



Client Alert

Financial Markets Developments

Global Trade and Financial Institutions Confront US\$25 Billion Trade Finance Gap

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Summary

The effect of the global financial crisis attracted the attention of high-level policy makers during the last quarter of 2008. The Director General of the World Trade Organization (WTO) convened a meeting of major financial institutions on November 12, 2008 to discuss the effects of the global financial crisis on the availability and cost of trade finance. The Organisation for Economic Co-operation and Development (OECD) held a meeting on the same subject on November 17. On November 26, the WTO's Working Group on Trade, Debt and Finance discussed the problem of trade finance in developing countries and confirmed the Expert Group's assessment of the extent of the shortage and its consequences for developing countries. The consensus emerging from these meetings is that:

- the world currently confronts a shortfall of trade financing in the amount of approximately US\$25 billion
- the cost of available trade financing has risen significantly
- the adverse conditions in the trade finance market affect most directly developing countries and their exporters

International organizations such as the WTO and the OECD are urging action to close this gap so that global trade does not diminish and contribute further to worsening economic conditions.

The power of the WTO and OECD in the area of trade finance is limited and indirect; it is largely confined to their power to prod governments and financial institutions into action. This is a useful function. Governments can directly affect the supply of trade financing made available by international organizations such as the World Bank's International Finance Corporation (IFC), regional development banks and Export Credit Agencies (ECAs). Increased cooperation between these international financial institutions (IFIs) and private lenders could address the liquidity shortage in the near term. In the medium and long term, the WTO, OECD and member governments can examine the prevailing rules used to evaluate the underlying risks of trade finance, and they can directly address the concern that the existing rules unfairly increase the cost and availability of financing trade involving developing countries.



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Analysis

On November 12, 2008, WTO Director General Pascal Lamy hosted 30 representatives from major trade finance providers, including representatives of key international finance institutions and private sector banks, for a meeting of the Director General's Trade Finance Expert Group (the "Expert Group"). The meeting's purpose was to consider current market conditions for trade finance, review past measures taken to improve these conditions and propose specific initiatives to address market conditions and prevent further deterioration in light of the global financial crisis.

The meeting's participants reportedly agreed that market conditions had worsened since April 2008, when the Expert Group last met. In public statements prior to this second meeting, Mr. Lamy stressed the critical role of available and affordable credit in facilitating international trade. He also conveyed the concerns raised by certain WTO members, such as Brazil, that international agreements relevant to trade finance, notably the Basel II Accord,¹ unfairly penalize developing countries by placing them in a higher risk category for trade financing, in that the rules are based on the assessed creditworthiness of countries whereas trade credit transactions are collateralized by the traded goods. Brazil and others have suggested that such rules have "pro-cyclical impacts" that effectively intensify an economic downturn, rather than allowing trade to expand and contribute to recovery. Pressure for review of Basel II, from regulators and private banks, is expected to intensify.

Two problems are considered to have contributed to the recent and continuing deterioration of the trade finance market during the past six months. First, limited liquidity in global credit markets has created an estimated US\$25 billion dollar deficit in the supply of trade financing available. This gap has driven up borrowing costs significantly for importers and exporters seeking credit to finance international trade. Second, financial institutions have grown increasingly risk-averse in response

to the financial crisis and the downturn in the global economy. Despite the low-risk nature of trade finance loans, which generally have short maturities and are collateralized by the traded goods, expectations of further deterioration in global credit markets have decreased the willingness of lenders to finance trade and to tie up liquidity in such loans. Such risk aversion is considered to be particularly acute in emerging market economies.

Some steps already are being taken to address these problems, and others can be expected to follow. For example, the World Bank is in the process of tripling to US\$3 billion the ceiling for trade finance guarantees available through the Bank's IFC. Similar steps by regional development banks are certainly possible, assuming that the governments represented on the Executive Boards of those institutions can be convinced of the need for the action. Also, the Berne Union, which represents public and private sector trade insurance and export-import banks, has reported that ECAs have increased their business by over 30 percent in the last twelve months. A number of governments, including those of China, Germany and Japan, have reportedly supported this increased level of activity by the ECAs.

The WTO and OECD meetings indicate that these two institutions intend to play a role in following the issue and advocating for more action. Immediate steps could include increased public sector support for IFIs and ECAs to cover risk and provide liquidity under existing arrangements. Also, increased risk-sharing agreements between private lenders and IFIs and ECAs could be effective in addressing the liquidity shortage. Such agreements could be facilitated in the medium term through the development of improved mechanisms for information sharing, risk assessment techniques and data collection on trade finance.

Increased cooperation between and among private lenders could also contribute importantly to addressing the problem. In particular, there is a natural segmentation in the trade finance market, with major commercial banks dominating the

¹ The Basel II Accord comprises a set of recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision in June 2004. The Accord aims to establish an international standard for banks' minimum capital requirements that closely matches the underlying risks that the banks face. National regulatory agencies may then use this standard and the Committee's recommendations to implement and adopt domestic banking laws and regulations to govern the capital adequacy requirements of internationally active banks.

high-value transactions, while smaller commercial banks tend to be involved in the other transactions. The liquidity crisis is believed to be affecting more directly the low-value transactions, which are generally of little interest to the large commercial banks because of the high transaction costs. Cooperation between banks operating in different segments of the market could address the liquidity gap at the lower-value end of the market. For this to happen on a significant scale, there will likely be a need for capacity-building in many of the smaller and developing country banks in order to increase the major banks' confidence in them as reliable partners.

None of this will happen overnight, and the WTO and OECD meetings during the last quarter of 2008 signal recognition that the problem must be addressed in the short, medium and long term. The WTO and OECD can help the process by continuing to shed light on the problem, prodding their member governments to action and providing the institutional framework to monitor progress toward a solution. They can also provide the analytical basis for the concern that structural problems in the governing agreements—such as the Basel II Accords—unfairly affect developing countries, and they can encourage governments to pursue new or modified agreements. Finally, they can advocate for increased risk-sharing and cooperation between IFIs, ECAs and private lenders, collecting and disseminating information relating to such agreements in order to encourage broader cooperation.

Outlook

The November meetings at the WTO and the OECD suggest that an action plan involving IFIs and private lenders could emerge to address the access and cost of trade financing. The WTO will remain involved in the effort through future meetings of the Expert Group, which is scheduled to meet again in March 2009, in advance of the April meeting of the G20 countries. While lacking direct authority over trade finance, organizations like the WTO and the OECD will play a useful if limited role in addressing the issue of financing world trade.

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