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Tuesday 12 October, 2010

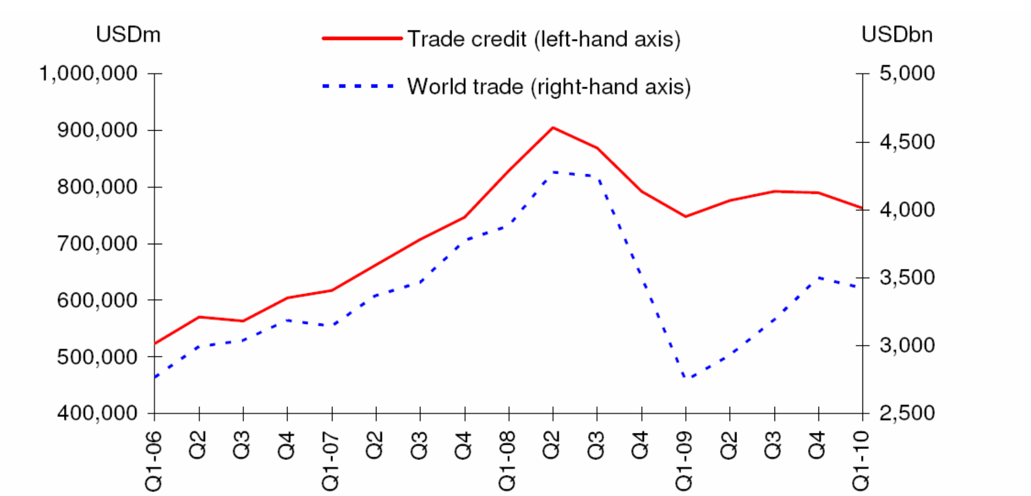
Basel III to limit world trade

The cost of trade finance could increase five-fold as a result of the new Basel III regulations putting a dent in world trade and threatening the export potential of many smaller New Zealand firms. These are the findings from new research by credit reference agency Dun & Bradstreet.

The report says that the new capital ratio buffers introduced as part of the Basel III regulations will apply to traditional trade finance facilities that currently fund around 30 percent of world trade. Basel III defines these facilities, such as Letters of Credit, as off-balance sheet items and will require their risk weighting to increase from 20 to 100 percent, meaning that capital buffers for these asset backed loans will need to increase five-fold.

Dun & Bradstreet expects banks that engage in trade finance to either pass this increased cost onto their customers or divert these funds to other more profitable activities, reducing their trade credit exposure and restricting access to letters of credit. As a result trade financing conditions are likely to deteriorate for most companies, particularly those exporting to emerging markets where letters of credit are the primary means of securing sales and payment. It is feared that this could negatively impact world trade given its heavy reliance on these types of funding facilities.

During the global financial crisis there was a clear correlation between the decline in available trade finance and world trade levels. During 2009 the gap between demand and supply was so wide that the G20 had to step in and provide a USD250 billion package to support trade finance and ultimately world trade.



Trade credit / world trade Q1 2006-Q1 2010

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The news is particularly bad for New Zealand's exporters. More than 90 percent of New Zealand firms employ less than 20 people. Its exporters sell a significant portion of their goods to the Asia-Pacific region and Dun & Bradstreet analysis indicates that more than 80 percent sell less than $10 million worth of goods and services per year.

Dun & Bradstreet believes the impact on trade finance is an unintended consequence of the Basel III reforms and regulators should reconsider their treatment of these off-balance sheet items. While off-balance sheet items have been a source of leverage in recent years, trade bills differ in that they are supported by underlying transactions and identifiable goods that form part of the transaction. For example, letters of credit have underlying collateral and detailed documentation and are traditionally regarded as low risk products.

If the proposals remain it is expected that firms will take on more of this funding role themselves by increasing their exposure to open accounts where customers are permitted to make payment for goods or services at some time after delivery. While such business-to-business trade credit is the largest source of short term funds for most firms around the world creditors are exposed to extra levels of counter-party risk when they provide these credit lines across borders. Dun & Bradstreet's global payment data shows just how significant such counter-party risk can be for New Zealand's exporters.

% of payments made at 30+ days past terms	
Country	**Q1 2010**
Australia	27.7
Bangladesh	21.0
Cambodia	33.2
China	29.9
Fiji	41.7
Hong Kong	20.0
India	27.4
Indonesia	26.5
Japan	14.7
Korea (South)	15.7
Malaysia	40.1
Myanmar	25.7
Nepal	22.1
New Zealand	25.4
Pakistan	22.7
Papua New Guinea	24.7
Philippines	27.1
Singapore	37.2
Sri Lanka	25.5
Taiwan	19.2
Thailand	25.3
Vietnam	27.0

Firms from countries that are major trading partners for New Zealand such as Malaysia and Singapore are paying close to 40 percent of their accounts to overseas suppliers at more than thirty days past due. Other key partners such as China, Thailand and Australia are paying around 30 percent of their accounts delinquently. As a result New Zealand firms exposed to these delinquent payers are already a higher risk than average of experiencing financial distress over the next twelve months.

Dun & Bradstreet New Zealand's General Manager John Scott believes regulators need to be alert to the firm level implication of Basel III in addition to the macro-economic impact.

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"There is no doubt that the Basel III reforms will address real systemic weaknesses that emerged in the global financial system. However, regulators need to be mindful of the implications at the firm level and ensure that unintended consequence don't emerge that could do further harm to the real economy," said Mr Scott.

"Trade finance facilities have not historically been high risk instruments or a source of leverage for banks. Therefore, we need to consider how trade finance will be affected by these new regulations and work to minimise any downside.

"A lack of trade finance contributed significantly to the sharp contraction in world trade during the global financial crisis and we need to ensure we don't create another set of circumstances that weaken the global trading environment."

The impact of these reforms is one factor contributing to Dun & Bradstreet's subdued outlook for world growth. It latest Global Economic & Risk Outlook data advises customers that Dun & Bradstreet expects the global economy to slow progressively throughout the second half of 2010 and into 2011 off the back of slowing world trade, high levels of unemployment and ongoing market volatility. Dun & Bradstreet is forecasting global growth of 3.0 percent in 2010 before slowing to 2.7 percent in 2011. Some of the softest expectations focus on those countries most exposed to world trade.

The Dun & Bradstreet report also argues that the Basel III regulations will see a further shift in market share from smaller to larger banks. While many of the world's biggest banks already meet the Basel III standards most small banks do not and will likely have to cut back on lending in order to increase capital buffers. This could facilitate a further shift in market share to the larger banks. If the big banks chose not to fill this gap then trade finance will deteriorate further. As a consequence many exporters may look to other more expensive products such as overdrafts and factoring to fund their international operations.

For New Zealand firms, particularly exporters, this will require a greater focus on risk management including both country and company risk analysis. In addition to understanding the capacity and propensity of a customer to pay their bills on time, firms will need to consider other issues such as the time it takes to transfer foreign exchange and any government rules that limit such transfers.

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