Aaron Woolner, above n 69.

[83] Ibid.

[84] BAFT-IFSA, *Key concerns regarding trade finance and transaction banking* (2012) <https://www.baft-ifsa.com/eWeb/docs/Misc%20Documents/JointIndustryLetterTalkingPoints.pdf>.

[85] Citibank, above n 80.

[86] BAFT-IFSA, above n 84.

[87] David Enrich, Geoffrey T. Smith and Andrew Morse, above n 53.

[88] Laurence Neville, above n 70.

and other problems in the banking sector.[89] Furthermore, the Basel Committee is faced with the challenge that if they make concessions for one type of financing, others might make such claims as well.[90] This would put a great deal of strain on the whole regulatory system and potentially undermine its objectives.[91]

Given that statistical information demonstrates that trade finance is less risky than other forms of finance, there is a strong case for the industry to continue lobbying the Basel Committee to modify the Basel III rules. Without changes to the leverage ratio and AVC, it is highly likely that the price of trade finance will increase, with damaging consequences for global trade and thus global growth.

A Crisis Contains Within t an Opportunity – for China

The idea that the Chinese character for crisis contains within it the character for opportunity is such an elegant idea that it is often used by authors.[92] Sadly it is not the case[93] – but it is such a nice, elegant idea it should be.

Nonetheless, matters of calligraphy aside, this crisis of inadequate trade finance in the East Asian region would seem to present an opportunity for Chinese banks which I am somewhat surprised they have not seized. At the Loan Market Association's syndicated loan conference in London in 2012, there was a general consensus among panel members that

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[89] Ibid.

[90] Garima Chitkara and Aaron Woolner, above n 69.

[91] Ibid.

[92] John F. Kennedy famously used the idea during a campaign speech in 1959 – see Yahia Lababidi, 'Crisis', *Philosophy Now* (online), May/June 2013 <http://philosophynow.org/issues/73/Crisis>; 'Many deserve kudos for confronting PDO's funding, staffing issues', *American Press* (online), 17 June 2013 <http://www.americanpress.com/AP-Editorial-6-18-13>.

[93] Victor H. Mair, *How a misunderstanding about Chinese characters has led many astray* (September 2009) <http://pinyin.info/chinese/crisis.html>.

Chinese banks were preparing themselves to fill the void left by the French banks in the commodity finance market.[94] According to Simon Tyler, head of corporate banking for China Construction Bank, London:

> "Banks such as Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China, and China's Bank of Communications are already in talks about their moves over to London and are very keen on developing relationships with the top players. Although it will be a while before this presence is fully realised, partly because they are being very cautious. But slowly and surely as this happens we'll see them competing with each other as much as with international banks."[95]

One reason for Chinese banks to be cautious is the rapid growth of credit in China, which has been growing at 22% a year.[96] In 2012, credit in China grew more than twice as fast as GDP.[97] The Chinese government is now taking measures to tighten liquidity levels and limit risky lending, in what some analysts say could be Beijing's most drastic clampdown on credit in two decades.[98] In late June 2013, China's central bank temporarily stopped lending money in an attempt to reduce the reliance of banks on credit.[99] China's other banks are now

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[94] 'Asian banks stand by to fill the commodity finance gap', *Global Trade Review* (online), 21 September 2012 <http://www.gtreview.com/trade-finance/global-trade-review-news/2012/September/Asian-banks-stand-by-to-fill-the-commodity-financing-gap-_10284.shtml>.

[95] Ibid.

[96] 'China crunch to hit commodities', *Global Trade Review* (online), 26 June 2013 <http://www.gtreview.com/trade-finance/global-trade-review-news/2013/June/China-crunch-to-hit-commodities_10986.shtml>.

[97] Ibid.

[98] Joe McDonald, 'China's campaign to clean up risky bank lending threatens credit for entrepreneurs', *Star Tribune* (online), 28 June 2013 <http://www.startribune.com/politics/national/213445171.html?page=all&prepage=1&c=y#continue>.

[99] 'China finds "violations" in lending by state-owned banks', *BBC News Business* (online), 28 June 2013 <http://www.bbc.co.uk/news/business-23093552>; 'Bear in the China shop', *The Economist* (online), 27 June

following the government’s orders by reducing lending, impacting the availability of finance for certain commodities such as gold, rubber and base metals.[100] In May, two banks stopped issuing letters of credit with long maturity dates to jewelers importing gold into the mainland for export processing.[101]

In addition to the Chinese government’s crackdown on lending, other challenges exist that may delay China’s entry into the trade finance space. One example is the difficulty faced in opening branches in London and wider Europe due to licensing requirements..[102] It may also take time for China to establish the requisite ‘back office’ needed to compete consistently in the trade finance industry.[103] Trade finance document checking is very technical and requires very substantial and detailed training of staff, which will take some considerable time.[104]

While China has not yet stepped into the trade finance gap left by the Europeans, it seems likely to do so in the next few years. Though rigorous training willbe required, China has proven itself very adroit at acquiring expertise in a wide range of technical and scientific fields, and the trade finance industry should be no exception. In addition, providing trade finance would seem to be a clever move for a government wanting to cut back on risky

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2013 <http://www.economist.com/news/leaders/21580144-not-countrys-lehman-moment-it-does-herald-change-momentum-bear-china?frsc=dg%7ca>.

[100] Fayen Wong and Polly Yam, ‘China banks curb loans to commodities firms in hot-money battle’, *Reuters* (online), 22 May 2013 <http://www.reuters.com/article/2013/06/05/china-commodity-credit-idUSL3N0DY0IZ20130605>.

[101] Ibid.

[102] ‘Asian banks stand by to fill the commodity finance gap’, above n 94.

[103] ‘China banks behind on commodities’, *Global Trade Review* (online), 23 May 2013 <http://www.gtreview.com/trade-finance/global-trade-review-news/2013/May/China-banks-behind-on-commodities_10920.shtml>.

[104] R.P. Buckley, ‘The 1993 Revision of the Uniform Customs and Practice for Documentary Credits’ (1995) 28 *George Washington Journal of International Law and Economics* 265.

lending, given the exceptionally low rate of default on trade credits.[105] In 2012, 73% of all export transactions took place in the Asia-Pacific, and the region received the most letters of credit.[106] There is an opportunity for China to make a considerable impact should it choose to step into the trade finance industry.

Deepening cross-border cooperation

Deepening regional cooperation on trade finance would be beneficial to all parties.[107] By pooling resources and expertise, our region would be better equipped to tackle bottlenecks in trade financing.[108] The cost of providing trade finance would also likely decrease.[109] Cooperation within the region would reduce reliance on foreign finance, which tends to be heavily procyclical and often destabilising.[110] This is particularly significant given the current trade finance gap caused by the retreat of European banks from Asia.

In the past, several developing countries with well-developed trade finance institutions have tackled South-South trade finance bottlenecks by opening branches of their institutions in other countries within the region.[111] An example is the Thai Export-Import Bank, which opened a branch in Moscow in 2009 to facilitate the financing of Thai exports to the Russian market.[112]

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[105] Thierry Senechal (ed), above n 63, 10.

[106] Chito Santiago, 'Shortage of trade finance continues', *The Asset* (online), 24 June 2013 <http://www.theasset.com/article/24575.html>.

[107] Wei Liu and Yann Duval, above n 6, 3.

[108] Ibid.

[109] UNCTAD, above n 15.

[110] Ibid.

[111] Ibid.

[112] Ibid.

In March 2012 the Export-Import banks of the BRICS (Brazil, Russia, India, China and South Africa) signed two agreements to extend credit facilities to each other in local currencies.[113] It is expected that the move will reduce the demand for fully convertible currencies for transactions among the BRICS, which should help to reduce transaction costs.[114] The initiative will also assist to shield the BRICS from the Eurozone crisis and boost trade despite the slow growth of developed country markets.[115]

Strengthening the regional network of export-import banks and development finance institutions within Asia would assist our region to achieve the aims of the BRICS agreement. As the Eurozone crisis continues, European banks may well continue to withdraw credit from our region. Deepening cross-border cooperation within Asia will reduce the cost of trade finance within the region, tackle current trade finance bottlenecks and help to insulate Asian economies from the crisis in Europe.

Despite the benefits that could be derived from regional cooperation, previous initiatives to improve financial cooperation within Asia have not always received support. In 2010, an East Asia Summit (EAS) Trade Finance workshop was held in Sydney and brought together trade finance officials from 13 nations to exchange views on trade finance proposals that could advance regional trade.[116] Though financial cooperation was given special attention at the workshop, Australia's idea of establishing an EAS Trade Finance Network was not supported

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[113] Ibid.

[114] Ibid.

[115] Ibid.

[116] Australian Parliamentary Secretary for Trade, 'East Asia Summit trade finance workshop helps advance regional trade' (Media Release, 14 May 2010) <http://www.trademinister.gov.au/parlsec/releases/2010/ab100514.html>.

by other members.[117] Nonetheless, the creation of a trade finance network within Asia is something that regional countries should continue to pursue. Its potential benefits to the region, given the ongoing demand for trade credit in the region, mean it would be very worthwhile.

Creating a ring-fenced liquidity pool for trade finance

Since the global financial crisis, banks have become more risk averse and prefer to work with large, sound multinational firms.[118] Consequently, SMEs and new exporters have been especially vulnerable to the tightening trade finance conditions.[119] SMEs typically have a weaker capital base and bargaining power in relation to global buyers and banks, and have been subjected to large increases in trade finance costs.[120] This is especially true of emerging firms, that often face higher interest rates, higher fees on letters of credit and higher capital requirements than established firms.[121] In addition, firms in developing countries with underdeveloped financial systems and weak contractual enforcement systems are particularly affected by a lack of affordable trade finance as they need it the most.[122] The lack of available trade finance for SMEs in developing countries impacts economic growth and job creation there.[123]

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[117] Eko NM Saputro, 'The East Asia Summit and regional financial cooperation', *East Asia Forum* (online), 18 August 2011 <http://www.eastasiaforum.org/2011/08/18/the-east-asia-summit-and-regional-financial-cooperation/>.

[118] Jean-Pierre Chauffour and Mariem Malouche, 'Trade finance during the 2008-9 trade collapse: key takeaways' (September 2011) 66 *World Bank Economic Premise* 5.

[119] Ibid.

[120] Ibid.

[121] UNCTAD, above n 15.

[122] Jean-Pierre Chauffour and Mariem Malouche, above n 118.

[123] Thierry Senechal (ed), above n 1, 11.

Establishing a small, targeted liquidity pool run by international financial institutions would be useful to assist smaller segments of the market that are more vulnerable to the contraction of trade credit supply.[124] After the global financial crisis, much of the increased liquidity support provided by central banks was used to ease money market conditions and improve liquidity ratios.[125] As a result, trade transactions did not benefit greatly from the liquidity support, despite having remained a safe haven during the banking crisis.[126] Creating a ring-fenced liquidity pool for trade finance would ensure that adequate funds remain available to assist trade by SMEs and new exporters, even during times of crises when banks may prefer to direct funds elsewhere.

For banks, the downside to ring fencing is that liquidity is prevented from being used for other purposes at times when the other purposes might be more pressing.[127] Large cross-border banking groups benefit from the efficiency of holding liquidity centrally and directing it to locations where it is most needed.[128] This process is more cost-effective than ring fencing liquidity.[129] Nonetheless, any disadvantages of a ring-fenced liquidity pool for trade finance could well be outweighed by the benefit of ensuring that trade finance is still available for SMEs and new exporters when economic crises occur and trade finance conditions tighten.

<u>Encouraging co-finance between the various providers of trade finance, including public sector-backed institutions</u>

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[124] Marc Auboin, above n 4, 5.

[125] Marc Auboin and Martina Engemann, above n 4, 19.

[126] Ibid.

[127] Viren Vaghela, 'Asian regulators get tough on liquidity ring-fencing', *Asia Risk* (online), 1 April 2011 <http://www.risk.net/asia-risk/feature/2041993/asian-regulators-tough-liquidity-ring-fencing>.

[128] Ibid.

[129] Ibid.

The majority of trade finance is provided by the private sector. In 2009, private banks accounted for about 80 per cent of all trade finance lending operations.[130] Such reliance on banks leaves trading firms vulnerable in times of crisis, as seen with the recent drop in trade credit within Asia. To reduce the impact of crises on trade finance flows, public sector actors, such as ECAs and RDBs, should share jointly some of the private sector risk.[131] In the words of Pascal Lamy:

> "One clear lesson from the Asian financial crisis is that in periods prone to a lack of trust and transparency, and herd behaviour, all actors – including private banks… export credit agencies and regional development banks – should pool their resources, as far as practicable."[132]

An example of a successful private/public partnership was the introduction in 2009 of the Global Trade Liquidity Program by the IFC, which allowed for a 40-60 per cent co-lending agreement between the IFC and commercial banks.[133] The program allowed banks to continue to support clients with trade finance, and gave the IFC the ability to channel liquidity and credit into markets to help revitalise trade flows by leveraging the banks' vast networks across emerging markets globally.[134]

Mobilising both private and public-sector institutions to form a partnership during times of crisis would ensure that institutions with excess capacities had an opportunity to meet the needs of those with insufficient funds.[135] However, co-financing between the two sectors need not only occur in times of crisis. Longer-term public involvement would help to close

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[130] Pascal Lamy, 'Trade finance: rebooting the engine' (2009) 1 *International Trade Forum* 4.

[131] Marc Auboin, above n 4, 5.

[132] Pascal Lamy, above n 130, 4.

[133] Marc Auboin and Martina Engemann, above n 4, 18.

[134] International Finance Corporation, above n 18.

[135] Marc Auboin and Martina Engemann, above n 4, 14.

the structural market gaps in poor countries.[136] Furthermore, ongoing risk sharing between the public and private sectors should reduce the impact of any future financial crisis on the availability of trade finance.

Establishing a regional trade finance database to facilitate the collection and exchange of information

Filling information gaps between public and private institutions is of great importance, particularly during times of economic crisis. While responding to the financial crisis that commenced in 2008, members of the Bankers' Association for Trade and Finance (BAFT) complained that a series of measures announced by ECAs and RDBs were hard to track.[137] They also lacked access to critical information, such as who was providing what finance, and upon what criteria.[138] Such information gaps affect the ability of both the public and private sectors to respond to trade finance challenges, particularly in developing countries.[139] It is thus crucial that information is collected and shared among trade finance stakeholders within the region.

The ICC Trade Register established by the ICC and ADB in 2009 was a significant step towards increasing trade finance information. So far the database has recorded over 15 million transactions worldwide, reflecting 70 per cent of global transactions.[140] It is currently the most comprehensive database available on trade and export finance.[141] Nevertheless, the

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[136] Marc Auboin and Martina Engemann, above n 4, 3.

[137] Pascal Lamy, above n 130, 5.

[138] Ibid.

[139] Ibid.

[140] International Chamber of Commerce, *The ICC Trade Register* (2012) <http://www.iccwbo.org/uploadedFiles/Services/Trade_Facilitation/ICC%20Trade%20Register%20Brochure.pdf>.

[141] Ibid.

register only records data provided from participating banks.[142] While this includes 21 of the most active banks in worldwide trade finance,[143] gaps in data remain. Within our region, much more information is needed as to how SMEs, in particular, finance their trade and the challenges they face.

While the ICC Trade Register provides useful information regarding trade finance transactions, it is not released immediately. The ICC released the latest trade finance report on 24 June 2013, nearly two years after its prior report..[144] This information is crucial for the development of policy regarding trade finance, but does not provide stakeholders with up-to-date information about the type and amount of trade finance being provided at the present time. In times of crisis, such information is needed to allow trade finance institutions to respond rapidly.

In order to address gaps in trade finance information, a regional database should be created that disseminates relevant information to both public and private institutions, such as the development of programs by ECAs. Such a database should include all trade finance stakeholders within the Asian region, not just commercial banks. It is important that the information gap between the public and private sectors is filled so that both sectors can respond quickly when shortfalls in trade finance arise.

Conclusion

Trade is essential to the health and growth of economies worldwide. The availability of trade finance is crucial as most trade transactions are supported by some form of credit financing.[145] There is also a strong link between trade finance, economic growth, and job

142 Thierry Senechal (ed), above n 62.

143 Ibid.

144 Thierry Senechal (ed), above n 63.

145 Marc Auboin, above n 3.

creation, which is particularly important in our region. In a survey conducted by the ADB in the fourth quarter of 2012, 138 companies said that a 5 percent increase in trade finance support would result in a 2 percent increase in their business and a 2 percent increase in their staffing needs.[146] The same companies said that a 10 percent increase in trade finance support would result in 5 percent more production and jobs.[147] These statistics show how crucial trade finance is to East Asia.

The financial crisis of 2007-2008 sparked a global shortfall in trade finance and while the G20 and financial agencies worldwide responded in a significant way, a substantial trade finance gap remains. A recent survey by the ADB shows that in 2011, banks responding to the ADB survey received trade finance requests of $4.6 trillion[148]and had to reject $1.6 trillion of these requests.[149] This figure indicates that a significant proportion of global trade is unable to be financed. Given global trade totalled $18 trillion in 2011, it is likely that the actual trade finance gap is very substantial indeed.[150]

The shortfall has particularly affected our region, as a higher proportion of trade is financed in East Asia than any other region. The ADB survey suggests a trade finance gap of at least $425 billion in developing Asia,[151] which has developed in part due to the rapid reduction in finance provided by European banks struggling with the ongoing economic crisis at home. While international and Japanese banks have stepped in, the amount of trade finance provided in Asia is still insufficient, and the cost has increased considerably.

[146] Thierry Senechal (ed), above n 1, 60.

[147] Ibid.

[148] Steven Beck et al., above n 43, 3.

[149] Ibid.

[150] Thierry Senechal (ed), above n 1, 35.

[151] Steven Beck et al., above n 43, 3.

The impending full implementation of Basel III poses a further challenge to trade finance in our region. While the relaxation of the LCR requirements in January 2013 eased the pressure on trade finance, it did not eradicate it. Further adjustments are required to ensure that the longer-term impact of Basel III does not increase the cost of financing trade. In particular, changes to the leverage ratio and AVC are necessary to prevent rising trade finance prices impacting on global growth. With respect, the proposal to increase the risk weighting on trade finance to 100% must have been the work of people without experience in these markets. No one who understands the finance of international trade could perceive it as a risky industry, or as a source of unwanted leverage in the system.

A number of strategies could be implemented to address a lack of affordable trade finance in our region. These include strengthening cross-border cooperation, encouraging co-financing between the public and private sectors, establishing a regional trade finance database to share information and creating ring-fenced liquidity pools for trade finance. In times of crisis, it is essential that all stakeholders work together and share information and resources to address trade finance needs efficiently and effectively.

It is a little curious that China has not yet seized the opportunity presented by Europe's rapid retreat from trade finance in Asia to step into the gap. Given the low risk nature of trade finance, it would seem an attractive way for Chinese domestic banks to expand into conducting international business. Nevertheless, the substantial size of the current trade finance gap suggests there is still space for China to make a move. Trade finance offers China a very low risk field into which its banks could expand. Such a move would help to address the ongoing trade finance gap and support the further development of economies in the Asian region.