

3. Relevance of the Global Trade Finance Program

Chapter Highlights

- ❖ The GTFP has been a relevant response to demand for trade finance risk mitigation in emerging markets, although rapid growth in lower-risk markets in recent years raises the need for close monitoring of its additionality in these markets.
- ❖ The GTFP was highly relevant as it was designed and introduced. In its early years it was concentrated among high-risk, low-income countries and in the Africa Region, where access to trade finance was least available.
- ❖ The global financial crisis triggered an expansion in demand and relevance of the program beyond the higher-risk markets in which it was initially concentrated.
- ❖ Since the crisis, the relevance of continued expansion of the program in lower-risk markets is less clear, and there is a need for IFC to strengthen its additionality assessment methodology.

Factors Affecting the Supply of Trade Finance

The relevance of the GTFP lies in its ability to enhance the supply of trade finance without preempting market solutions. IFC's mandate is to support private sector development in member countries without undertaking activities for which sufficient private capital would be available on reasonable terms.¹ Supporting private sector development without competing with private players or undermining viable market solutions – IFC's *additionality* – provides the underlying rationale for IFC's engagement in any activity. The additionality of IFC engagement in trade finance lies in the extent to which it helps enable viable trade transactions that would otherwise not occur because of the inadequate supply of trade finance at reasonable cost. It is this definition of additionality that is applied in this report.

The GTFP is a supply-side intervention that aims to increase the supply of trade finance from international banks to local banks. It aims to enhance the supply of trade finance so that demand in underserved markets can be met. Other than through advisory services programs aimed at importers/exporters to increase awareness of trade finance instruments, the GTFP generally does not seek to influence the demand side of trade finance. Assuming that banking sector intermediation is required for a transaction to take place, there are two levels at which the risk/reward perspective of banks may cause an inadequate supply of trade finance and prevent transactions from happening. First, the local banking sector may be unwilling to extend credit to the local importer/exporter without cash up front or collateral that the local firm may not

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be able to provide. The GTFP does not aim to address this relationship between issuing banks and their local clients, other than by helping increase the overall available volume of trade finance. Second, the issuing bank may not be able to get credit (for example, by getting a letter of credit confirmed) from international banks in the exporter's region. The GTFP aims to influence this second relationship and the perception of risks between banks.

Table 3.1. Factors That May Limit the Supply of Trade Finance

Factor	Reasons	Potential GTFP role
Perceived high credit risk of local importer or exporter by local issuing bank	The local issuing bank's risk/reward perspective may favor large, high-volume, well-established local importers with collateral rather than small, unknown local importers with limited collateral and small volumes.	The GTFP does not directly influence this relationship, other than by helping increase the overall level of trade finance available. Long-term solutions involve improving the competitiveness in the banking system that affects the risk/reward perspective of banks to reach smaller, riskier clients.
Perceived high credit risk of local issuing bank by international confirming bank	The international confirming bank's risk/reward perspective may favor a well-established local bank with strong balance sheets in large markets, rather than smaller, riskier, less well-established local banks in small markets.	The GTFP is among several risk-mitigation instruments that can limit the exposure of international banks to the credit risk of a local issuing bank. Other risk-mitigation instruments include cash collateral, interbank risk sharing, private insurance, export credit agency guarantees, and other DFI trade finance programs. The availability and cost of these other instruments varies substantially across markets. Long-term solutions involve building the reputation, market position, and financial strength of the local bank.
Constraints on the international confirming bank caused by internal factors	Factors affecting an international bank's risk/reward perspective may include its capacity to establish relationships in emerging markets, internal prudential controls and exposure limits, familiarity with the country, capital position, and access to information.	The GTFP can help address some of these internal factors by substituting the payment risk of the issuing bank with IFC's AAA rating, introducing banks to each other, and sharing information. Long-term options include improving the risk/reward perspective of doing business in emerging markets and increased information availability.
Constraints on the international confirming bank caused by external regulations	Prudential regulations, such as Basel III, may govern capital adequacy and leverage ratios that can affect an international confirming bank's risk/reward perspective of doing business in emerging markets.	By substituting the payment risk of the emerging market bank with IFC's AAA rating, the GTFP can help reduce capital costs and improve the risk/reward perspective of international confirming banks.
Perceived high risks in the banking sector of the local issuing bank	Regardless of the standing of individual banks, overall weaknesses in the banking sector in a host country can affect the international confirming bank's risk perspective. These include a poor regulatory environment; poor compliance; capital inadequacy; high nonperforming loans; and high exposure to the sovereign.	GTFP can substitute the payment risk of the emerging market bank with IFC's AAA rating. Long-term solutions include an improved banking sector regulatory environment and compliance and strengthened financial soundness indicators in the system.
Perceived high political and macroeconomic risks in the country of the local issuing bank	An international confirming bank's risk/reward perspective may be affected by political and macroeconomic instability in the developing country that may affect a local institution's ability to honor debt.	GTFP provides a comprehensive guarantee that covers political and commercial risks. Long-term solutions include improved governance and political and macroeconomic stability that reduce perceptions of political and macroeconomic risk.

Source: IEG.

Note: DFI = development finance institution.

There are several scenarios in which international confirming banks may not supply adequate trade finance to issuing banks in emerging markets. Conditions under which the supply of trade finance can be limited include if international confirming banks have no relationship or credit limit with the local issuing bank; if they have reached their exposure limits with the issuing bank or the country of the issuing bank; or if they have risk/reward perspectives that result in trade finance prices that are too high to meet local demand (Table 3.1).

The least risky scenario for an international bank to confirm a letter of credit is to obtain prepayment or cash deposits for the value of the transaction from the issuing bank. However, this may not be competitive or viable. For an international bank to provide trade finance credit it has to take the payment and country risks of the issuing bank. To do so, it will need to establish a relationship with the issuing bank and conduct and maintain due diligence that assesses the creditworthiness and probability of default of the institution based on both institution-specific and country macroeconomic and political risks. It will also need to obtain other information to meet “know-your-customer,” anti-money-laundering, and other due diligence requirements. Based on its due diligence, it will then establish a credit line that sets a limit up to which it is willing to be exposed to that bank. The confirming bank will then provide credit, including confirming letters of credit, up to this limit.

Several risk-mitigation options may exist once a confirming bank reaches its exposure limits on an institution or country. If the prudential limit on a line of credit is reached, if a confirming bank’s overall exposure limit in a country is reached, or if a confirming bank is otherwise unwilling to take the payment risk of an issuing bank, then it will not assume exposure to the local bank without some form of risk mitigation. The availability of the different risk-mitigation options varies significantly from market to market. Depending on the availability of instruments in each market, the international confirming bank can do any of the following:

- *Refuse the transaction.* This is likely only if no viable risk-mitigation options exist at all. In general, confirming banks will seek to somehow accept the transaction, including by charging fees that are commensurate with the risks. Banks that follow their corporate clients may seek to somehow enable the transaction in order to serve their clients. However, banks that deleverage and reducing their trade finance portfolios might refuse transactions regardless of the risk-mitigation opportunities. In the event of a refusal by a confirming bank, the issuing bank can seek confirmation from another confirming bank that it may have a clean line with or that is willing to employ a form of risk mitigation.
- *Ask the issuing bank to prepay or deposit cash collateral for the value of the transaction.* This option may be viable for issuing banks in liquid positions, where the opportunity cost of deploying cash in other income-earning

instruments is low. This option might be less viable in the case of illiquid issuing banks or those with inadequate foreign currency reserves, where the opportunity costs are high. In such cases, a confirming bank requesting cash collateral from the issuing bank may make the transaction commercially unviable. If cash security from the issuing bank is obtained, the trade transaction has minimal risk for the confirming bank.

- *Share the transaction with another confirming bank.* A main form of risk mitigation is for a bank to go through another confirming bank that has adequate room on its credit line. A bank can also sell part of its trade finance exposure in an emerging market transaction, institution, or country to other banks. The applicability and availability of the interbank risk-sharing market is subject to the risk perspectives and exposures of other confirming banks. The market is reported to be less available for riskier institutions and countries following the global financial crisis.
- *Obtain private insurance against the value of the transaction.* Private insurers such as Lloyds of London can provide cover against default on a transaction. Limitations of private insurance are that only some, usually less-risky, markets are covered; private insurers will not insure the full amount of the transaction; or the confirming bank now bears the risk of the insurance company.
- *Obtain insurance from an export credit agency or other government agency.* Insurance from an export credit agency is a public sector solution. Limitations of insurance from these agencies include (i) coverage only of exports originating out of their country, (ii) a focus on medium to longer-term transactions, and (iii) slow and cumbersome processing that can take weeks to get approved.
- *Obtain a trade finance guarantee from a development finance institution.* Multilateral development bank (MDB) providers of trade finance insurance include IFC, EBRD, the African Development Bank, the Inter-American Development Bank, the Asian Development Bank, and the Islamic Development Bank. Once a guarantee is obtained, then the confirming bank bears the payment risk of the MDB.

A range of internal factors can influence a confirming bank's exposure limits and use of risk-mitigation instruments. A bank's prudential framework will guide its exposure limits to each country and institution as well its use of risk-mitigation instruments, each of which has particular capital allocation and cost implications. Other factors include the bank's prior experience and activity in the country; lack of familiarity with institutions outside its core countries of business; availability of information; and the resources available to conduct due diligence. High due diligence costs can make commencing and continuing business with small emerging market banks unprofitable. The trade finance line of the bank may also be competing with its other business lines to use country and institution exposure limits.

Banks that aim to provide full service to their major corporate customers will be driven by the nature and presence of their client businesses, whereas other banks engaged in trade finance as a self-standing line of business will have a different approach. The establishment of an initial line might be based on the overall low risk of trade finance, but confirming banks might see the risk/reward ratio of a transaction as too high because of factors such as the inability to calculate risks, difficulty in obtaining information, small markets, high due diligence costs, and perceived high country political and macroeconomic risks.

Country and specific institutional factors are important determinants of the size of credit lines and availability of risk-mitigation instruments (see Figure 3.1). Factors determining the availability and size of clean credit lines from confirming banks as well as the applicability of alternate risk-mitigation instruments include (i) the political and macroeconomic risks in the country – or likelihood that adverse government policies and actions will lead to a payment default; (ii) the state of the banking sector in the country: if the banking sector is well regulated, has depth, is diversified, and most banks have strong balance sheets, these factors mitigate against a default; and (iii) factors particular to that institution – the institution’s market position, management quality, or financial health.

These factors may be long standing (that is, in politically unstable countries or countries with undeveloped financial systems) or short term, such as countries in a temporary political or financial crisis. Such crises can be the result of causes within a country or region, or global reasons, or a combination of these factors. When risks are high or increase, international banks will contain or reduce their exposure limits. In these situations, there is also less likelihood that viable market-based risk-mitigation instruments will be available. Private insurance and interbank risk-sharing mechanisms are less available in high political risk countries, in countries that may have fundamentally weak banking systems, in countries in crisis, or in smaller countries where the limited volumes generated might not justify the costs of due diligence involved.

The regulatory environment is also a key factor behind a confirming bank’s risk appetite. The establishment of credit limits and the availability of risk-mitigation instruments are also affected by the national or international prudential regulatory environments for confirming banks. Basel II guidelines that set international prudential standards for banks in 2004–11 established risk-weighted capital adequacy norms that influenced the trade finance risk appetite, credit exposures, and pricing by international commercial banks in riskier emerging markets. Since 2011, higher risk-weighted capital adequacy ratios and leverage ratios (unweighted by risk) are being phased in under Basel III. The new requirements are expected to further the deleveraging process among some European banks that is occurring to offset capital erosion caused by the sovereign debt crisis in Europe.

Figure 3.1. IFC Additionality in Providing Risk Mitigation under the GTFP

↑ Low Risk = Financial Institution Risk = High Risk ↓	IFC additionality, where alternate risk-mitigation instruments are not available	Highest IFC additionality
	<ul style="list-style-type: none"> • Stable country with lower political and macroeconomic risks • Higher risk institution (smaller, lower-tier, newly established institution) • Some alternate risk-mitigation instruments available • More likelihood of knowledge gaps; prohibitive due diligence costs/expected volume; need for introductions 	<ul style="list-style-type: none"> • Risky country and risky issuing bank • Confirming banks will generally have restricted exposure limits and higher pricing because of higher capital provisioning requirements • Alternate risk-mitigation instruments such as private insurance; risk sharing will be less available • Local issuing banks generate volume larger than prudential limits • IFC takes a higher degree of risk
	Lowest IFC additionality	IFC additionality, where alternate risk-mitigation instruments are not available
	<ul style="list-style-type: none"> • Safest countries and issuing banks • Confirming banks will generally have higher exposure limits • Greater availability of risk-mitigation instruments • Possibility of regulatory arbitrage • IFC takes a lower degree of risk 	<ul style="list-style-type: none"> • Higher country political and macroeconomic risks • Less risky financial institution (that is, top-tier, well-established, financially strong) • Some alternate risk-mitigation instruments available
← Low Risk = Emerging Market Country Risk = High Risk →		

Source: IEG.

IFC has developed a preliminary framework for assessing additionality using a matrix of country and institutional indicators. In a 2012 internal report to the Board, IFC described its ongoing work on developing an additionality matrix that proposes to measure the additionality of trade finance operations based on both institutional and country factors. Its matrix proposes to categorize the “market position” of issuing banks as well as the “trade finance risk” of the country. To measure the market position of the participating institution, the client banks will be classified based on factors such as the number of correspondent banks in their network, the market share the bank, and clean lines available. To measure the trade finance risk in the country, the proposal aims to gauge the risk of private bank default on trade obligations as well as the risk that a country’s government would fail to support trade obligations in the event of a private bank default. Additionality would then be

measured based on the degree of maturity and market position of the issuing bank, as well as the trade finance risk in the country.

IEG's framework adopts a similar logic but uses basic indicators of country and institution risk that are presently available. As IFC's matrix and indicators are further refined and developed, they are likely to provide a more detailed measure of the program's additionality.

Table 3.2. Changes in the Use of GTFP, 2006–12

	FY06	FY07	FY08	FY09	FY10	FY11	FY12	All years FY06–12
Volume of guarantees issued (\$ millions)	265	770	1,448	2,376	3,462	4,623	5,975	18,919
Share of GTFP in LICs (%)	74	53	47	43	19	10	8	21
Share of issuing banks in LICs (%)	63	46	53	45	28	24	20	34
Share of GTFP in IDA and blend countries (%)	75	53	51	51	51	53	48	51
Share of issuing banks in IDA and blend countries (%)	68	56	66	58	57	59	59	57
Share of GTFP in high-risk countries (above 75) (%)	74	57	33	33	28	28	24	29
Share of issuing banks in high-risk countries (IFC) (%)	63	40	34	52	53	48	42	52
Share of volume in Africa (%)	70	49	41	27	22	20	22	25
Share of issuing banks in Africa (%)	47	26	29	26	25	23	26	25

Source: IEG, based on IFC data.

Additionality of the GTFP

The GTFP was a relevant response to market demand for trade finance risk mitigation and it was concentrated in high-risk, low-income countries in its early years. When the GTFP was approved by the Board in FY05, global financial markets were highly liquid and there were low expectations of volatility (IMF 2005a, 2005b, 2006). Low global credit spreads along with improved policy environments and improving resilience in domestic banking systems in many emerging markets were encouraging international investors to move out along the risk spectrum with greater appetite and favorable credit terms to emerging markets. Demand for additional risk-mitigation instruments was in the highest risk markets. The GTFP addressed numerous weaknesses in IFC's past efforts to support trade finance. Its flexibility, quick response mechanisms, and foundation on IFC's global network of partner banks placed it in a position to meet this demand.

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In the first years of the program, guarantees were mainly issued in the highest risk markets. In FY06–08, 45 percent of GTFP volume was in high-risk countries (using IFC’s country risk rating); 52 percent was in LICs; and 47 percent in the Africa Region (Table 3.3). It was also used in countries that were experiencing temporary crises that had increased risk aversion among confirming banks. This was the case, for example, in Lebanon following political instability in 2006–07, in Kenya following the elections in 2007, and in Pakistan following political uncertainty and economic instability after 2007.

During the global economic crisis, the GTFP offered a viable risk-mitigation instrument with relevance in significantly broader markets. By mid-2008, global credit markets had tightened sharply, precipitated by the U.S. subprime mortgage crisis. The deterioration in credit quality reduced liquidity and increased uncertainty, widened credit spreads, and triggered a broad deleveraging process and retrenchment from riskier markets (IMF 2008a, 2008b, 2009a). In late 2008, with the collapse of several major global financial institutions, credit markets briefly froze.

The high level of uncertainty abated shortly thereafter and credit markets resumed, although with a higher degree of risk aversion. The crisis also affected the availability of risk-mitigation instruments, including private credit insurance and interbank risk sharing. The GTFP saw a temporary drop in demand, mirroring the lack of activity among major international banks in early late 2008. There then ensued strong, broader-based demand for the GTFP and other MDB trade finance programs for coverage even among more credit-worthy banks in countries with lower political risk. This demand was to some extent driven by increased caution and more stringent prudential regulations among international banks rather than temporary crises or underlying weaknesses in some developing countries.

Table 3.3. GTFP Use by Country and Issuing Bank Risk Ratings by Region, 2006–12

Region	Share in high-risk countries (75+) (%)	Share in high-risk banks (4B and higher) (%)	Share in both high-risk banks and high-risk countries (%)
Africa	23	9	5
East Asia and Pacific	0	33	0
Europe and Central Asia	21	12	8
Latin America and the Caribbean	23	5	5
Middle East and North Africa	88	29	28
South Asia	5	16	1

Source: IEG, based on IFC data.

Note: “Country risk” is based on IFC’s country risk rating and “institution risk” is based on IFC’s credit risk rating for each client bank. The composition of the credit risk rating is such that it includes an element of country risk, and therefore there is some overlap in the two indicators. IFC is developing indicators to measure the maturity and market position of the issuing bank as well as the “trade finance risk” in the country. The country risk rating scale is from 0 to 100, with 100 being the highest risk. The bank credit risk rating scale is, from lowest to highest risk: 2A, 2B, 3A, 3B, 4A, 4B, 5A, 5B, 6.

The supply of trade finance recovered in 2010, although with continued risk aversion in difficult markets. By mid-2010, the immediate adverse effects of the crisis on trade finance had abated (ICC 2011). Some commercial banks active in the Africa Region reported increased liquidity and noted that “supply of trade finance was not the problem” but that demand was lower because of a drop in trade volumes and that trade finance prices were dropping (Turner, Mokaddem, and Ben Ahmed 2010). In 2011–12, the European sovereign debt crisis worsened, however, affecting European-based banks that were traditionally major players in trade finance. A deleveraging process was initiated by these banks to improve their capital positions and enable them to comply with the new Basel III regulations. At the same time, U.S.- and Asian-based banks began to increase their trade finance activities, although whether they will fill the gaps left by European banks remains to be seen.

Since 2010, GTFP use has increased in high-risk markets, but its continued relevance in some lower-risk markets is less clear. The proportion of GTFP use in *high-risk banks in high-risk countries* increased from 3.5 percent of the program volume in 2006–08 to 9 percent in 2009–12 (Table 3.4). However, the proportion of the program volume in *low-risk banks in low-risk countries* rose from 10 percent in 2006–08 to 21 percent in 2009–12 (Table 3.4). With the broader demand for the program after the onset of the crisis, the GTFP was no longer “focused” on high-risk, low-income, Africa Region countries.

Table 3.4. GTFP Guarantees by Country and Issuing Bank Risk (percent of total GTFP volume)

Country risk	2006	2007	2008	2006-08	2009	2010	2011	2012	2009-12	Total
High Risk (>75)	74	57	33	45	33	28	28	24	27	29
High-risk banks (4B, 5A, 5B, 6)	6	3	3	4	8	9	8	10	9	8
Moderate-risk banks (4A)	1	9	14	11	16	13	14	6	11	11
Low-risk banks (2A, 2B, 3A, 3B)	31	39	15	24	8	6	5	5	6	8
Unrated	37	6	1	6	1	1	0	2	1	2
Medium Risk (55–70)	26	42	49	44	45	45	49	53	49	48
High-risk banks (4B, 5A, 5B, 6)	0	1	1	1	5	4	8	7	6	6
Moderate-risk banks (4A)	0	2	2	2	10	17	12	14	13	12
Low-risk banks (2A, 2B, 3A, 3B)	17	29	43	36	29	23	29	28	27	28
Unrated	9	10	4	6	2	1	1	4	2	3
Low Risk (< 50)	0	1	18	11	22	27	23	24	24	22
High-risk banks (4B, 5A, 5B, 6)	0	0	0	0	0	0	0	0	0	0
Moderate-risk banks (4A)	0	0	0	0	0	1	0	0	0	0
Low-risk banks (2A, 2B, 3A, 3B)	0	1	17	10	21	26	21	19	21	20
Unrated	0	0	0	0	1	0	1	5	2	2
Total	100	100	100	100	100	100	100	100	100	100

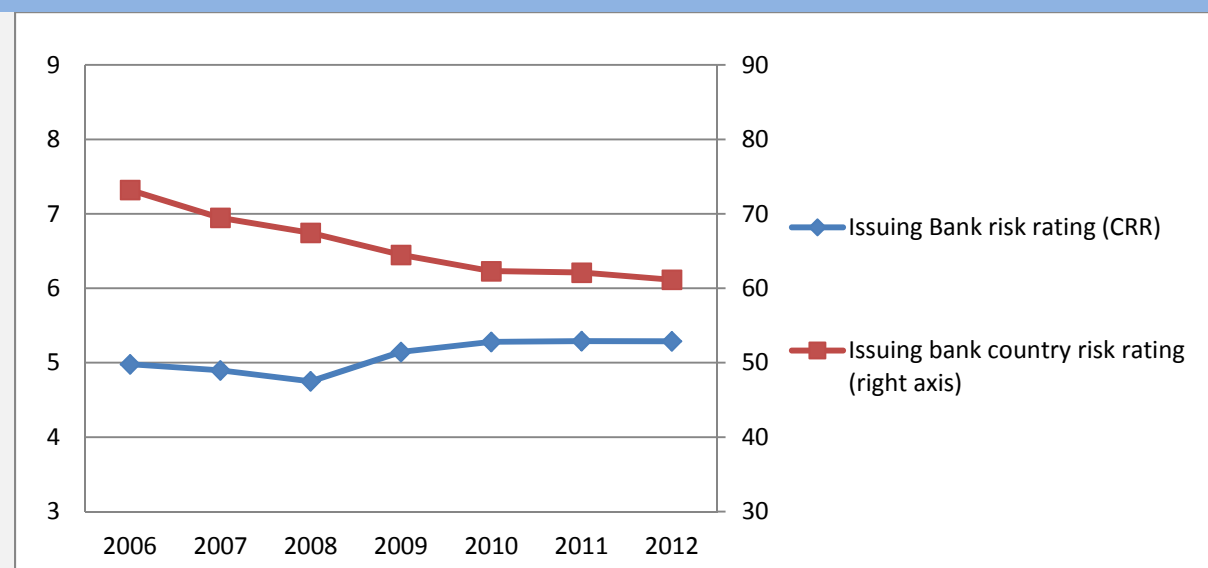
Source: IEG, based on IFC data.

Note: The country risk rating scale is from 0 to 100, with 100 being the highest risk countries. The bank credit risk rating scale, from lowest to highest risk: 2A, 2B, 3A, 3B, 4A, 4B, 5A, 5B, 6.

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In 2009–12, the share of guarantees in high-risk countries was 27 percent (from 45 percent in 2006–08); 16 percent in LICs (from 52 percent); and 22 percent in Africa (from 47 percent). Figure 3.2 illustrates the trend in the risk profile of the GTFP by country and bank risk. The trend suggests a decline in country risk profile with a modest increase in bank risk profile (Table 3.4). However, an analysis of new banks added into the program suggests that both country and bank risk levels have declined over time. Although GTFP started as a facility designed to facilitate trade in opaque financial systems in risky countries, it has increasingly generated new business in less risky country and bank settings. The absence of a method to assess additionality (that is currently being developed) inhibits a clear determination of GTFP’s relevance and additionality in some of these markets.

Figure 3.2. Average GTFP Country and Issuing Bank Risk Levels, FY06-12 (volume weighted)



Source: IEG, based on IFC data.

Note: Issuing bank rating 3 = lowest risk; 9 = highest risk. Country risk rating: 30 = lowest risk; 90 = highest risk.

Case studies point to high GTFP additionality in small, high-risk, crisis-affected countries. It is difficult to establish additionality for each trade transaction given limited information on the availability of alternate risk-mitigation instruments and their price, limitations, and suitability in any given point in time. However, IEG case studies in Côte D’Ivoire, Liberia, and the Democratic Republic of the Congo and interviews with international confirming banks indicated that the GTFP had high additionality in these countries. Each was a conflict-affected country with weak banking systems that affected perceptions of risk and the availability of trade finance and risk-mitigation options. Both GTFP and non-GTFP issuing banks in these countries indicated that they had to put up cash collateral for most trade transactions.

The small volumes and perceptions of high country and banking sector risk discouraged large lines of credit from international trade banks and made few risk-mitigation instruments available other than cash collateral. An international confirming bank indicated that it needs to spend \$50,000 a year per issuing bank in such countries to maintain its due diligence. The infrequent and small volumes generated in these countries made maintenance of the relationship and credit lines unviable. Large confirming banks interviewed by IEG also indicated that the GTFP “made a difference” to them in the more risky markets, but in safer markets, they were more able to find an alternative to make the transaction happen.

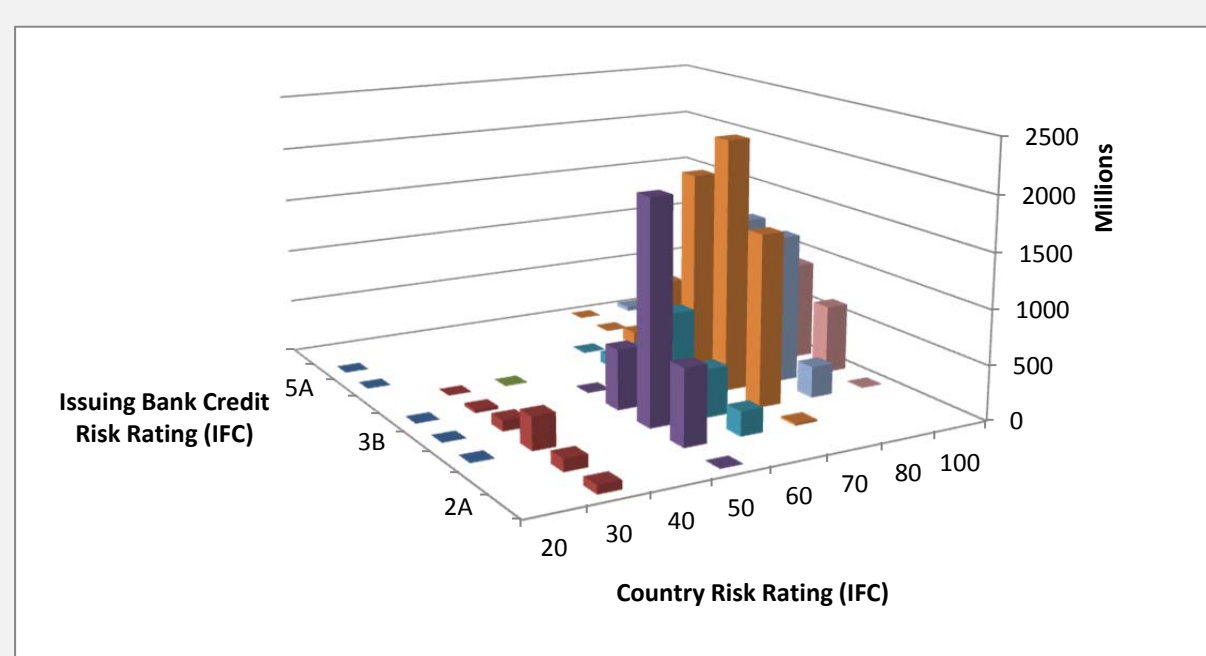
GTFP has also had high additionality in larger countries that have fundamentally weak banking systems or long-standing country risks, particularly by targeting lower-tier institutions. Vietnam has dominated the share of GTFP in the East Asia and Pacific Region, representing about 60 percent of total volume in the region since 2006. Its banking sector has been consistently perceived as relatively high risk because of overly rapid credit growth in the mid-2000s, the uncertain quality of loans, and weaknesses in banking sector regulation and supervision of the financial sector. The banking sector has seen increasing stress in 2012, with low liquidity, volatile funding sources, and the 2012 arrest of several high-level banking executives.² In Pakistan, which is the largest GTFP user country in the Middle East and North Africa Region, the banking sector has been perceived as high risk because of high levels of nonperforming loans, concerns over political interference in loan recovery, and political and macroeconomic instability.

Case studies indicated a concentration of GTFP activity in less-risky, top-tier banks in some countries (see Figure 3.3).³ Lebanon has consistently been rated as a high-risk country. At the same time, however, its banking sector was not significantly affected by the global financial crisis, and since 2008, it has seen substantial growth and profitability.⁴ Five of the six GTFP issuing banks are top-tier (“alpha”) banks that accounted for 98 percent of the GTFP volume in Lebanon.⁵ These banks are the largest, most liquid, highest capitalized banks in the country and have well-established trade finance businesses and long-standing relationships with international confirming banks around the world. In Nigeria, which is a medium-risk country, GTFP is concentrated in low-risk banks, which accounted for 94 percent of the volume in the country in FY06–12. Moreover, a significant proportion of the volume was driven by two confirming banks that used the GTFP to confirm letters of credit issued by their own parent companies.

Participating banks indicated that they generally did not use the program for transactions that they would conduct anyway. A key underlying criterion for IFC additionality is whether the trade transaction would not have happened without the IFC intervention. In a survey of GTFP participating banks conducted by IEG, 56 percent of issuing banks and 71 percent of confirming banks indicated that they had

not used the program for transactions that they would have done anyway. In many cases, it is likely that a GTFP guarantee was needed for the transaction to take place, as alternative risk-mitigation instruments were not available, particularly in the higher-risk markets. A confluence of various factors needs to be present that eliminates all other possible options, and this is often the case in higher risk markets. Given the nature of the instrument, however, it is very difficult to establish with certainty if any particular trade transaction would or would not have taken place without the GTFP.

Figure 3.3. GTFP Guarantee Volume by Country and Issuing Bank Credit Risk Ratings, 2006–12



Source: IEG, based on IFC data.

Under some circumstances, transactions are more likely to have taken place without the GTFP. In IEG’s survey of participating banks, 44 percent of issuing banks (accounting for 17 percent of GTFP commitments since 2006) and 20 percent of confirming banks (5 percent of commitments) indicated that they have used the GTFP for transactions that they would have done anyway.⁶ IEG interviews indicated some circumstances under which transactions would likely have happened anyway. For example, confirming banks that follow their corporate customers and aim to meet all their needs indicated that they would somehow find a way to make a transaction happen, including by going through other banks.

Well-established local issuing banks in countries such as Nigeria, Lebanon, and Pakistan also indicated that they would somehow make a transaction happen for their well-established customers, although at possible higher cost. Large importers,

such traders in oil and other commodities, were also more likely to find an alternate source of finance or put cash up to make a transaction happen.

IFC's pricing is an important tool to help ensure additionality. Given the difficulties in measuring additionality for each transaction, along with the potential ability of the program to crowd out existing market solutions, IFC's pricing is an important tool to help ensure additionality. The aim is to price guarantees at levels that do not undermine the use of other available risk-mitigation instruments but that still make the transaction commercially viable. At present, GTFP guarantees are priced by regional trade officers on an individual transaction basis at "market." This is done by checking with issuing and confirming banks on what price they would offer/pay for such a transaction on a clean (unsecured) basis. IFC's pricing will then be set at a slightly lower price than what the issuing bank would pay the confirming bank for a clean transaction, in order to provide the confirming bank with a margin. The final price to the issuing bank is therefore the same as if it were a clean line.

Pricing is correlated with size, country risk, and institutional risk. A regression analysis of GTFP data estimated the impact of four factors on the pricing of letters of credit guarantees: tenor (in months), amount (in millions of dollars), country risk (IFC rating), and credit risk rating (measured as part of the quarterly portfolio review process). Of the four factors, three were estimated to have a statistically significant impact on price: amount, country risk, and credit risk. The relationship between transaction tenor and price was not statistically established. The transaction amount was found to have a significantly negative impact on pricing: larger transactions are charged lower prices. Both measures of risk—country and credit—were shown to have a positive impact on prices: more risky countries and issuing banks are charged higher prices. The results suggest that a \$10 million increase in transaction size would lower the price by 30 basis points. Conversely, an increase in the country risk score of 10 points (on a 100-point scale) would increase the price by 10 basis points. A deterioration of the credit risk rating of an issuing bank by a single notch (from, say, 3A to 3B) would increase the price of the guarantee by 13 basis points.

GTFP prices have varied considerably across markets. Pricing has averaged 1.5 percent over the life of the program, with considerable variation by region, product, country income group, country risk, and institution risk. For example, guarantee pricing averaged 2.4 percent in South Asia and 1.9 percent in Europe and Central Asia, compared with 1.1 percent in the East Asia and Pacific and Latin America and the Caribbean Regions (see Table 3.5). In China and India, GTFP pricing averaged 0.7 percent and 0.9 percent, respectively, indicating the availability of lower-priced trade finance in these countries. Pricing of guarantees under GTFP has been highest in the Africa Region among LICs and among high-risk countries. The average price was 1 percent in low-risk countries, compared with 1.7 percent in high-risk

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countries. By institution, the average price for a safe 2A-rated bank was 0.7 percent, compared with higher than 2 percent for more risky 5A/5B banks.

Table 3.5. Pricing of GTFP Guarantees, FY06–12 (volume-weighted annual average, percent)

	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY06–12
All GTFP	1.9	1.6	1.3	1.7	1.7	1.4	1.4	1.5
Region								
East Asia and Pacific		3.3	0.9	1.3	1.3	1.0	1.2	1.1
Latin America and the Caribbean	0.7	0.8	0.9	1.5	1.0	1.0	1.3	1.1
Africa	2.2	2.0	1.7	1.6	1.7	1.6	1.5	1.6
Middle East and North Africa	0.9	1.2	1.0	1.8	2.3	1.8	1.4	1.7
Europe and Central Asia	2.5	2.0	1.8	2.5	2.5	1.8	1.5	1.9
South Asia	2.2	2.1	2.3	2.5	2.5	2.5	2.2	2.4
Country risk (IFC)								
Low Risk (< 50)		0.8	0.9	1.4	0.8	0.8	1.1	1.0
Medium Risk (55-70)	1.3	1.4	1.6	1.8	1.9	1.5	1.5	1.6
High Risk (>75)	2.2	1.7	1.1	1.8	2.1	1.8	1.6	1.7
Bank credit risk rating (IFC)								
2A				0.6	0.9	0.6		0.7
2B		0.7	0.9	1.2	0.7	0.6	0.9	0.8
3A	1.5	1.8	1.6	1.7	1.1	1.2	1.2	1.3
3B	2.2	1.7	1.3	1.6	1.9	1.5	1.5	1.6
4A	1.5	1.0	1.0	1.9	2.0	1.7	1.6	1.7
4B	2.3	1.2	1.8	1.6	1.8	1.4	1.4	1.5
5A			1.1	2.7	2.5	2.1	1.8	2.1
5B		1.2	2.1	2.7	2.3	1.7	1.7	2.0
6				1.6	2.1	1.6	1.8	1.7
GTFP product								
Pre export finance	0.7	0.7	0.8	1.5	0.9	1.0	1.3	1.1
Pre import finance		1.3	1.2	1.3	1.3	1.0	1.3	1.2
Letter of credit	2.2	1.8	1.5	1.8	2.0	1.8	1.5	1.7
Performance guarantee	3.0		1.4	2.3	1.4	2.9	1.4	1.9
Country income group (issuing bank)								
High Income		0.8	0.8	1.0	1.0	1.0	0.9	1.0
Upper middle Income	1.7	1.2	1.0	1.6	1.3	1.2	1.2	1.2
Lower middle Income	0.7	0.9	1.6	1.7	2.1	1.5	1.5	1.6
Low Income	2.2	2.0	1.6	1.9	1.6	1.9	1.9	1.8

Source: IEG, based on IFC data.

Note: The country risk rating scale is from 0 to 100, with 100 being the highest risk countries. Bank credit risk rating scale, from lowest to highest risk: 2A, 2B, 3A, 3B, 4A, 4B, 5A, 5B, 6.

Further efforts to support optimal pricing can help ensure additionality. Feedback from IEG's survey and interviews indicates that IFC's prices were largely aligned with market prices. Among participating banks surveyed, 82 percent of confirming banks and 52 percent of issuing banks indicated that GTFP pricing was around the market average. However, pricing each individual transaction involves some subjectivity, and the process is not fully transparent. The main concern is that in an opaque market, it may not be clear if IFC is providing a service to help ensure that a trade transaction takes place or is offering a more competitive option for trades that would happen anyway and therefore crowding out market solutions.

In IEG's survey of participating GTFP banks, 18 percent of confirming banks and 18 percent of issuing banks indicated that IFC's pricing was below market average. IFC currently has regional volume targets that encourage achieving certain volumes in each region but does not have parallel revenue or return on capital targets. This may create some tension between the dual objectives of meeting volume targets and ensuring pricing that will not crowd out viable existing options. Additional efforts to ensure optimal pricing may therefore be warranted. Although an emphasis on ensuring the highest pricing that markets can absorb may have a trade-off in terms of volume, it can help ensure the GTFP's continued additionality and its concentration in the most relevant markets.

Summary

- The GTFP is a supply-side intervention that aims to influence the relationship between international and local banks. It does not directly address the relationship between issuing banks and their local clients. IFC aims to choose member banks, in part based on their SME client base.
- Alternate risk-mitigation instruments to the GTFP may or may not exist in each market and include prepayment or cash deposits from issuing banks for value of the transaction; interbank risk sharing; private insurance; and insurance from an export credit agency. The availability of these instruments varies considerably across markets.
- The GTFP program was a relevant response to demand for trade finance risk mitigation in risky markets. In its early years, it was concentrated in high-risk, low-income countries, particularly in Africa. During the global economic crisis, the GTFP offered a viable risk-mitigation instrument with relevance in significantly broader markets.
- In the years since the 2008 global financial crisis, the GTFP has increased its presence in higher-risk markets but also maintained a significant presence in

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lower-risk markets, raising a need for close monitoring of its additionality in these markets.

- Pricing is an important tool to help ensure additionality. IFC's pricing process has ensured that its prices are largely aligned with markets.
- IFC has internal regional volume targets but not revenue targets that may create some tension between the dual objectives of meeting volume targets and ensuring pricing levels that will not crowd out viable existing instruments.

NOTES

¹ See IFC, *Articles of Agreement*, Article III: Operations (as amended through June 27, 2012).

² Economist Intelligence Unit. Vietnam's banking sector has consistently received a CCC rating since 2008 from EIU Financial Services. Definition of a CCC rating: "Questionable capacity and commitment to honoring obligations. Patchy payment record."

³ Although the terms *first tier* and *second tier* are often used to justify GTFP activity, IFC does not apply a formal definition of the tier of a bank in a country and does not have a database that systematically tracks this across countries.

⁴ Economist Intelligence Unit, World Bank.

⁵ Data and classification of banks in Lebanon is from the Lebanon Banker's Association.

⁶ On September 5, 2012, IEG sent surveys to 217 issuing banks and 237 confirming banks in IFC's GTFP network, of which 76 issuing banks (35 percent) and 40 confirming banks (17 percent) responded. The response rates for active banks (those that used the program more than 10 times in the last 6 years) were 22 percent for confirming banks and 35 percent for issuing banks. The issuing banks that responded account for 37 percent of the GTFP total since 2006; the confirming banks that responded account for 45 percent.