



# What next for trade finance?

*Trade & Forfeiting Review* talks to Citi's JOHN AHEARN about tightened credit, stricter regulations and the impending cash reserve mandates of Basel II.

**A**s the storm clouds finally begin to clear and the global economy moves gingerly towards recovery, trade finance professionals find themselves in a landscape that's dramatically different from the pre-crisis environment.

The trade industry is now in the middle of a major shakeup affecting financial institutions and the corporates they serve. Among the most visible and significant factors in the new trade environment are newly tightened credit, changes in accounting regulations, and stringent new capital reserve requirements – highlighted by the anticipated impact of Basel II regulations.

While the European Union has implemented Basel II, largely reflected in its Capital Requirements directives, the US will be making the move during 2011. And that's even before the proposed, tough new amendments to Basel II – dubbed Basel III – are finalised.

This confluence of factors presents a vexing challenge for financial institutions, requiring significant and fundamental change on the part of global trade professionals.

“Regulators are trying to tighten capital requirements across the board, on

## Basel II highlights

Multiple methods for calculating risk-weighted assets (RWA) are available for each of three risk types it covers: market, credit and operational:

- For market risk, standards have been enhanced to model default risk;
- For credit risk, a formula-based calculation uses an institution's internal risk parameters associated with each facility, such as probability of default (PD) and loss given default (LGD);
- For operational risk, a new internal simulation model estimates frequency and severity of operational losses.

RWA is aligned with the actual economic risk and a bank's internal measurement of economic capital.

all products in the banking industry as a whole,” according to John Ahearn, Global Head of Trade for Citi's Global Transaction Services. “Although trade performed well

during the crisis, it is nevertheless being affected by this new environment.”

## Constricted credit

In 2009, losses incurred by traditional trade products were no worse than those suffered by other banking facilities, according to ‘Rethinking Trade Finance’, a recent report published by the International Chamber of Commerce (ICC). Yet, despite the parity performance, financial credit lines shrank last year, buffeted by higher lending costs and risk premiums caused by:

- Rising liquidity pressures;
- Scarcity of capital;
- Increased capital requirements;
- Heightened counterparty and country risk aversion to trade finance providers and banks.

While demand for trade financing was (and remains) robust, access to it is still constricted – and expensive.

## Apples and regulators

One of the major reasons for the tightening trade finance environment: stricter accounting regulations, enacted in response to the credit crisis.



### What Basel II means

How will Basel II affect global trade and trade finance? No one can say for sure until its capital requirements are announced and implemented. But most banking professionals agree that the new regulations will prompt a reset of the industry in general, and global trade finance in particular.

Among the potential scenarios that may emerge are:

- The cost of trade finance may become more expensive, hampering economic growth;
- The cost of capital may prompt trade consolidation into major financial institutions, as Tier 2 and Tier 3 banks consider dropping trade as a core product.

Many financial institutions have already begun preparing for the new regulatory landscape. Among them: Citi. The global bank is developing a multi-bank structure designed specifically to address the capital constraints of Basel II and allow for distribution of trade assets. The intent is to also address the accounting complexities of new FASB rules (FASB 166 and 167) and ensure non-consolidation.

### Looking ahead

Ever-tightening credit and ever-stricter regulations continue to challenge financial institutions. And a number of trends that took shape in 2010 will continue into 2011, including:

- Credit availability for cross-border trade finance will remain a concern. Banking relationships are consolidating, focused on credit availability from reliable partners rather than diversification of lines. And they are supported by export credit agencies;
- Pressure to streamline operational processes to lower costs, arising as a result of consolidation. Banks that remain in the trade space will face increased price competition as consolidated banks improve efficiencies, costs and combine capabilities;
- Smaller and/or weaker players – those lacking credit and/or capabilities – will need to partner with stronger industry players. They may also seek outsourcing options in technology and operational processes;
- Investments that were deferred during the downturn will be restarted to support regulatory and market changes such as Basel II, SWIFT updates, supply chain finance and so on;
- As markets normalise and credit spreads return from their historic highs, trade banks are refocusing on enhancing their trade by offering supply chain finance and working capital solutions will continue to be a high priority as banks look to swap liquidity and credit risk with partners.

Wherever trade finance eventually shakes out, one thing is certain, says Ahearn. “There needs to be a much greater understanding of the economic impact of all these regulations on each line of business in the banking world.”

Among the trade instruments that came under the regulatory microscope in the aftermath of the crisis include off-balance-sheet tools, such as letters of credit (LCs). These have become prime targets for increased regulation and additional capital charges, to the frustration of exporters and banks alike.

The rapidly changing regulatory environment has also affected securitisation. With the well-chronicled collapse of collateralised debt obligations (CDOs) and securitised mortgage products in 2008, this entire debt category was stained. But when regulators started to clamp down on those volatile products, more solid and valuable credit instruments – such as receivables portfolios – were tarred with the same broad brush by regulations.

That one-bad-apple phenomenon is unfortunate, says Ahearn. “The remedies that regulators are trying to drive into the banking sector are good, because they are an attempt to avoid another crisis,” he says.

“But just because certain products went bad doesn’t mean the whole of the banking industry is corrupt.”

### Basel’s ‘extraordinary’ requirements

Perhaps the most significant trade finance trend coming out of the crisis is a comprehensive new approach to calculating risk capital — manifested in Basel II.

Basel II regulatory changes will require a more risk-sensitive method of evaluating risk capital. As such, it is expected to mandate dramatically higher bank capital reserves.

By requiring banks to keep more core capital on hand, Basel II will have a major impact on global trade. Investments will need to be restructured to support new requirements, and financial institutions will be compelled to change the way they handle cash. It’s no wonder, then, that banks are viewing next year’s Basel II launch with more than a little apprehension.

“As they examine Basel II, institutions are beginning to understand the amount

of capital they’ll have to place against the trade business,” says Ahearn. “It will be extraordinary.” □

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Ahearn is also a member of the board of directors of the Bankers’ Association for Finance and Trade and the Pacific Rim Bankers Association. He has been an adjunct professor at Centenary College and an editor on various trade textbooks for the American Banker’s Association (ABA).

For more information, please contact your Citi representative or go to [www.transactionservices.citi.com](http://www.transactionservices.citi.com)