REVIVAL OF THE DOCUMENTARY CREDIT HAVE BANKS MISSED AN OPPORTUNITY?

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The demand for Documentary Credits a was diminishing due to Buyers and Sellers who are regular trading partners switching to the less complex solutions such as Documentary Collections and then to low cost Open Account as the method of payment. The global financial crisis has given a new lease of life to documentary credits which is an instrument having an inbuilt mechanism to mitigate risk. However, will the banks be prepared to cater to this newly created demand, or will it be a case of another missed opportunity to revive this profitable area of business?

Introduction

The Documentary Credit (LC) was a very useful instrument and a popular method of payment in international trade. It was extensively used especially in Asia and the Far East and this region continue to be the highest users of documentary credits. The regulators of certain countries forced Importers to make payments under documentary credits in order to facilitate the monitoring the foreign exchange outflows and better manage the value of their own currency in the foreign exchange market.

When Sri Lanka liberalized the exchange controls by freeing the country's current account transactions from exchange control in 1977 it was mandatory for all payments for imports to be made under documentary credits and the importers were required to submit to the commercial banks, the 'Authorized Dealers in Foreign Exchange' appointed by the Central Bank of Sri Lanka and a form containing details of each documentary credit issued had to be sent to the Central Bank to enable them to forecast the foreign exchange requirements for imports into Sri Lanka and take necessary steps to ensure that the required foreign exchange resources are made available to meet all commitments under the documentary credits issued when they fall due. However after managing the initial spikes for the unprecedented demand for foreign exchange the government took steps to relax this mandatory requirement and today importers are allowed to use Documentary Collections both Documents against Payment and Documents against Acceptance terms for imports into Sri Lanka.

Documentary Credits are seen in various forms. Those issued by European Banks appear to be very simple to operate with only a few documents being called for, and the very few terms and conditions being included in the credit. This makes it easier to prepare complying documents and the task of examination of documents is therefore much easier. However the LCs issued by banks in the Middle-East and most countries in Asia and the Far-East are usually lengthy. They not only call for a larger number of documents but they also have many terms and conditions incorporated which makes the preparation and the examination of documents a very difficult task.

The misuse of this powerful instrument by importers, exporters as well as banks, due to fraudulent transactions and wrongful dishonor as a ruse to delay or avoid payment, with even the banks, on certain occasions wielding to pressure from their valued clients, led to traders moving on to less complex Documentary Collections. Thereafter the traders who have been doing business with each other for long periods of time and were prepared to trust each other found that it would be a waste in paying the ever increasing bank charges for LCs and for the handling the Documentary Collections and started to move on to Open Account as their method of payment. This not only resulted in a loss of income to banks but also made it more difficult for banks to maintain their customer performance and loyalty due to their requiring less financial facilities to issue or negotiate Documentary Credits.

The global financial crisis once again made sellers pay greater attention to risk management, and being highly concerned with the high risk Open Account as their method of payment they started moving back to either Documentary Collections or if they desired to move to even a less riskier Documentary Credit as their choice for the method of payment. But the question now is, whether banks are prepared to cater to this new demand when they themselves have become more concerned about risk and have become more cautious in extending such facilities to their customers.

Global Trade Finance

The Status Update issued in September 2009 to ICC Trade Finance Survey conducted by Banking Commission of the International Chamber of Commerce in March 2009 which was presented to the meeting of the G20 held recently summarises their key findings of the report as follows:

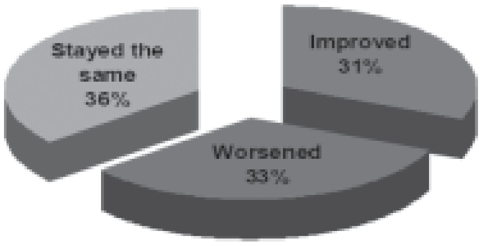
Economic Outlook

Evidence shows that the impact of the financial crisis on trade finance has reached its peak in 2008 and in the first half of 2009, with the most detrimental effects still impacting emerging markets. Although there are signs of recovery (i.e. the ICC/Ifo world economic climate index which is compiled by the ICC and the Ifo Institute for Economic Research on a quarterly basis by surveying over 1000 experts in 92 countries, rose significantly in the first half of 2009, from 50.1 points in January 2009 to 78.7 points in July 2009), the world economy remains in recession. It has even worsened in some areas, as reported by ICC members. Many respondents to this interim report recognized that the preliminary signs of recovery are not strong enough to conclude that the global recession is receding. The findings for the first half of 2009 point to the fact that some major risks still remain, and that the economic recovery will continue to be on shaky ground in the coming months.

Supply of trade finance and corporate demand

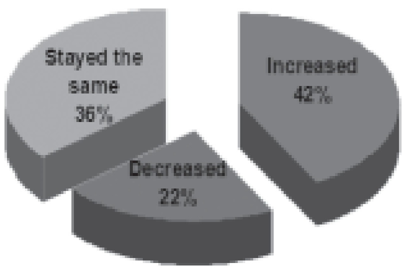
In contrast to the same period last year, demand for Trade Finance increased in the first half of 2009, with supply improving at the same time. 67% of ICC respondents indicated that trade transaction volumes had either remained the same or had improved in the first half of 2009. Still, evidence collected on a regional basis shows that some sectors of the industry have been differently impacted by the crisis, i.e., whilst volumes remained the same, a regional survey of major Trade Finance banks in the London market suggested that values are down in the range of 10-30%.

Figure 1 - Trade Transaction Volume First Half 2009



At the same time, corporate demand for traditional trade products was sustained in the first half of 2009, with 78% of respondents indicating that demand has remained the same or increased. This figure corroborates anecdotal evidence indicating that the situation is improving worldwide for both imports and exports compared with the same period in 2008. The comments received also indicated that the demand from exporters for the confirmation of L/Cs is still strong. The trend for exporters to move from open account to L/Cs, perceived to be more secure, has again been confirmed.

Figure 2 - Corporate Demand for Traditonal Trade Products

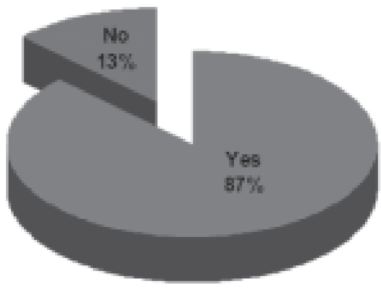


At the present time, there is evidence that the market for Trade Finance is fairly open. In general, evidence suggests that the ability of banks to provide trade credit has improved since the start of 2009, broadly reflecting enhanced capacity (and liquidity) in the banking sector as a whole. However, many respondents still report impaired credit lines and capital availability at their own institutions and/or at counterparty banks, albeit to varying degrees. This is particularly true in developing/emerging markets for which risk appetites remain low.

Pricing of Trade Finance Credit

The pricing of trade instruments remained high in the first half of 2009, despite a tendency to stabilize in Q2. Some banks reported further increases in pricing for bank undertakings relative to Q4 2008, typically of around 50 to 100 basis points. Nonetheless, some 87% of respondents concluded that trade finance was perceived to be an affordable solution for both lenders and borrowers. Overall, there seems to be a consensus that the prevailing high prices are considered to be an affordable cost, given the additional security that the L/Cs offer the parties.

Figure 3 - Is Trade Finance Perceived to be Affordable?



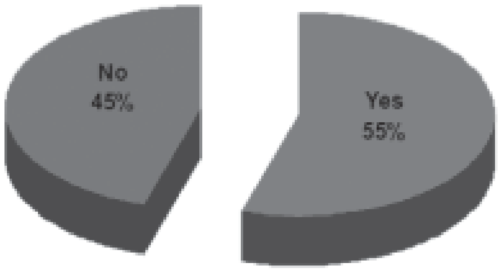
Evidence collected still shows increased country risk and therefore capital costs in some regions, leading to the high price of trade finance products. There are particular concerns about the cost of export credit insurance, the price for which increased in early 2009. This is likely to be a particular problem for SMEs.

There is evidence of stabilization in price increases for trade finance instruments, though pricing remains relatively high for some products and some risks. The trend for counterparty risk aversion, which previously resulted in significantly higher risk pricing in 2008 (confirmation commission/discounting fees, etc.), is not expected to prevail in coming months as markets show signs of recovery.

Use of Trade Facilitation Programs

The majority of respondents (55%) indicated that their institution has been utilizing trade facilitation programs implemented by Multilateral Development Banks (MDBs). With demand for Trade Finance increasing over the recent months and supply improving, the effects of the liquidity pool recently put in place by multilateral organizations is playing a positive role. A number of respondents reported that the G20 decision to support US$250 billion worth of trade over a two-year period was a major step towards alleviating the shocks to trade resulting from the financial crisis. They believe that, in the months to come, financial markets should continue to improve if sustained efforts by governments and international organizations are maintained.

Figure 4 - Trade Facilitation Program Usage

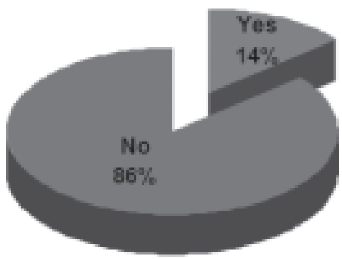


It remains difficult to say with any precision whether a (significant) gap in the provision of trade credit compared with corporate demand remains and, if so, how it can be filled by MDBs. Many respondents pointed out that their banks preferred to take in charge the entire risk without having recourse to MDB coverage, with the resultant retention of commissions. Some respondents also noted that the lack of coverage by MDBs for specific markets and/or counterparties (e.g. state-owned banks) constituted a major constraint.

Capital Requirement Relief under Basel II

Despite the request by G20 leaders last April to soften the capital requirements under Basel II, the survey conducted for this interim report shows no significant sign of relief in the capital requirements for traditional trade finance transactions. Indeed, some 86% of respondents indicated that they experienced no regulatory relief in capital requirements. As a result, increased capital costs keep constraining trade finance business volumes, limiting the amount of liquidity in the market, and impacting trade in the developing world.

Figure 5 - Relief in Capital Requirements for Traditional Trade Products



The case for revised treatment of trade finance in the allocation of banks' capital rests on the historically low risk profile of the activity. Many respondents again attested that they have experienced relatively few losses on trade lending over the past few decades. This primarily reflects the fixed, short-term maturity of trade finance products, and the fact that exposures are liquidated by cash upon maturity

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Whilst there appears to be greater recognition of the need to address the impact of the Basel II on the provision of trade finance, respondents have only observed very limited follow-up, if any, by regulators to the mandate from the London Summit requesting more proportionate capital weightings for traditional trade transactions.

Recommendations

Despite some improvement in the availability of trade finance, it remains unclear whether the market would be able to meet any significant upturn in the possible increase in commodity prices at the current time. A recovery in demand for merchandise trade without a corresponding increase in the ability of banks to provide credit, would risk a significant dislocation of trade, thus hampering the global recovery.

Looking ahead, problems are still expected to hamper the availability of trade finance at least though the first half of 2010. For that reason, it is essential that renewed attention be given to the implementation of the G20 trade finance agenda with a view to fostering further improvements in bank finance capacity.

Specific steps should include:

● filling the information gap in trade finance, in particular in terms of business performance data evidencing the loss history of different trade finance risk categories; (it should be noted that ICC is now developing a new Global Survey that will attempt to collect such information in 2010)

● further enlargement of the multilateral trade finance programs to expand both capacity and coverage, especially for low-income and export-dependent countries;

● rapid implementation of national programs to guarantee trade and provide refinancing options, in particular through Export Credit Agencies which may also develop more direct lending schemes on emerging markets including through sub-participation in bank lending; and

● application of appropriate supervisory changes to the Basel II framework to allow more proportionate capital weightings for traditional trade finance transactions. In particular, national regulators should seek to exempt trade finance products from the one-year maturity floor applied to lending facilities in most countries and allow key risk attributes to be determined on the basis of industry benchmarks reflecting the low risk nature of trade finance.

Trade Finance and Documentary Credits

It is important to note that the statistics quoted above refers to trade an not LCs. Although the mix has indicated an increase in the percentage of LCs issued it is not good news to find that the total value of LC business has been lower than that for the corresponding period of the previous year. Therefore LCs business will continue to suffer in the light of the reluctance of banks to take on the risk in issuing LC in a not so conducive environment.

SWIFT Traffic

Although the SWIFT traffic does not represent the entire trade finance business due to the use of alternative forms of communication such as Bank group links and correspondent banking links, being one of the most preferred modes of communication between banks, it continues to be a good indicator of the trends in business volumes handled by banks. SWIFT trade traffic in 2008 was lower than that in 2007 by 2 million messages. It has been found that 29% of SWIFT trade traffic represented Documentary Collections. Another important statistic was that 70% of trade transactions sent by Asia through SWIFT remained in Asia.

It is important to remember that trade finance referred to above does not mean LC business alone since it includes other methods of payment as well. In 2007 the trend was to move away from LCs first to Documentary Collections and thereafter to Open Account and the demand for LCs was reducing all the time.

The global crisis made suppliers to be more concerned about risk mitigation and certain transactions hitherto handled on Open Account basis was shifted to Documentary Collections and even LCs. Therefore it created an increased demand for LCs. However, the banks too were becoming cautious and sometimes too overcautious in acceding to customer requests. Hence it was not surprising for the ICC survey to reveal that 47% of the banks responding indicated reduction in Export LC volumes, 40% of the banks responding indicated a reduction in corporate credit lines between Q4 2007 and Q4 2008, 51% of the banks indicated reduction in the Financial Institution credit lines for the same period, 58% of the banks indicated a significant increase in confirmation fees (over the usual annual increases) in the last two years, 33% of banks had not been able to meet customer demands. This situation would have been worse if not for the business created by most MDBs providing credit facilities in the form of reimbursements under LCs.

Another significant development was the increase in the number of refusals of presentations under LCs. The ICC survey also revealed that 30% of the banks which responded have indicated an increase in refusals and 20% indicated increased pressure from applicants to refuse mainly due to falling commodity prices. This not only leads to poor practice for LCs but also a greater reluctance by banks to issue credits thereby making the situation worse. It is interesting to find in the ICC survey reported that 70% of documents presented are found to be discrepant on first presentation banks should not resort to refusal of documents for the discrepancies found for the purpose of avoiding a transaction due to the applicant's risk.

The Documentary Credit is one of the most useful instruments to banks and LC business is one of the most profitable businesses creating ample opportunities to make profits. It also creates value to almost all parties involved with an LC transaction.

Guarantee for Many

Documentary Credits are unique in that they provide guarantees to almost all the parties involved in the transaction viz. the seller, the buyer, the issuing bank, the confirming bank and a nominated bank which has not added their confirmation to the credit. Therefore it can be a very useful payment instrument for international trade transactions.

A documentary credit provides a seller, guarantee of payment from a bank for the goods or services to be supplied by them. It helps to mitigate the credit risk of non-payment by the buyer. It also can be used to mitigate the transfer risk or country risk due to the buyer's country no t being in a position to provide the necessary foreign exchange resources to enable the buyer to make payment.

To a buyer, the documentary credit is a guarantee that the seller will not be paid until required goods are dispatched or services supplied and the documents called for under the credit are submitted. The issuing bank is also placed in the same position as the buyer with regard to the risk they take in making payment under the credit and financing the transaction.

A confirming bank has a guarantee from the issuing bank in obtaining reimbursement for payments made under the credit. Therefore it needs to be satisfied with both the credit risk of the issuing bank as well as the transfer risk of the country in which the issuing bank is located. The position of a nominated bank (other than a confirming bank) negotiating documents is similar to that of a confirming bank when the bank nominated to negotiate documents under a credit decides to act on its nomination.

Banks or other financial institutions which are financing sellers of goods or suppliers of services even if they are not a nominated bank under the credit also ha a guarantee from a bank and has evidence of the source of repayment for the advances they grant.

International Organisations providing concessionary trade finance usually routes their financing in the form of reimbursement under documentary credits issued by banks on behalf of buyers favouring the suppliers. The agreement by the lending organization to reimburse a bank which has negotiated or honoured a drawing under a credit is a guarantee to the supplier and the nominated bank which mitigates any credit risk of the issuing bank and/or the transfer risk of the country in which the issuing bank is located thereby making the documentary credit more acceptable to the beneficiary and the nominated bank.

Goldmine for Banks

The main benefit of a documentary credit other than the fact that it provides guarantees to almost all parties to a transaction is that it provides opportunities for banks to earn both interest income as well as non-interest income. In the case of foreign currency transactions banks earn exchange income as well.

An issuing bank levies a commission for issuing a credit which is based on the value of the credit and its validity period. Some banks charge an additional fee for arranging confirmation of a credit it issues, by a bank abroad. It also charges for any amendments to the credit it issues and a cancellation prior to expiry or cancellation without utilisation. If reimbursement is provided direct through a bank with which it maintains a 'Nostro' account it also levies interest from the date of reimbursement until the date of settlement of the drawing by the credit applicant.

A confirming bank gives the beneficiary of the credit the same guarantee given by the issuing bank in order to mitigate the credit risk of the issuing bank and/or the transfer risk of the country in which the issuing bank is located and levies a commission for adding their confirmation, the charge being based on the value of the credit and the validity period. The percentage of commission levied will depend on the degree of risk perceived by it with regard to the credit risk of the bank which issued the credit and the transfer risk of the country risk of the country in which the issuing bank is located. The confirming bank may also have an opportunity to earn interest income from the date they advance funds to the beneficiary until it receives the reimbursement either from a reimbursing bank or the issuing bank

The bank that advises a credit to the beneficiary also levies an advising commission for the service it provides and this fee is a flat fee irrespective of the value of the credit unless it is being advised after adding their confirmation to the credit.

If the issuing bank nominates a reimbursing bank, the latter will levy a fee for each reimbursement it makes under the credit and certain bank also levy a fee for setting up a reimbursement.

An irrevocable reimbursement authority is issued by a reimbursing bank to a nominated bank whereby the reimbursing bank irrevocably undertakes to honour a reimbursement claim submitted by the nominated bank before expiry up to the value of the credit. The reimbursing bank similar to a confirming bank levies a charge based on the value of the credit and the validity period.

Another important advantage for the banks which finance importers / exporters under LCs, has been the fact that banks are able to exercise more control over the transaction thereby reducing the risk. This is the reason that the default rate of trade finance transactions, to be much lower than for other similar transactions.

Variety of Options

There are many types of credits cater to different needs. It can be made available by sight payment, deferred payment, acceptance and negotiation, With the exception of the last option the bank with which the credit is available enters into a definite obligation under the LC. However, in the case of negotiation the payment of funds may be with recourse to the beneficiary

If a buyer contracts with a seller to purchase the same quantity of goods fro the same value at the same price revolving for shipments at periodic intervals, the buyer can issue a revolving LC, It provides for the LC once utilized to be available for another shipment for a number of times stipulated in the LC. They can make it revolve either against time or value, depending the terms of their contract with the seller.

Red Clause or Advance Payment credits provide for advance payments to be drawn by the beneficiary up to a specified amount or percentage of the value of the credit. It is arrangement where the buyer arranges through his bank to finance a supplier who does not have funds of his own or does not have the capacity to borrow funds from a lending institution to process the order and effect the shipment. A nominated bank of a Red Clause credit which is satisfied with the credit risk of the issuing bank and the transfer risk of the country will be willing to make advances as the repayment of such advances together with interest thereon is guaranteed by the issuing bank.

Green Clause credits are very similar to Red Clause credits the only difference is that the advances made under a Green clause credit has to be backed by mortgage of goods or other or other securities. These two types of credits are also used especially in commodities trading such as wool and wheat, to tie down suppliers in a sellers' market thereby not allowing other buyers to purchase the high demand goods.

Transferable credits have been a very useful financial instrument for middlemen who add value to both buyers and suppliers by promoting trade at a profit. The advantage of a transferable credit is that a nominated bank is usually agreeable to transfer a credit at the request of the first beneficiary to one or more second beneficiaries. This is due to the fact that the transferring bank although have certain responsibilities imposed on it in transferring a credit however, does not enter into any legal obligation under the credit (unless they have added their confirmation ton the credit). In this operation a transferable documentary credit is issued in favour of the middleman who will transfer it to one or more beneficiaries at a lower price/value than that they received from the final buyer who is the applicant of the credit the difference being the profit margin for the middleman. When the second beneficiary presents the documents the middleman has to submit their drafts and invoices for the increased value as per the original credit and by substituting them for the drafts and invoices presented by the second beneficiary, the set of documents for the increased value is negotiated under the credit and the second beneficiary is paid the value of their invoice and the difference is paid to the middleman. The negotiating bank thereafter obtains reimbursement from the Issuing bank or their agent. Transferable credits are also used by buyers to facilitate their agents to find suitable suppliers and transfer the credits in their favour for the original value without retaining a profit margin and the agents are paid their commission outside the credit.

If a LC is received by a middleman does not state that it is transferable the middleman can use the Back-to Back Credit operation to do the transaction similar to that done under a transferable credit. The transaction is handled by the middleman arranging for the issue of a second LC on the strength of the first in favour of the final supplier. Although the process is very similar the middleman needs to have a facility from his bank to issue the second LC. The second issuing bank should be prepared to issue the LC since it takes a higher risk as their customer the middleman ,only has a very small stake in the transaction compared to the value of the LC it is requested to issue.

The method of providing reimbursement for drawings under the LCs, also creates certain options to the seller. They can either request for it to be provided immediately or at a later date. The time of payment will determine whether the payment of interest due to the banks, are to be made by the buyer or the seller.

Conclusion

The main weakness of a LC is that it is a complex instrument and therefore banks have to deploy specially trained staff to handle the operations incurring additional costs. However for the banks the advantages / benefits are very much greater and could be a pot of gold. Today there is high emphasis on Risk Management so much so that some risk managers have become blockers – unable to understand risks associated with certain market segments and refusing customer demands. Banks must seize this rare opportunity to revive this important area of business by catering to the demand and adopt good LC practice and ensure that they reap the benefits in the form of increased business and higher profits or they may never get another opportunity to rejuanate this highly profitable area of business.

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DC Insight