

# Global Risks – Trade Finance 2011

An initiative of the ICC Banking Commission

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- Statistical analysis of trade finance risks
- Notable features from the ICC Register
- The safe nature of trade finance
- Impacts of the regulatory regime

PUBLIC RELEASE REPORT

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*The world business organization*

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## Preface



Since 2009 the International Chamber of Commerce' Banking Commission has provided a unique and timely analysis of the risks involved in trade finance.

Underscored by an unprecedented pace of regulatory change, in particular the emergence of the new Basel framework for banking supervision, stakeholders from across business, government and international organizations faced a new imperative in understanding and managing risks in trade finance markets.

It was in 2009 that ICC and Asian Development Bank (ADB) decided to establish a major project, the ICC Trade Finance Register, to collect performance data on trade finance products. This initiative aimed to help the industry develop a pool of data to substantiate the argument that trade finance was, relatively speaking, a low-risk form of financing. At the same time, the Register sought to provide the much-needed empirical basis for discussions regarding the treatment of trade financing under the Basel framework.

This report, *Global Risks – Trade Finance 2011*, provides a synthesis of the work carried out under the Register project and highlights key data and trends enhancing our understanding of how trade finance functions in today's economic environment based upon a unique and comprehensive set of global features presented for the first time in an official ICC report.

*Global Risks – Trade Finance 2011* is a useful tool for both policy makers and senior executives in financial institutions around the world. It will enable institutions to better understand the level of risks involved in different trade finance products and allow bankers to benchmark their activities in a more rigorous fashion.

Most importantly, I hope that by focusing on the critical connections between default levels in trade finance and the shaping of new regulatory recommendations, decision makers will be able to engage collectively in efforts to improve the global financial system's overall resilience.

We would like to thank the participating banks and all partners to the ICC Register project for their continuing support. I believe you will find this report to be both informative and provocative.

A handwritten signature in black ink, appearing to read 'Kah Chye Tan'.

Kah Chye Tan  
Chair, ICC Banking Commission  
Global Head of Trade and Working  
Capital, Barclays

## Acknowledgements

This report was prepared by the ICC Banking Commission Steering Group on the Trade Finance Register. We would like to thank the group members: Thierry Senechal, Dan Taylor, Derek Ennis, Don Smith and David Bischof. In particular, we would like to thank Professor Fritz Foley of Harvard Business School.

This ICC report would not have been possible without the pathfinding work done during the global financial crisis of 2007-2009 by the ICC Banking Commission membership and various policy makers. We would like to express our gratitude to WTO Director-General Pascal Lamy for providing the initial impetus to create a consolidated trade finance database hosted by ICC. The WTO Expert Group on Trade Finance became an important forum during the crisis, holding regular meetings with partners from commercial banks, the Berne Union, regional development banks and other multilateral export credit and specialized agencies. This group, of which ICC was a member, was instrumental in understanding the causes of the shortage of trade finance and in devising cooperative solutions through which public institutions could help private sector financial institutions shoulder the risk of operating in an unstable financial environment.

We would also like to thank Steven Beck of the Asian Development Bank (ADB) for funding the initial phase of the ICC Register Project in 2010.

SWIFT once again graciously provided background information on trade finance messaging volumes worldwide, thereby helping us to compare some of our findings with SWIFT's data. More than ever, we renew our thanks to ICC's technology partner, Coastline Solutions, for collecting the data presented in this report.

The International Chamber of Commerce (ICC) also expresses its appreciation to its partners and sponsors for their support in the preparation of this 2011 version of the report:

- |                                 |                                |
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## Key messages

- **Trade Finance, which supports USD14-16 trillion in annual global commerce, is crucial for international trade.** It facilitates and enables the management of cross-border trade for bank and corporate clients. These transactions are underpinned by the movement of goods and services and evidenced by commercial contracts that document the relationship between buyer and seller.
- **The ICC Trade Finance Register bridged the information gap impeding the formulation of policies.** The absence of data capturing all kinds of trade finance (bank-intermediated and inter-firm) had proven to be a major constraint for measuring the extent of the trade finance shortfall and its effect on trade flows. The ICC's Trade Finance Register is a significant step forward because it has created a living database of the trade finance market and has helped to demonstrate the resilience of the trade finance business.
- **The ICC Trade Finance Register, the most comprehensive dataset now available on the market, has demonstrated the true nature of trade finance.** Historically, trade finance had been considered to be an extremely low-risk, routine operation. This perception—which is reflected in much of the specialist literature on the subject—developed partly as a result of the anecdotal experience of practitioners over the past half century. Today, ICC Register data reveal that a minimum of 60-65 percent of traditional global trade finance activity is based on assets (or about USD2.2-2.5 trillion).
- **Data pooled within the Register supports the view that trade finance is a low-risk asset class.** Notable features of the dataset are:
  - **Short tenor of trade transactions.** The average tenor of all products in the dataset is 147 days; the off-balance-sheet products covered by the Register (import L/Cs, export confirmed LCs, and standby L/Cs and guarantees) have average tenors of less than 80 days.
  - **Low default and loss across all product types.** Fewer than 3,000 defaults were observed in the full dataset comprising 11.4 million transactions. For the three focus years of this report, default rates for off-balance sheet trade products were especially low, with only 947 defaults in a sample of 5.2 million transactions. Using a standard calculation, ICC calculated the following average default and loss rates within each product type over the three focus years of this report (2008-2010):
    - Import L/Cs: default 0.077 percent, loss 0.007 percent
    - Export confirmed LCs: default 0.09 percent, loss 0.03 percent
    - Standbys and guarantees: default 0.013 percent, loss 0.0007percent
    - Import loans – corporate risk, default 0.06 percent, loss 0.07 percent
    - Import loans – bank risk, default 0.09 percent, loss 0.05 percent
    - Export loans – corporate risk, default 0.29 percent, loss 0.017 percent
    - Export loans – bank risk, default 0.17 percent, loss 0.01 percent
- **ICC concluded that trade finance was not the main driver behind the 2008 trade collapse.** First, the shortfall in trade finance could not be considered as a factor in the sharp 2008-2009 drop in trade flows. Trade finance and trade volumes dropped primarily as a result of the spillover of the financial crisis to the real economy,

resulting in lower activity and destocking. Moreover, the crisis was caused by factors exterior to the trade finance industry.

- **Based on the key findings of *Global Risks – Trade Finance 2011*, ICC maintains that new Basel regulations should not constrain trade finance supply**, especially for banks based in low-income countries (as well as second- and third-tier banks in middle-income countries). ICC has called on standards setters and policy makers to carefully study the potential unforeseen impact of Basel III changes on trade finance.
- In particular, **the report's 2011 data supports the view that the increase in the leverage ratio under the new regime would not reflect market realities and may significantly curtail banks' ability to provide affordable financing** to businesses in developing countries and to SMEs in developed countries. In addition, the dataset confirmed that the one-year maturity floor applied to trade assets under the advanced model should be reconsidered, and that the actual maturity of trade transactions should be the most logical standard to be applied.

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## List of Acronyms

<b>ADB</b>	Asian Development Bank
<b>BCBS</b>	Basel Committee on Banking Supervision
<b>BIS</b>	Bank of International Settlement
<b>CCF</b>	Credit Conversion Factor
<b>EBRD</b>	European Bank for Reconstruction and Development
<b>FSB</b>	Financial Stability Board
<b>ICC</b>	International Chamber of Commerce
<b>IDB</b>	Inter-American Development Bank
<b>IFC</b>	International Finance Corporation
<b>L/Cs</b>	Letters of credit
<b>LGD</b>	Loss given default
<b>MDBs</b>	Multilateral Development Banks
<b>SME</b>	Small and Medium-sized Enterprise
<b>SWIFT</b>	Society for Worldwide Interbank Financial Telecommunication
<b>UCP</b>	Uniform Customs and Practices for Documentary Credits (ICC Rules)
<b>USD</b>	United States Dollar
<b>WTO</b>	World Trade Organization

## Introductory remarks

### Ensuring the effective functioning of trade finance: ICC bridging the information gap

This Report presents the global trade finance industry's outlook on the risks of defaults in trade finance. It builds on the work of the official and private sectors to explore this issue, and continues the analysis carried out by the ICC Banking Commission and its members over the past two years – work that was originally presented in a report in September 2010.

In the wake of the global financial crisis of 2007-2009, it was obvious that adequate and affordable trade finance was fundamental to economic recovery and growth. Market conditions were grim when ICC voiced strong support for the need to reinforce the global financial regulatory framework and the banking sector's ability to absorb economic shocks, and to build a stronger, safer international financial structure.

While ICC signaled its intention to provide assistance to standard-setters to craft the next generation of Basel rules, it also insisted that the regulatory medicine should help cure the patient and not aggravate the disease. As most trade in developing countries was financed using traditional trade finance products such as L/Cs, any shortage of available trade finance would be a major barrier to trade, particularly for small- and medium-sized enterprises (SMEs) in these countries.

To further advance ICC's research capabilities concerning the regulation of trade finance, ICC created the ICC Trade Finance Register, with a goal of collecting precise performance data on trade finance products. Given the overarching economic imperative of promoting international trade as an engine of global economic recovery, the ICC Trade Finance Register was a powerful instrument providing a basis for

reconsidering mitigation of the risk inherent in trade instruments and correlating this with mitigating credit risk under the Basel framework.

Based on the findings of the ICC Trade Finance Register, the ICC Banking Commission was able to provide standard-setters with evidenced-based recommendations on trade finance, in particular: 1°) implementing a waiver of the one-year maturity floor for trade products on an international basis, using instead the actual maturity period on trade transactions; and 2°) re-evaluating the basis for calculating risk-weighted assets for trade facilities, in view of the observed rates of recovery and demonstrated contingencies related to payments and losses.

### Banking regulations: a complex ecological system

In developing the Trade Finance Register, ICC recognized that banking regulations operate in a complex ecological system, which has a large interconnected web of strands through which regulations can impact business in different ways.

As one example, an unwarranted augmentation of the leverage ratio under the new Basel regime can have adverse effects on global trade and growth by (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) re-defining 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.

In recent years, ICC market intelligence research found that implementation of the Basel framework could significantly increase the capital intensity of trade finance lending in periods of crisis, thereby constraining the ability of banks to provide short-term trade credit.

ICC repeatedly indicated that these increases would have particularly adverse consequences on trade finance for SMEs and counterparties in developing economies.

### **The advantages of cooperation between business and standard-setters**

The ICC Banking Commission has had the privilege of regularly meeting with the Basel Committee on Banking Supervision (BCBS) on many occasions, as well as with other policy makers – global, regional and national. Over the period 2009-2011, this dialogue demonstrated how cooperation between business and regulators can be beneficial when drafting the next generation of banking supervision rules.

The economics of regulation are very complex. While there is no doubt that public authorities can operate independently, ICC believes it is important to bridge the information gap among the various stakeholders involved in reviewing the Basel framework. The issues involved in financial regulation require a solid understanding on all sides.

It is clear that there is a strong need to eliminate toxic assets from spreading

throughout the global financial system and harming the global economy as they have in the past. G-20 leaders and global standard setters have rightly sought to adopt more stringent international regulations to strengthen the international financial system in order to avoid the repetition of regulatory failures.

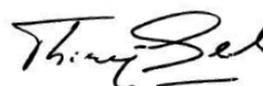
However, policy makers should also be aware that disrupting international trade with overly stringent regulatory requirements can have harmful side effects, especially if the requirements do not reflect the underlying nature of trade finance.

There are positive steps government can take to facilitate trade. In particular, in light of the deteriorating market conditions during the last quarter of 2011, governments should support new measures to make trade finance more accessible and affordable.

One major advantage of the Trade Finance Register project is that it allows trade finance professionals and regulators to better understand each other's processes and objectives.

Through its work on the Register, ICC hopes that it has demonstrated the importance of trade finance in the functioning of the global economy and helped policy makers to craft a fair and rules-based multilateral trading system that will benefit nations at all levels of development.

Sincerely,



Thierry Senechal  
ICC Senior Policy Manager  
Banking Commission

# SECTION 1. Background and Methodology

## The Register: purpose and scope

1. World trade relies upon reliable, adequate, and cost-effective sources of financing, both long-term (for capital investments) and short-term (to fill the time lag between the production of goods and receipt of payments). Collectively known as “trade finance”, this has been associated with the expansion of international trade during the past century, and has generally been considered to be a routine operation – providing fluidity and security to the movement of goods and services. Best estimates suggest that bank-intermediated trade finance currently underpins around 30 percent of world trade.
2. The global financial crisis of 2007-2009 gave rise to concerns about a significant shortfall in the supply of trade finance, particularly in developing and emerging economies. Despite impressive policy interventions to support the financing of trade in 2009-2010, any significant increase in the Basel framework capital requirements of some trade finance transactions—particularly those involving small- and medium-sized enterprises or counterparties in developing markets—appears to be inconsistent with the view of many industry practitioners that trade finance has historically maintained a low-risk profile in comparison with other financial instruments.
3. Although it had long been suggested that trade finance was a low-risk asset class, there had been little empirical information to support this argument, particularly from a regulatory perspective. In this context—and in the interests of supporting world trade as an engine of economic recovery—the Asian Development Bank (ADB) proposed that ICC establish a Trade Finance Register to pool performance data for trade finance products. This was agreed at the September 2009 meeting of the WTO Expert Group on Trade Finance.
4. Following discussions with financial institutions and partners, it was agreed that the Register would seek to collect high-level performance data from major trade finance banks, with a view to providing an empirical basis for discussions regarding the treatment of trade financing under the Basel framework.

## Dataset and methodology

5. This report examines portfolio-level data comprising 11,414,240 transactions provided by 14 international banks, with operations covering a broad range of jurisdictions (both OECD and non-OECD). Data was submitted to the Register by 14 banks using a common matrix to isolate statistics relevant to the calculation of regulatory capital

requirements—*inter alia*, total throughput; default exposures; write-offs and recoveries; and expiry of products without payment.

6. The total data provided covers the six-year period from 2005-2010. This report focuses on the three-year period from 2008-2010. This historical time period was chosen for three primary reasons:
  - a. consistency with Basel II data requirements for the calculation of key risk attributes, such as Loss Given Default;
  - b. the imperative of capturing data at the height of the 2008-2009 financial crisis; and
  - c. the short tenor of trade finance transactions (e.g., typically 60-180 days).
7. Data has been provided for the products listed below. For ease of reference, a short overview of each of these product types is found in Annex A.

#### Products in the ICC Trade Finance Register

1. Export confirmed L/Cs – payable at sight
2. Export confirmed L/Cs – usance (payable at a future date, not payable At sight)
3. Import L/Cs issued – payable at sight
4. Import L/Cs issued – usance (payable at a future date, not payable at sight)
5. Performance guarantees and performance standby L/Cs issued
6. Performance standby L/Cs confirmed
7. Loans for export – bank risk
8. Loans for export – corporate risk
9. Loans for import – bank risk
10. Loans for import – corporate risk
11. Shipping guarantees

8. In addition to stating the Total Bank Assets for which they were reporting for each year of their submission, participants were requested to provide 16 sets of data for each of 11 products for each year (2005-2010), by country of risk. Information was requested by country for each of the 249 ISO listed countries.
9. Participants were provided a separate row for each product in order to enter their data as totals in those cases where the data was not available at the country level. Similarly, where distinct data was not available for “at sight” versus “usance”, a totals row was provided. The resulting spreadsheet contained over 3,500 rows of data for each of the 11 products for each year.
10. The information requested was as follows:

1. Total (aggregate) number of transactions per product type for calendar year
2. Total cumulative exposure (USD) per product type for calendar year
3. Total (aggregate) number of transactions defaulted per product type for calendar year
4. Total (aggregate) exposure (USD) in default per product type for calendar year
5. Total (aggregate) number of customers where there was a write-off per product type for calendar year
6. Total (aggregate) number of transactions where there was a write-off per product type for calendar year
7. Total (aggregate) exposure (USD) of transactions written-off per product type for calendar year
8. Total exposure (USD) per product type as at balance sheet 31 December
9. Total exposure (USD) that is in default per product type as at balance sheet 31 December
10. Total recovery for calendar year
11. Number of document sets rejected on first presentation
12. Number of transactions that expire without payment
13. Number of transactions that are not "paid" after obligor defaults for calendar year
14. Loss ratio for trade – corporate clients transactions
15. Loss ratio for trade – bank clients transactions
16. Total commercial and industrial loan default ratio (USD) for calendar year bank and corporate

## SECTION 2. Main Findings

### Background

11. There has historically been little empirical evidence to demonstrate the low-risk, self-liquidating nature of trade finance. This lack of data has been particularly problematic given the concern that has been raised in recent years that the capital requirements for trade finance transactions under the Basel II framework are not necessarily proportionate with the low-risk profile of the activity.
12. Under the impetus of Pascal Lamy of WTO, ICC decided in 2009 to establish a Trade Finance Register to collect performance data on trade finance products. This initiative aims to help the industry develop a pool of data to substantiate the argument that trade finance was a low-risk form of financing. At the same time, it sought to provide the much-needed empirical basis for discussions regarding the treatment of trade financing under the Basel framework.
13. At its most basic, bank-intermediated trade finance provides structure, security and fluidity to the exchange of goods or services between a willing buyer and a willing seller. The underlying presence of two (or more) parties keen to “do business”, suggests that the completion rate on trade finance transactions should be extremely high. Moreover, in theoretical terms, the risk of a bank incurring a defaulted exposure is further reduced by, *inter alia*, the fixed, short-term maturity of trade finance products, and the fact that exposures are usually liquidated by cash upon maturity.
14. The present report provides an analysis of the main features of this data relevant to the calculation of regulatory capital requirements for five trade finance product types – (i) import letters-of-credit (“L/Cs”) issued; (ii) export confirmed L/Cs; (iii) guarantees and standby L/Cs; (v) import loans; and (vi) export loans. Except where noted, this Executive Summary is focused on the years 2008, 2009 and 2010 to demonstrate the impact of the global recession on the traditional trade products: Loans for exports to banks and corporations, loans for imports to corporations, import and export letters of credit (L/Cs), standby letters of credit and performance guarantees.
15. Where insufficient participants, transaction volume or assets were reported, such as loans for imports to banks, no conclusions are drawn. The data reflects between 60 to 65 percent of traditional global trade finance activity based on contingent liabilities.<sup>1</sup>

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<sup>1</sup> The US banks participating in the project have combined net letters of credit (L/Cs) outstanding as of 31 December 2010 USD312,687,663,000 which is 68 percent of the net L/Cs outstanding of the 300 largest US L/C bank portfolios as reported by *Documentary Credit World*, May 2011. Based on the identities of all the participating banks, their global reach and trade portfolios, extrapolating this figure to the entire participant list it is conservatively estimated the data reflects a minimum of 60-65 percent of the trade business globally.

## Aggregate summary

16. A group of leading international banks provided portfolio-level data for the period 2005-2010, comprising 11,414,240 transactions with a total value of USD5,190,667,066. Given the short business cycle, six years of data was considered sufficient to produce meaningful data.
17. The below summary reflects the actual number of reported transactions, the cumulative exposure in US dollars, actual default exposure as of 31 December as a percent of cumulative exposure and actual aggregate amount written off as of 31 December as a percent of cumulative exposure for the three focus years 2008-2010 except where noted.

**Summary table of key findings for the period reported**

Product	Transactions	\$ in 000s	Default %	Loss %
<b>Loans for Export – Bank Risk (2008-2010)</b>	955,201	355,073,525	0.1733	0.0127
<b>Loans for Export – Corp Risk (2008-2010)</b>	1,009,922	234,398,914	0.2918	0.0167
<b>Loans for Import – Corp Risk (2008-2010)</b>	655,199	389,796,641	0.0597	0.0697
<b>Import L/Cs (2007-2010)</b>	1,438,291	727,012,390	0.0673	0.0061
<b>Export Confirmed L/Cs (2008-2010)</b>	389,129	195,664,331	0.0907	0.0349
<b>Performance Guarantees/ Standby L/Cs (2009-2010)</b>	396,059	347,828,425	0.0135	0.0007

Source: ICC Trade Finance Register data

18. As noted above, the default and loss percentages, even in severe economic times, are minimal. Moreover, trade transactions have a short maturity. In 2009, SWIFT produced a Trade Snapshot on four specific days (from Quarter 4 2008 till Quarter 3 2009). More than 50 percent of L/Cs expire within 60 days and close to 90 percent expire within 90 days. Less than 8 percent expire after more than 120 days.<sup>2</sup> This four-day random sample from 2009 is validated by the bank data submitted for this report as discussed in the analysis below.

## Product type breakdown

19. Our findings are set out below in the following order: Loans for Export – Bank Risk; Loans for Export – Corporate Risk; Loans for Import – Corporate Risk; Import Letters of Credit; Export Confirmed Letters of Credit; and Performance Guarantees and Performance Standby Letters of Credit (Issued and Confirmed).

<sup>2</sup> SWIFT, Trade Data Snapshot – TSAG (Results, October 2009).

**(a) Loans for Export – Bank Risk**

Product	Transactions	USD in 000s	Default %	Loss %
<b>Loans for Export – Bank Risk</b>	955,201	355,073,525	0.1733	0.0127

20. 2007 and the first half of 2008 were the global peaks of the economic boom preceding the recession. Trade finance loans for Export – Bank Risk have an average life cycle of 121 days. Only 344 of 955,201 transactions resulted in a default, and only 69 of the 955,201 transactions resulted in a loss. Losses in dollar terms were 0.0127 percent as shown above.

**(b) Loans for Export – Corporate Risk**

Product	Transactions	USD in 000s	Default %	Loss %
<b>Loans for Export – Corporate Risk</b>	1,009,922	234,398,914	0.2918	0.0167

21. Trade finance loans for Export – Corporate Risk have an average life cycle of 137 days. Only 681 of 1,009,922 transactions resulted in a default, and only 24 of the 1,009,922 transactions resulted in a loss. Losses in dollar terms were 0.0167 percent as shown above.

**(c) Loans for Import – Corporate Risk**

Product	Transactions	USD in 000s	Default %	Loss %
<b>Loans for Import – Corp Risk</b>	655,199	389,796,641	0.0597	0.0697

22. Trade finance loans for Import – Corporate Risk have an average life cycle of 86 days. Only 255 of 655,199 transactions resulted in a default, and only 166 of the transactions resulted in a loss. Losses in dollar terms were 0.0697 percent as shown above.

**(d) Import Letters of Credit**

Product	Transactions	USD in 000s	Default %	Loss %
<b>Import L/Cs (2007- 2010)</b>	1,438,291	727,012,390	0.0673	0.0061

23. Import Letters of Credit payable “at sight” have an average life of 75 days, while those payable at a future date (a “usance” credit available by deferred payment or acceptance) have an average life cycle of 126 days. A number of banks reported a combined average life cycle. Incorporating this data into the above brings the average

life cycle of an import letter of credit to 98 days. Only 235 of 1,438,291 transactions resulted in a default, and only 68 of the transactions resulted in a loss.

24. Losses in dollar terms were 0.0061 percent as shown above. The dollar losses reflect both the collateralized nature of import letters of credit and the immediate reimbursement by an issuing bank from its client. Note this table also includes data from 2007.

### (e) Export Confirmed Letters of Credit

Product	Transactions	USD in 000s	Default %	Loss %
Export Confirmed L/Cs	389,129	195,664,331	0.0907	0.0349

25. Export Confirmed Letters of Credit have an average life cycle of 92 days. This includes credits payable “at sight” and those payable at a future date (a “usance” credit available by deferred payment or acceptance). Only 54 of 389,129 transactions resulted in a default, and only 19 of the transactions resulted in a loss. Losses in dollar terms were 0.0349 percent as shown above.

### (f) Performance Guarantees and Performance Standby Letters of Credit (Issued and Confirmed)

Product	Transactions	USD in 000s	Default %	Loss %
Performance Guarantees/ Standby L/Cs (2009-2010)	396,059	347,828,425	0.0135	0.0007

26. This product set includes Performance Guarantees Issued, and Performance Standby Letters of Credit Issued and Confirmed. Guarantees are not confirmed. Financial guarantees and financial standby credits are not included. The included products have an average life cycle of 451 days.
27. Only 114 of 396,059 transactions resulted in a default, and only five of the transactions resulted in a loss. Losses in dollar terms were 0.0007 percent as shown above. This product set includes only data for two years, 2009 and 2010, due to the number of participants and the volume of transactions for earlier years. The average life cycle and exceptionally low loss experience reflect the nature of the use of these instruments and the transactions which they support.

## Overall assessment

28. The data pooled within the ICC Register supports the view that trade finance is a low-risk asset class, including the following findings:
- a. **Short tenor of trade transactions.** The average un-weighted tenor of all products in the dataset 2005-2010 is 147 days; the off-balance-sheet products covered by the ICC Register (import L/Cs payable at sight average length is 75 days, usance import L/Cs 126 days. Sight and usance export confirmed L/Cs) exhibit average tenors of 103 days, and performance standby L/Cs and guarantees average tenor is 451 days.
  - b. **Low default and loss across all product types.** Fewer than 3,000 defaults were observed in the full dataset of 11.4 million transactions. Default rates for off-balance sheet trade products were especially low, with only 947 defaults in a sample of 5.2 million transactions. These low rates of default and loss are consistent with the ICC's theoretical understanding of the mechanics and context of trade financing. Using a standard calculation, ICC calculated the following average default and loss rates within each product type over the three focus years of this report (2008-2010):
    - i. import L/Cs, default 0.077 percent, loss 0.007 percent
    - ii. export confirmed L/Cs, default 0.09 percent, loss 0.03 percent
    - iii. standbys and guarantees, default 0.013 percent, loss 0.0007 percent
    - iv. import loans – corporate risk, default 0.06 percent, loss 0.07 percent
    - v. import loans – bank risk, default 0.09 percent, loss 0.05 percent
    - vi. export loans – corporate risk, default 0.29 percent, loss 0.017 percent
    - vii. export loans – bank risk, default 0.17 percent, loss 0.01 percent
29. **Relatively few losses through the global economic downturn.** Fewer than 500 losses were recorded out of more than 7.5 million transactions in 2008, 2009 and 2010. Indeed, the number of losses on some products (for example, import loans and L/Cs, guarantees, and standby L/Cs) remained negligible throughout this period (269 out of more than 4 million transactions) despite prevailing economic conditions and higher transaction volumes.
30. **Limited credit conversion from off- to on-balance sheet.** Counterparty default – unlike, for instance, credit default swaps – does not in itself automatically result in the conversion of contingent trade products from off- to on-balance sheet. From the data, ICC found that documentary and (implied) performance contingencies inherent in trade products, mitigated potential defaults for on-balance-sheet exposures. In the case of import L/Cs, for instance, an average of 70 percent of document sets presented to banks to make drawings under import L/Cs contained discrepancies on first presentation<sup>3</sup>. In these cases, the bank has no obligation to waive the documentary discrepancies and make payment unless it receives reimbursement or unless the discrepancies are corrected within the validity period of the L/C.

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<sup>3</sup> Numerous studies report the percent of discrepant documents at 60-90+ percent. A survey undertaken by the IFSA reported 73%. The number of participants capturing and reporting this data for the *Global Task – Trade Finance 2011* was insufficient to draw a further conclusion.

31. In summary, the *Global Risks – Trade Finance 2011* data supports the view that traditional trade finance, such as letters of credit, has a very low loss experience. Contingent liabilities such as these do not convert to “on-balance sheet” liabilities when paid because the issuing/confirming bank reimburses itself immediately from its client and is typically heavily collateralized. Trade loans to corporates and banks carry a very low loss history and defaults do not necessarily result in write-offs. Although the data collected for this report would support a lower risk-based capital weighting, the Basel II Risk-Based Capital Credit Conversion Factors are more than sufficient and should be retained. Moreover, the data supports using the actual maturity of trade transactions, not a one-year floor.

## SECTION 3. Special MDB Focus

### Overall assessment

32. Multilateral development banks (MDBs) have trade finance programs supporting trade in the most challenging markets. The statistics provided by the MDB trade finance programs have been separated from this Report's primary commercial bank data to avoid double counting. The MDBs that provided statistics include in alphabetical order Asian Development Bank (ADB), Inter-American Development Bank (IDB) and International Finance Corporation (IFC).
33. The MDB trade finance programs assume only bank risk in their respective developing member countries. The statistics provided by the MDBs exhibit no defaults and no losses. Of the 11,892 guarantees, covering bank risk on a wide variety of instruments including L/Cs, issued by MDB trade finance programs valued at over USD20 billion over the past six years, no defaults and no losses have occurred. Of the 11,258 trade loans disbursed by MDBs to banks valued at USD15.8 billion, no defaults and no losses have occurred.

## SECTION 4. Conclusion

34. Trade Finance has historically been an engine of growth in world commerce, a critical source of economic growth and a provider of hard currency to developing countries. Traditionally, trade finance has been considered one of the safest, most collateralized, and most self-liquidating forms of finance. This report provides the empirical evidence that this is clearly the case.
35. As demonstrated in this report, traditional trade finance has a very low loss experience. Contingent liabilities such as letters of credit do not convert to “on-balance sheet” liabilities when paid because the issuing/confirming bank reimburses itself immediately from its client and is typically heavily collateralized. Such off-balance sheet contingencies would support significantly lower capital allocations.
36. Likewise, traditional trade loans to corporate entities and banks carry a very low loss history and should carry lower capital allocations. In both categories, defaults do not necessarily result in write-offs since transactions are liquidated by the sale of the underlying merchandise, and the bank is reimbursed for the amount of the transaction.
37. The data in this report supports the short-term nature of trade transactions and supports using the actual maturity of trade transactions as opposed to a one-year minimum. The data collected for this report would support lower risk-based capital weightings; the Basel II risk-based capital Credit Conversion Factors are more than sufficient and, at a maximum, and should be retained.

# Annex. Products covered in the ICC Register

## Trade finance: background

There are a wide variety of payment methods available in international trade, each with particular advantages and disadvantages. In essence, if traders seek to assure a high level of payment security, then the payment method chosen will be relatively more costly. Conversely, if payment security is not a priority, because the parties know or trust each other, then cheaper and simpler payment methods can be used.

The central risks in international trade are the exporter's risk of non-payment and the importer's risk that the goods shipped will not conform to the contract. Both of these risks may be reduced via the documentary safeguards provided by the letter of credit mechanism (commercial letters of credit are referred to by bankers as "documentary credits" – the two terms are hereafter used interchangeably). However, since documentary credits involve relatively higher banking fees and more complex documentary procedures, this option is not always appropriate. Parties with long trading histories or residing in adjacent countries may be willing to make sales on open account or with payment in advance – payment modes which are easier and less expensive, but which do not similarly reduce risk.

Let us briefly list the key payment options from the point of view of the exporter:

1. Cash in advance – Obviously the safest for the exporter, this is generally unavailable in competitive markets. A partial advance payment (e.g. 20–30 percent) may be more acceptable to the importer and therefore more realistic, but this leaves the exporter exposed to risk on the balance. Despite the great risks to the importer of payment by cash in advance, some importers may find they have no choice. It does happen, for example, that importers from certain developing countries find it necessary to pay in advance in order to obtain high-demand goods from developed countries.
2. Documentary credit or "D/C" (also known as a "letter of credit" or "L/C") – After cash in advance, this is usually considered the next safest method for the exporter. However, because of its complex documentary nature, the documentary credit can be relatively expensive in terms of banking fees; moreover, the exporter must have a rigorous document preparation system in place in order to avoid the risk of non-payment due to non-conforming documents being presented to the bank.
3. Documentary collection – This is not as safe as a letter of credit, but is significantly cheaper; the seller must be willing to take the risk that the importer will not pay or accept the documents.

4. Open account – This is the least safe method and is generally used when the importer is fully trusted and creditworthy. The exporter should consider the need for protection with credit insurance.

## Import L/Cs issued

In its simplest form, an import L/C is normally issued by a bank on behalf of a purchaser of merchandise or a recipient of services, in favour of a beneficiary, usually the seller of the merchandise or provider of services. The issuer (usually a bank) irrevocably promises to pay the seller/provider if presented with documents which comply with the terms and conditions of the L/C, either:

- i. at “sight”, which means as soon as a compliant set of documents are presented to the paying bank; or
- ii. after a specified term, e.g. at 30, 60, 90 or 180 days after sight or shipment date (“usance”).

Under an L/C the obligation of a bank to pay the beneficiary is contingent, not only on the exporter delivering the correct documents as detailed in the L/C, but also on all requirements of the L/C being complied with. As such, an L/C will remain an off-balance sheet exposure until the documents are presented and honoured by the bank, usually in accordance with the provisions of a standardized code of practice, the ICC *Uniform Customs and Practice for Documentary Credits* (“UCP 600”).

Until this event occurs, there is a probability that the L/C might never convert to an on-balance sheet exposure even in the event that the importer defaults. If discrepant documents are presented, the bank has no obligation to waive the documentary discrepancies and make payment, even if the applicant waives the discrepancies, unless it provides reimbursement or the discrepancies are corrected within the L/C’s validity.

Furthermore, if the documents are compliant and/or accepted by the issuing bank, the latter normally has a security interest in these documents, which usually provide for control of the underlying goods. Therefore, in the event the issuing bank accepts the documents but does not feel comfortable with the credit risk of its client/applicant, the bank can withhold the documents and the related goods.

## Export confirmed L/Cs

A confirmed L/C is one to which a second bank, usually in the exporter’s country and at the issuing bank or exporter’s request, adds its additional commitment (confirmation) that payment will be made. Confirmation is generally used when there is perceived to be some risk that the bank issuing the L/C may not be able to fulfil its obligation to pay. This could be due to a perceived risk of bank failure or instability in the country of the issuing bank.

From the perspective of the confirming bank, the risk of incurring a defaulted exposure is contingent on four factors: (i) compliant documents being presented; (ii) any additional terms

and conditions of the L/C being complied with; (iii) the issuing bank failing to honour its commitment to reimburse; and (iv) the importer deciding not to purchase the goods/services backed by the L/C.

It should be noted that the data provided to the Register indicates that demand for bank confirmations almost doubled in 2009 relative to 2008, underscoring the important role that L/C confirmations play in facilitating trade during periods of economic instability.

## Guarantees and standby letters of credit

In international trade transactions, providers of goods, services or performance commonly request a bank guarantee or bond from their client. These instruments provide a means of securing performance or other obligations under the terms of a contract. In these transactions, the bank acts as a guarantor and will pay the beneficiary a specific sum, usually on presentation of a written demand.

In return, the bank will require a counter-indemnity from its client for the full amount and any costs. In a similar vein, a standby letter of credit is a type of trade debt guarantee that is only drawn against in the event the importer defaults in some way – for example, if it fails to pay for a consignment within an agreed period. A standby L/C includes an expiry date. Standby L/Cs will normally call for a statement of default from the exporter and also evidence of default.

Prior to providing a performance standby L/C or performance guarantee, a bank will check that there is an underlying commercial contract and that the calling of the instrument is triggered by a performance event, usually evidenced by documentation – and not by the customer failing to pay. As such, even in the event of default, a contingent standby or guarantee will not necessarily result in an on-balance sheet exposure. Guarantees and standby letters of credit are often issued subject to industry standards under either the ICC *Uniform Rules for Demand Guarantees* (“URDG”) or the ICC *International Standby Practices* (“ISP98”).

## Import loans

Import loans are a flexible short-term borrowing facility, linked to one or more specific import transactions. There are typically two types of import loans:

- a) Loan against import – made available to importers trading on documentary credit or documentary collection terms. Goods are released to the importer under trust receipts, meaning that the importer can use the goods immediately, but they belong to the bank until the importer settles the loan.
- b) Clean import loan – rather than being triggered by the receipt of a documentary credit or documentary collection, the advance is made on presentation of supplier invoices and evidence of shipment only.

## Export loans

As with import loans, export loans are a flexible short-term borrowing facility, linked to one or more export transactions. A bank may assume “bank risk” in issuing an export loan facility when “discounting” an export L/C, for example. This is a common means of working capital financing when an L/C is used as the settlement instrument.

From the perspective of the bank discounting the L/C, the risk of incurring a defaulted exposure is contingent on a number of factors: (i) the exporter being unable to provide the goods/services stipulated by the L/C; (ii) the issuing bank failing to honour its commitment to pay the exporter; and (iii) the importer deciding not to purchase the goods/services backed by the L/C.

## The International Chamber of Commerce (ICC)

ICC is the world business organization, a representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world. The fundamental mission of ICC is to promote trade and investment across frontiers and help business corporations meet the challenges and opportunities of globalization. Its conviction that trade is a powerful force for peace and prosperity dates from the organization's origins early in the last century. The small group of far-sighted business leaders who founded ICC in 1919 called themselves "the merchants of peace". Today ICC groups hundreds of thousands of member companies and associations from over 120 countries. National committees work with their members to address the concerns of business in their countries and convey to their governments the business views formulated by ICC.

ICC has three main activities: rules-setting, dispute resolution and policy. Because its member companies and associations are themselves engaged in international business, ICC has unrivalled authority in making rules that govern the conduct of business across borders. Although these rules are voluntary, they are observed in countless thousands of transactions every day and have become part of the fabric of international trade. ICC also provides essential services, foremost among them the ICC International Court of Arbitration, the world's leading arbitral institution. Another service is the World Chambers Federation, ICC's worldwide network of chambers of commerce, fostering interaction and exchange of chamber best practice. ICC enjoys a close working relationship with the United Nations and other intergovernmental organizations, including the World Trade Organization and the G8/G20.

## ICC Banking Commission

The ICC Banking Commission is a leading global rule-making body for the trade finance industry. The Banking Commission is known for producing universally accepted rules and guidelines for documentary credits, documentary collections, bank-to-bank reimbursements and bank guarantees. ICC's voluntary market-based approaches have often been praised for levelling the playing field in trade finance practices. The ICC Banking Commission is also a unique forum where business and policy makers work together to address the global challenges of trade & finance. The Banking Commission is at the forefront of efforts to understand and to help business respond to new developments and concerns in the regulatory sphere, such as the Basel regime, anti-money laundering and the challenges of facilitating international trade finance across boundaries, in particular in the developing world.

The Officers of the Banking Commission and its secretariat are:

- [KAH CHYE TAN](#)  
Chair, Global Head of Trade and Working Capital, Barclays
- [GEORGES AFFAKI](#)  
Vice-Chair, Member of the Executive Committee and Global Head of Structured Finance, CIB Legal, BNP Paribas
- [STEVEN BECK](#)  
Banking Commission Senior Advisor, Head of Trade Finance, Asian Development Bank
- [GARY COLLYER](#)  
Banking Commission Senior Technical Advisor, Founder Collyer Consulting
- [DAN TAYLOR](#)  
Vice-Chair, Executive Director, TSS Global Market Infrastructures, J.P. Morgan Chase
- [ALEXANDER ZELENOV](#)  
Vice-Chair, Director, Financial Institutions Department, Vnesheconombank
- [YANLING ZHANG](#)  
Vice-Chair, Chairwoman, Bank of China Private Aviation Limited
- [THIERRY SÉNÉCHAL](#)  
Executive Secretary, Banking Commission Secretariat, International Chamber of Commerce