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Report on findings of ICC-ADB Register on Trade & Finance

Statistical analysis of risk profile of trade finance products

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ADB

Contact:
Thierry Senechal
Senior Policy Manager, Banking Commission

International Chamber of Commerce (ICC)
38 Cours Albert 1er, 75008 Paris, France
Tel +33 (0)1 49 53 28 05
Fax: +33 (0)1 49 53 28 59
tsl@iccwbo.org

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List of Acronyms

ADB	Asian Development Bank
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CCF	Credit Conversion Factor
ICC	International Chamber of Commerce
L/C	Letter of credit
LGD	Loss given default
OECD	Organization for Economic Co-operation and Development
UCP	Uniform Customs and Practices for Documentary Credits (ICC Rules)
USD	United States Dollar

Executive Summary

Background

Historically, trade finance has been considered an extremely low-risk, routine operation. This perception—which is reflected in much of the specialist literature on the subject—has developed partly as a result of the anecdotal experience of practitioners over the past half century; but also on the basis of a theoretical understanding of the specific mechanics of trade financing.

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.

There has historically been relatively little empirical evidence to support this argument, however. 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 do not reflect the low risk-profile of the activity.

In this context, the ICC-ADB Register on Trade & Finance (the "Register") was established to enable banks to pool performance data for trade finance products. At this initial stage, nine banks provided portfolio-level data comprising 5,223,357 transactions, with a total throughput between 2005 and 2009 of USD2.5 trillion.

ICC recognises that this data collection exercise is the first step in examining the risk profile of trade finance products, and that this process will most likely require further enhancement to meet regulatory requirements for data collection. In the second phase of the project, ICC will work to enhance and expand the data collected, thus creating a compelling base of information for the Trade Finance Industry. In this context, it is ICC's overarching objective to ensure that the treatment of trade products is fully consistent with the Basel Committee's macro-prudential objective to promote financial stability, as well as the current imperative to support international trade as an engine of economic growth.

This report below 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.

Key Findings

The data set presented in this report provides an initial, "high-level" indication of the risk-profile of trade financing. In this connection, particularly notable features of the data (from a regulatory perspective) include:

a) **the short tenor of trade transactions**
The fixed, short-term maturity of trade finance products is confirmed by looking at the "churn" rate of transactions within the data set. The average tenor of all products within the data set is 115 days, with all of the off-balance sheet products covered by the Register (import L/Cs; export confirmed L/Cs; standby L/Cs and guarantees) exhibiting average tenors of less than 80 days.

b) **low default across all product types**

Only 1,140 defaults have been reported within the full data set of 5,223,357 transactions. Reported default rates for off-balance sheet trade products are especially low—i.e. 110 defaults from a total of 2,392,257 transactions.

Using a standard calculation, we estimate that the average rate of default within each product type over the five years is: import L/Cs, 0.058%; export confirmed L/Cs, 0.282% (or 0.008%)[1]; standbys and guarantees, 0.010%; import loans, 0.124% (corporate risk) and 0.293% (bank risk); export loans, 0.168% (corporate) and 0.023% (bank).

c) **relatively few defaults through global economic downturn**
Only 445 defaults were reported in 2008 and 2009, out of a total of over 2.8million transactions written through this period. Indeed, the number of defaults reported on some products (e.g. import loans, guarantees and standby L/Cs) remained negligible through this period, in spite of prevailing economic conditions and higher transaction volumes.

d) **good recovery rates for all product types**
Looking at recoveries from written-off transactions, we observe from the data set an average recovery rate of 59.7% across all product types, with the highest recovery rate recorded on exposures to export loans (bank risk) 81.5%, and a low of 28.1% (export confirmed L/Cs). This latter figure may, however, be obscured by uncompleted recoveries as a result of ongoing bank restructurings in two jurisdictions.

e) **limited credit conversion from off- to on-balance sheet**
Counterparty default—unlike, for instance, in credit default swaps—does not in itself automatically crystallize the conversion of contingent trade products from off- to on-balance sheet. We observe from the data, documentary and (implied) performance contingencies inherent to trade products, which mitigate against potential defaulted on-balance sheet exposures.

In the case of import L/Cs, for instance, an average of 50% of document sets presented to banks to make drawings under import L/Cs contained discrepancies on first presentation. In these cases there is no obligation on the bank to waive the documentary discrepancies and make payment, unless they provide reimbursement or the discrepancies are corrected within the L/C validity . A significant proportion of L/Cs facilities also expire utilised—this may occur, for instance, where an export chooses not to ship the goods stipulated in the L/C as a result of concerns about the creditworthiness of its customer.

Conclusions

Given the overarching economic imperative of promoting international trade as an engine of global economic recovery, it is hoped that the data pooled in the Register will provide a basis for reviewing the risk mitigants inherent to trade instruments and the correlation with credit risk mitigants under the Basel framework. We look forward to discussing the findings of the initial phase of the project—as well as the ways in which the data collection exercise might be refined and expanded going forwards—with the Basel Committee and national regulators in due course.

[1] An alternative calculation for the rate of default on export confirmed L/Cs is suggested in the report, given that factors underlying a defaulted confirmed export L/C are likely to be unique to each particular transaction.

Report on findings of ICC–ADB Register on Trade & Finance

Statistical analysis of risk profile of trade finance products

1. Background

ICC Banking Commission and ADB

1.1. The ICC Banking Commission is the leading global rule-making body for the trade finance industry, as well as a worldwide forum for trade finance experts whose common aim is to facilitate international trade finance. The commission has more than 500 members in 85 countries, many of them from developing countries.

1.2. 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.

1.3. ADB, based in Manila, is a triple A-rated financial institution dedicated to reducing poverty in Asia and the Pacific through inclusive economic growth, environmentally sustainable growth, and regional integration. Established in 1966, it is owned by 67 members – 48 from the region. In 2009, it approved a total of $16.1 billion in financing operations through loans, grants, guarantees, a trade finance program, equity investments, and technical assistance projects. ADB also mobilized cofinancing amounting to $3.2 billion

The Register: Purpose and Scope

1.4. World trade inherently 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). The latter, known as "trade finance", has been associated with the expansion of international trade in the past century, and has generally been considered a routine operation—providing fluidity and security to the movement of goods and services. Best estimates suggest that the bank-intermediated trade finance currently underpins around 30 per cent of world trade.

1.5. The global financial crisis 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 over the past eighteen months, a survey undertaken by ICC in September 2009 indicated that concerns remain as to the ability of the banking sector to meet any significant upturn in demand for credit in the current environment.

1.6. The crisis compounded the tightening effect of the impact of the implementation of the Basel II requirements on the ability of banks to provide trade finance to customers. As previous ICC position papers have noted,[2] the significant increase in Basel II's capital requirements of some trade finance transactions—particularly those involving small- and medium-sized enterprises or counterparties in developing markets—appears inconsistent with the view of many industry practitioners that trade finance has historically maintained a low risk profile in comparison with other financial instruments.

[2] ICC (2009) "ICC Banking Commission Recommendations: Impact of Basel II on Trade Finance"

1.7. Although it has long been suggested that trade finance is, relatively speaking, a low-risk asset class, there has 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—it was proposed by ADB and agreed at the September 2009 meeting of the WTO Expert Group on Trade Finance that ICC and ADB would establish a Register on Trade & Finance ("the Register") to pool performance data for trade finance products.

1.8. 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.

1.9. This report has been prepared to present to both the Basel Committee and national regulators, a summary of data collected from nine banks on the historical performance of trade finance products over the past five years. ICC recognises that this data collection exercise is the first step in examining the risk profile of trade finance products, and that this process will most likely require further enhancement to meet regulatory requirements for data collection. In the second phase of the project, ICC will work to enhance and expand the data collected, with a view to enabling a robust, evidence-based review of the treatment of trade products under the Basel framework going forwards.

2. Data set and methodology

2.1. This report examines portfolio-level data comprising 5,223,357 transactions provided by nine international banks, with operations covering a broad range of jurisdictions (both OECD and non-OECD). Data was submitted to the Register by banks between April and June 2010, using a common matrix to isolate statistics relevant to the calculation of regulatory capital requirements—*inter alia*, total throughput; defaulted exposures, write-offs and recoveries; and expiry of products without payment. A copy of the template matrix is included in Annex A, below. It should be noted that not all banks submitted data covering identical durations, but all data samples were within the same range of dates and were qualitatively matched at all times.

2.2. Data has been provided for five product types, as follows: (i) import letters-of-credit ("LCs") issued (sight and usance); (ii) export confirmed L/Cs (sight and usance); (iii) guarantees and standby L/Cs; (iv) import loans (separated by bank and corporate risk); (v) export loans (separated by bank and corporate risk). A short overview of each of these product types is provided in Annex B for ease of reference.

2.3. The data provided covers the five year period from 2005 – 2009. This historical time period was chosen for three primary reasons:

i. consistency with Basel II data requirements for the calculation of key risk attributes, such as Loss Given Default;

ii. the imperative of capturing downturn data at the height of the 2008/9 financial crisis; and

iii. the short tenor of trade finance transactions (e.g., typically 60 – 180 days).

With regard to the latter, the average tenor for each product covered by the Register is estimated in the analysis below, using the calculation:

$$Tenor = 365 \text{ days} \Big/ \frac{\text{total cumulative exposure}}{\text{total exposure at a given balance sheet date}}$$

2.4. On the basis of the data provided, the analysis below provides indicative figures for (i) default rates within each of the products; and (ii) loss/recovery rates,[3] using the following calculations:

$$\text{Default rate in the product} = \frac{\text{total yearly exposure in default}}{\text{total exposure at a given balance sheet date}}$$ [4]

$$\text{Loss rates} = \text{total exposure to written off products} - \text{total recovery}$$ [5]

2.5. In addition, where applicable, an analysis is provided of statistics related to the "conversion" of contingent trade products (e.g. L/Cs and performance guarantees) from off- to on-balance sheet. As described in Annex B, this conversion is not automatic—and in almost all cases is detached from an event of default—with draw-downs contingent on compliance with documentary requirements. In this context, data related to the number of discrepant documentary presentations and the ratio of transactions which expire without payment are presented where relevant to the product type. This data may be useful in providing an indication of appropriate Credit Conversion Factor ("CCF") weightings for off-balance sheet trade products.

2.6. Our findings are set out below in the following order: import L/Cs (section 3); export confirmed L/Cs (section 4); standby L/Cs and guarantees (section 5); import loans (section 6); and export loans (sections 7 - 8). A short conclusion is then provided in section 9.

3. Import L/Cs issued (sight and usance)

3.1. The data pooled in the Register includes a total of 1,196,270 import L/C transactions written between 2005 and 2009.

3.2. The average tenor of import L/C transactions within the data set is estimated at 79 days, using the calculation set out in paragraph 2.3, above. On this basis, it is suggested that there were around 23 "cycles" within this product category through the five year period 2005 – 2009.

Default rate in the product

3.3. We observe from the data set a very low rate of default on import L/Cs at an industry level—with only 23 defaulted transactions reported over the five-year period. More than two thirds of these defaults were reported in 2008, with the aggregate number of defaulted transactions returning to 2007 levels in 2009.

3.4. Using the calculation outlined in paragraph 2.4, above, the average rate of default for import L/Cs over the five year period was 0.058%, with a high of 0.227% and a low of 0.0002%.

[3] A standard definition of "default" was not provided for the purposes of pooling data in the initial phase of the project. It is also noted that the concept of "default within a particular product time" does not immediately accord with IRB practice. Nevertheless, it is hoped that the data presented provides a relatively robust and useful indication of the instance of default on trade products.
[4] A small number of banks were unable to isolate total exposure to particular product types at a given balance sheet date for particular products and/or years. Where that was the case an estimated figure was used based on the average ratio of year throughput to exposure on a given day (31 December) observed from those banks able to provide corresponding data. We believe that this methodology is relatively robust given that most banks will have similar peaks and troughs of business in view of yearly trade/inventory cycles.
[5] It should be noted that as banks provided aggregate data to the Register it has not been possible to provide weighted recovery rate figures.

3.5. In short, these relatively low rates of default are thought to be attributable to the transactional nature of trade financing which allows banks to carefully manage exposures; as well as the fact that companies will generally try to avoid defaulting on trade obligations, as continual access to trade finance is a lifeline for most firms.

Recovery Rate

3.6. The data set highlights a (significant) variance in industry-level recovery rates from year to year.[6] In two years (2007 and 2009) banks experienced no losses when firms defaulted on import L/Cs. In contrast, negligible recovery rates were reported in 2006 and 2008.

3.7. It is noted that the low rate of recovery in 2008 may suggest that there is a negative correlation between frequencies of default and recovery rates for import L/Cs. This would appear to be consistent with the findings of previous empirical studies examining the Loss Given Default experience of financial institutions.[7]

Discrepant documentary presentations and non-payment rate

3.8. A smaller sample of 1,033,367 transactions contains data related to the conversion of import L/Cs from off- to on-balance sheet.

3.9. As detailed in Annex B, an L/C will remain an off-balance sheet exposure until the documents stipulated in the L/C are presented by the exporter and honoured by the issuing bank. 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.

3.10. In this connection, it is instructive to note that over the five year period an average of 50% of document sets presented to banks to make drawings under import L/Cs contained discrepancies on first presentation. In these cases there is no obligation on the bank to waive the documentary discrepancies and make payment, even if the applicant waives those discrepancies, unless they provide reimbursement or the discrepancies are corrected within the L/C validity.

3.11. It is noted that the rate of discrepant presentations increased substantially in 2008 and 2009, with 56% of first presentations found to be discrepant through these two years. This increase is likely attributable to banks applying more stringent documentary criteria for the acceptance of documents, with a view to mitigating against potential exposure to financially stressed customers during the global economic downturn.

3.12. In addition, an average 11% of transactions covered by the data set expired unutilised. This may occur, for instance, where an exporter chooses not to ship goods because of concerns about a counterparty's creditworthiness. In this connection, it is instructive to note a the rate of expiry without payment for import L/Cs increased significantly during 2008 and 2009.[8]

3.13. It is our view that these figures affirm the CCF values applied to import letters of credit under the Basel II foundation approach

4. Export confirmed L/Cs (sight and usance)

[6] For ease of reference, we have sought to align defaulted exposures, write-offs and recoveries within individual years, where possible. This applies to all product types covered by the Registry. In addition, it is noted that some recoveries recorded may not be economic in nature—i.e. where a written-off trade transaction is placed within a workout facility, and the nexus with the original transaction is then cancelled (or "recovered").

[7] See e.g.: G. Gupton, D. Gates, and L. Carty (2000), "Bank loan losses given default", Moody's Global Credit Research.

[8] By analogy if the data set was limited to "distressed" customers we would envisage seeing a very high proportion of facilities that expire unutilised—principally as a result of exporters choosing not to ship goods to importers in financial distress, or where exporters request revised terms of settlement (e.g. payment in advance). It should also be noted that the risk of a bank incurring an on-balance sheet exposure is further reduced by the possibility that debtor-in-possession financing may enable a (defaulted) customer to settle its obligations. This dynamic is not captured by the data-set.

4.1. The data provided to the Register comprises 405,312 export L/C confirmations between 2005 and 2009.

4.2. The average tenor of export confirmed L/Cs within the data set is estimated at 53 days. On this basis, it is suggested that there were around 34 "cycles" within this product category through the five year period 2005 – 2009.

Default rate in the product

4.3. The data set highlights that defaults on export confirmed L/C obligations are relatively rare, with only six defaulted transactions reported between 2005 and 2008. That said, 27 defaulted transactions were reported in 2009, principally reflecting bank failures in a number of countries—most notably Kazakhstan and Ukraine.

4.4. Using the standard calculation outlined in paragraph 2.4, the average rate of default on export confirmed L/Cs over the five year period was 0.282%, with a high of 1.126% and a low of 0.0001%.

4.5. It is suggested that it may be appropriate to consider an alternative proxy for the average rate of default within the product in the case of export confirmed L/Cs. This is because the factors underlying a defaulted confirmed export L/C are likely to be unique to each particular transaction. This is, in part, because the risk of a confirming bank incurring a defaulted exposure is contingent on four factors: (i) compliant documents being presented by the exporter; (ii) any additional terms and conditions of the L/C being complied with; (iii) the issuing bank failing to honour its commitment to pay; and (iv) the importer deciding not to purchase the goods/services backed by the L/C.

4.6. On this basis, it is suggested that an alternative calculation might be used, as follows:

$$\text{Default rate in the product} = \frac{\text{total number of defaulted transactions}}{\text{total number of transactions}}$$

4.7. Using this alternative proxy, the rate of default for export confirmed L/Cs over the five year period was 0.008%, with a high of 0.029% and a low of 0.001%.

Recovery Rate

4.8. The recovery experience of financial institutions on defaulted confirmed L/Cs deviates substantially, *prima facie*, from ICC's expectation that recovery rates on defaulted confirmed L/Cs would be extremely high. The average observed industry-level recovery rate on defaulted confirmed L/Cs between 2005 and 2009 is 28.1%—the lowest rate of recovery of any of the product types covered by the Register.

4.9. Reviewing the data at portfolio level, we observe stark significant variance in banks' recovery rates within and between years. For example, in 2009 whilst there was a 100% recovery on 7 defaulted transactions, recovery rates of 0% were observed on a further 12 defaults.

4.10. It is our view that the (occasional) low recovery rates observed can be attributed to one of two factors, specifically:

i. default on the underlying trade transaction, rather than bank failure. This may occur, for instance, where a bank has made payment without recourse to its customer, but is subsequently precluded from being reimbursed by the issuing bank by underlying legal issues (e.g. a court injunction due to a breach of mandatory law); and

ii. ongoing bank restructurings, where recoveries remained uncompleted at the time that data was submitted to the Register (e.g. the ongoing Kazak and Ukraine restructurings).

4.11. With regard to the latter, we would ultimately anticipate high recovery rates where the default results from bank failure. In such situations, confirmed L/C exposures have been given priority payment (i.e. higher recovery rate than unsecured senior creditors), or bailed out by the sovereign or a multilateral bank.[9] It is suggested that this may explain (some of) the full recoveries observed within the data set. We are working with banks to ensure that in time we will be able to present more complete recovery data for these exposures.

Discrepant documentary presentations and non-payment rate

4.12. A smaller sample size of 52,479 transactions contains data related to the conversion of export confirmed L/Cs from off- to on-balance sheet.

4.13. In view of the issues outlined in paragraph 4.5, above, it is instructive to note that over the five year period 58% of documents sets presented to banks to make drawings under export confirmed L/Cs contained discrepancies on first presentation. In such instances, even after the default of an issuing bank, a confirming bank may choose not to make payment to the exporter if compliant documents are not presented to the bank—thus reducing the likelihood of incurring an on-balance sheet exposure. In addition, an average 12% of transactions covered by the data set expired unutilised.

4.14. As with import L/Cs rejection rates increased through the financial crisis, which again appears to indicate greater stringency in the examination of documents by banks to avoid on-balance sheet exposures.

4.15. It is our view that these figures broadly affirm the CCF values applied to confirmed letters of credit under the Basel II foundation approach.

5. Guarantees and Standby L/Cs (issuance and confirmations)

5.1. The data provided to the Register comprises 599,014 standby L/Cs and guarantees issued between 2005 and 2009.

5.2. The average tenor of export standby L/Cs and guarantees within the data set is estimated at 76 days. On this basis, it is suggested that there were around 24 “cycles” within this product category through the five year period 2005 – 2009.

Default rate in the product

5.3. We observe from the data set a very low rate of default on standby L/Cs and guarantees at an industry level—with only 53 defaulted transactions reported over the five year period. It is instructive to note that the rate of default on guarantees and standby L/Cs was highest prior to the downturn period, with 80% of total defaults recorded in 2005.

5.4. Using the calculation outlined in paragraph 2.4, the average default rate on standby L/Cs and guarantees over the five year period was 0.010%, with a high of 0.033% and a low of 0.001%.

Recovery Rate

5.5. The observed average recovery rate for the five year period for standby L/Cs and guarantees is 77%, with a 100% recovery rate reported in three of the five years. In contrast, the relatively low

[9] See e.g.: S. Gooptu and M. Martinez (1992) “Factors That Affect Short-Term Commercial Bank Lending to Developing Countries”, World Bank Working Papers.

rate of recovery in 2005 (21.9%) suggests that there is a negative correlation between frequencies of default and recovery rates for these products.

Rate of expiry without payment

5.6. A smaller sample size of 336,526 transactions contains data related to the conversion of guarantees and standby L/Cs from off- to on-balance sheet.[10]

5.7. We observe from this data set that a high proportion of guarantees and standby L/Cs expire without any payment being made. Over the five-year period, the average rate of expiry without payment for these transactions was 86%, with a high of 98% and a low of 71%.

5.8. The lower rates of expiry without payment on guarantees and standbys between 2005 – 2007 is thought to be attributable to: (i) standby L/Cs used as payment instruments; or (ii) guarantees with relatively long tenors which would not expire within the year. The experience of practitioners suggests that the call rate on "standard" performance and financial guarantees would not typically exceed 2 – 3%.

5.9. Moreover, it is noted that even in the event of counterparty default, a standby L/C or guarantee will often not result in an on-balance sheet exposure, with an average non-payment rate after default of 95% between 2005 and 2009. As noted in Annex B, the reason for this is thought to be that performance obligations secured by a guarantee will often be unaffected by a counterparty default (e.g. in a Chapter 11 scenario).

6. Import Loans (Corporate Risk)

6.1. The data pooled under the Register comprises 584,681 import loans (corporate risk) written between 2005 and 2009.

6.2. The average tenor of import loans within the data set is estimated at 115 days. On this basis, it is suggested that there were around 16 "cycles" within this product category through the five-year period 2005 – 2009.

Default rate in the product

6.3. From the data provided, import loans appear to exhibit a higher rate of default as compared with import letters of credit—albeit the aggregate number of defaults observed at an industry-level is relatively low as a proportion of all import loans written (0.035%).

6.4. Using the calculation outlined in paragraph 2.4, the average default rate on import loans to corporates over the five-year period was 0.124%, with a high of 0.292% and a low of 0.056.

Recovery Rate

6.5. The average recovery rate observed over the five year period was 50.3%, with a high of 84.9% and a low of 24.3%. It may be interesting to note that this average recovery rate is higher than that observed for import L/Cs.

7. Import Loans (Bank Risk)

[10] It should be noted that in the data collection exercise, no differentiation was made between performance and financial standbys and guarantees. The latter, as direct credit substitutes, are not classified as off-balance sheet items under the Basel framework. It is thought however that the analysis provided in paragraphs 5.6 – 5.8 has, nevertheless, relevance to the CCF ratios applied to performance obligations.

7.1. The data pooled under the Register comprises 808,671 import loans (bank risk) written between 2005 and 2009.

7.2. The average tenor of import loans within the data set is estimated at 91 days. On this basis, it is suggested that there were around 20 "cycles" within this product category through the five year period 2005 – 2009.

Default rate in the product

7.3. We observe from the data set a very low rate of default on this type of import loan at an industry level—with only 29 defaulted transactions reported over the five-year period. It is particularly instructive to note that no defaults were reported in 2008 and 2009, despite (i) the prevailing economic conditions, and (ii) an overall increase in the number and value of these transactions in these years.

7.4. Using the calculation outlined in paragraph 2.4, the average default rate on import loans over the five-year period was 0.293%, with a high of 1.263% and a low of 0%.

Recovery Rate

7.5. The average recovery rate over the five-year period was relatively high (73.0%), albeit a relatively low recovery rate (18.9%) was observed in 2005 (despite relatively low exposure to written-off transactions in that year).

8. Export Loans (Corporate Risk)

8.1. The data pooled within the Register comprises 877,053 export loans (corporate risk) written between 2005 and 2009.

8.2. The average tenor of export loans within the data set is estimated at 90 days. On this basis, there were around 20 "cycles" within this product category through the five-year period 2005 – 2009.

Default rate in the product

8.3. Export loans (or "pre-export finance") exhibit the highest rate of default of any of the product types covered by the Register, with 630 defaults observed over the five-year period. As with corresponding import loans, however, the aggregate number of defaults observed at an industry-level is very low as a proportion of all pre-export finance transactions (0.072%).

8.4. In addition, it is noted that the rate of defaults was highest prior to the onset of the financial crisis—with only 28 defaults recorded in 2008 and 2009.

8.5. Using the calculation outlined in paragraph 2.4, the average default rate on export loans over the five-year period was 0.168%, with a high of 1.458% and a low of 0.007%.

Recovery Rate

8.6. The average recovery rate on defaulted export loans over the five-year period was 60.7%, with a high of 100% and a low of 12.8%.

9. Export Loans (Bank Risk)

9.1. The data pooled under the Register comprises 752,356 export loans (bank risk) written between 2005 and 2009.

9.2. The average tenor of export loans within the data set is estimated at 256 days. On this basis, there were around 7 "cycles" within this product category through the five-year period 2005 – 2009.

Default rate in the product

9.3. Export loans (bank risk) exhibit a lower rate of default than corporate pre-export financing, with 116 defaults reported over the five year period. Frequencies of default were highest in between 2007 and 2009, with only five defaults recorded in prior years.

9.4. Using the calculation outlined in paragraph 2.4, the average default rate on these export loans over the five year period was 0.023%, with a high of 0.044% and a low of 0.014%.

9.5. As outlined in Annex B, this low rate of default is likely attributable to the fact that the risk of incurring a defaulted exposure on this type of export loan is contingent on a number of factors. Specifically: (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.

Recovery Rate

9.6. The average recovery rate on defaulted export loans (bank risk) was 81.5%—the highest of any of the products covered by the Register—with a low of 45.7% and a high of 101.6%. It is noted that this latter figure may be attributable, in part, to recoveries on transactions written off in prior years.

10. Conclusions and recommendations

10.1. It is our hope that the data set presented in this report provides an initial, "high-level" indication of the risk-profile of trade financing. In this connection, particularly notable features of the data (from a regulatory perspective) include:

i. **short tenor of trade finance transactions**. The average tenor of all products within the data set is 115 days, with all of the off-balance sheet products covered by the Register (import L/Cs; export confirmed L/Cs; standby L/Cs and guarantees) exhibiting average tenors of less than 80 days.

ii. **low defaults across all product types**, with only 1,140 defaults observed within the full data set of 5,223,357 transactions. Default rates for off-balance sheet trade products are especially low—i.e. 110 defaults from a total of 2,392,257 transactions.

iii. **low level of defaults through the downturn period.** Only 445 defaults were recorded in 2008 and 2009, out of a total of over 2.8million transactions written. Indeed, the number of defaults on some products (e.g. import loans, guarantees and standby L/Cs) remained negligible through 2008 – 2009, in spite of prevailing economic conditions and higher transaction volumes.

iv. **good recovery rates for all product types**, albeit often with significant variance year-on-year;

v. **limited credit conversion from of-to on-balance sheet**—*inter alia*, high rates of discrepant documentary presentations (L/Cs), high rates of expiry without payment, and non-payments after default (e.g. standby L/Cs and guarantees).

10.2. Given the overarching economic imperative of promoting international trade as an engine of global economic recovery, it is hoped that the data pooled in the Register will provide a basis

for reviewing considering the risk mitigants inherent to trade instruments and the correlation with credit risk mitigants under the Basel framework. We look forward to discussing the findings of the initial phase of the project—as well as the ways in which the data collection exercise might be refined and expanded going forwards—with the Basel Committee and national regulators in due course.

Annexes

ANNEX A: Data matrix template[11]

Product	Total (aggregate) number of transactions per product type for calendar year	Total cumulative exposure (USD) per product type for calender year	Total (aggregate) number of transactions defaulted per product type for calendar year	Total (aggregate) exposure (USD) that is in default per product type for calender year	Total (aggregate) number of transactions where there was a write-off per product type for calendar year	Total (aggregate) exposure (USD) of transactions written-off per product type for calendar year	Total exposure (USD) per product type as at balance sheet date 31 DEC	Total exposure (USD) that is in default per product type as at balance sheet date 31 DEC	Total recovery (USD) for calendar year	Number of document sets rejected on first presentation for calendar year	Number of transactions that expire without payment for calendar year	Number of transactions that are not "paid" after obligor defaults for calendar year
Export Confirmed L/Cs Sight												
Export Confirmed L/Cs Usance											N/A	N/A
Performance Guarantees and Performance SBDCs												
Performance SBDCs Confirmations												
Loans for Export: Bank risk										N/A	N/A	N/A
Loans for Export: Corporate risk										N/A	N/A	N/A
Import L/Cs issued Sight												
Import L/Cs Issued Usance											N/A	N/A
Loans for Import: Bank risk										N/A	N/A	N/A
Loans for Import: Corporate risk										N/A	N/A	N/A
Shipping Guarantees										N/A		

[11] It is noted that this matrix represents the first attempt by ICC to define a common matrix for the purposes of collecting performance data for trade facilities. ICC is currently working with members to further develop and refine this common template with a view to improving/expanding the data collected in line with regulatory requirements. We would welcome the input of the Basel Committee and/or national regulators into this process.

ANNEX B: Overview of products covered by the ICC-ADB Register

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 LC might never convert to an on-balance sheet exposure even in the event that the importer defaults. If discrepant documents are presented, there is no obligation on the bank to waive the documentary discrepancies and make payment, even if the applicant waives those discrepancies, unless they provide reimbursement or the discrepancies are corrected within the L/C 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 give control on the underlying goods. So, in case the issuing bank accepted the documents but does not feel comfortable with the credit risk on its client/applicant, the bank can withhold the documents and the related goods.

Export confirmed LCs

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 SBDCs

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 similar vein, a standby letter of credit is a type of trade debt guarantee that is only drawn against in the event that the importer defaults in some way—for example, 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 the customer failing to pay monies. 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 loan:

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 specific 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 called themselves "the merchants of peace".

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.

Business leaders and experts drawn from the ICC membership establish the business stance on broad issues of trade and investment policy as well as on vital technical and sectoral subjects. These include financial services, information technologies, telecommunications, marketing ethics, the environment, transportation, competition law and intellectual property, among others.

ICC enjoys a close working relationship with the United Nations and other intergovernmental organizations, including the World Trade Organization and the G8.

ICC was founded in 1919. Today it 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.

International Chamber of Commerce
The world business organization
Policy and Business Practices
38 Cours Albert 1er, 75008 Paris, France
Tel +33 (0)1 49 53 28 28 Fax +33 (0)1 49 53 28 59
E-mail icc@iccwbo.org Website www.iccwbo.org