Trade finance: turning folklore into fact

It is well known within the trade finance market that trade-related obligations perform better than straight financial loans and bonds in a sovereign debt crisis. This convention has acquired the status of folklore given it fairly reflects both logic and experience. The challenge is how to turn this folklore into fact. Trevor Utting, head of research at LTP Trade Risk Management, explains.

Trevor Utting

Sovereign defaults tend to be pretty chaotic affairs. They are usually attended by widespread political upheaval and a clampdown on the availability of foreign currency. Yet the government in question can usually be relied upon to organise favourable terms for trade-related financial transactions. These terms – largely access to foreign currency often at a relatively favourable exchange rate – are typically restricted to essential trade flows, but make perfect sense.

In the short term, the government needs to maintain the flow of both essential imports and key foreign exchange generating exports, while in the longer term it may have hopes of building an export-led recovery. After all, with sovereign crises typically accompanied by massive currency devaluation, there is often an opportunity for export growth. There lies the logic.

Experience of emerging market financial crises supports this. Subject to variations from country to country, in almost all cases trade paper has been at least partially exempt from foreign exchange controls imposed in the aftermath of a sovereign crisis. As the most recent example, Argentina once again demonstrates this favourable treatment of trade debt, a track record marred only in recent years by Russia's behaviour in 1998.

The Russians imposed a 90-day moratorium on foreign payments in the wake of the GKO default, including those relating to trade. But this decision appeared to be more indicative of the complete and utter confusion surrounding Russian economic policy-making at the time rather than the country's commitment to trade flows. In practice, major state-owned banks continued to make payments under trade facilities throughout this period.

So the general rule has been that provided the individual obligor can still perform, the government in question will grant it access to the foreign currency necessary to do so – as long as the transaction falls within the terms of its trade exemption.

But there is a problem in that whilst the market and most market observers believe this thesis to be true, there is an absence of hard data available to back it up. Ultimately, this places the trade finance market at a disadvantage, as the superior risk profile of trade-related financial obligations cannot be reflected in the quantitative financial models that measure risk against return.

In line with the above arguments, holders of Argentine bank guaranteed trade debt are better placed than holders of an Argentine bank syndicated loan. Yet in standard models of credit risk, the obligor (the Argentine bank) will have a single credit rating, thereby assigning the same risk profile to each financial exposure. In order to distinguish properly the differing risk profiles of these two financial exposures, investors should assign the trade paper a higher, transaction-based credit rating. Indeed, the trade paper should always be allocated a higher, transaction-based credit rating since it is always believed to be a better performer in the event of a sovereign crisis.

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This higher credit rating would allow investors to better measure risk versus reward, crucial in respect of both the pricing of, and the allocation of capital against, trade finance obligations. A higher credit rating boosts return on a risk-adjusted basis and lowers the requirement for potentially expensive capital. The transaction-based credit rating could be further refined to take documentary structure and standards into account.

Accurate measurement of trade finance risk profile is an absolute must. The global financial markets are moving relentlessly toward precise quantification of risk and return factors, driven by such initiatives as Basel II. The new capital allocation model will demand a graduated approach to the risk weighting of credit exposures, merely confirming a trend seen throughout the global banking industry in which RAROC models and portfolio theory are used to support internal decisions on risk and capital allocation. Even the growing use of mark-to-market valuation techniques in the trade finance industry supports this trend.

More than ever the trade finance market needs hard data to support the 'trade always pays' theory. Without it, the market is penalising itself as an asset class. But where can this hard data be found? One of the global trade finance banks could undertake and share with the industry an internal review of its own experience, providing at least a starting point for more accurate measurement across the wider marketplace. Or perhaps a credit rating agency could do the job, although rating agencies carry a high cost base and will seek to recover their costs in one form or another. A third – perhaps more realistic – alternative would be to commission a study under the aegis of a trade finance industry association. A working party of active trade finance banks could define terms, pool information, and create a database built from their experience in past sovereign crises, supplying the hard evidence necessary to populate those financial models.

Failure to act could result in the trade finance asset class becoming increasingly disadvantaged as the wider financial markets evolve. ❑

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