MENA Trade Finance

- What is trade finance?
- Why is trade finance important?
- What are the instruments used in trade finance?
- What are the recent developments in trade finance?
- How big is the trade finance opportunity?
- What is the potential for trade finance in MENA?
- What is Islamic trade finance?
- Who are the major/top players in MENA trade finance?
- What are the challenges facing the trade finance market?
- How Basel III impacts trade finance in the MENA region?

EXECUTIVE SUMMARY

Trade has long been recognized as an important tool for economic growth. Trade enhances a country's access to goods, services, technology, and even knowledge, among others. It fosters entrepreneurial activity, thereby creating jobs and demand for credit or trade finance.

Access to trade finance is crucial for every country. It helps in the exchange of goods and services in the international market. According to the World Trade Organization (WTO), trade finance supports nearly 90% of global trade, making it vital to economic prosperity. The importance of trade finance was clearly demonstrated during the economic crisis of 2008–09, when the global credit crunch magnified the slowdown in exports. The value of world merchandise trade declined 22.3% to USD12.5 trillion in 2009 from USD16.1 trillion in 2008.

Trade finance is a specialized area of finance that deals with short-term financing of import and export transactions. It covers a wide spectrum of payment arrangements between importers and exporters. Products available include letters of credit (L/Cs), import financing, guarantees, L/C confirmation, pre-shipment export financing, invoice financing, and documentary collections. Regardless of the term involved, trade finance fundamentally comprises four aspects: payment facilitation, financing, risk mitigation, and provision of information about the status of payments or shipments. Opportunities in trade finance are large and growing. International management consulting firm Oliver Wyman projects the global trade finance market to be worth USD38 billion (by revenue) by 2015.

Traditionally, only major banks, international financial institutions and government agencies provided trade finance. This, however, has now expanded to include several other banks and financial institutions. Global Finance magazine listed Citibank, BNP Paribas, UniCredit, Arab Bank, SEB, HSBC and Standard Bank as the world’s best trade finance banks in 2012. Similarly, Arab Bank, Emirates NBD and QNB Bank were listed among the best trade finance banks in the MENA region by the same magazine.

European banks, the dominant forces in the trade finance market, are pulling back from assisting companies in international trade. Hurt by the Eurozone crisis, stricter capital norms and low reserves of US dollars, European banks are busy cleaning up their loan books, making way for competitors to gain foothold in the trade finance market. Banks such as HSBC, Standard Chartered, JP Morgan, Citigroup, Wells Fargo, Sumitomo Mitsui and Mitsubishi UFJ Financial are actively pursuing this opportunity to capture the void left by European banks, notably French ones. A few days back, Citigroup launched a commodity trade finance business to capitalize on the deleveraging by European lenders such as BNP Paribas, Société Générale and Crédit Agricole.

According to a study by HSBC, trade in the MENA region is expected to grow 131% over 2012-2026, faster than global trade, which is estimated to increase 86% over the same period. It is assumed that growth in trade in the MENA region would be largely driven by hydrocarbons, while the US, China and India would be its major partners. However, HSBC believes that the MENA region should not be viewed as a pure hydrocarbon story while considering long-term trade. The study reveals that the MENA region’s initiatives to diversify from hydrocarbons are likely to boost growth in several sectors. These include commodities (such as iron ore, lead, rice and wheat), for which the region is increasingly being used as a trade route; infrastructure (iron and steel products, among others, that are required for construction); fertilizers; and electronic products such as integrated circuitry. Furthermore, Oman, Libya

and Qatar are likely to emerge as key trade partners within the region, while Malta, Poland and Brazil would be its major partners in the international market.

On the other hand, implementation of Basel III rules could take some wind off the trade finance business, despite the fact that banks in MENA/GCC (known to be generally conservative and well-capitalized) are better placed than many of their international counterparts to achieve a timely transition to the new regulatory environment. The new rules require banks to maintain higher capital reserve against trade finance deals. The proposed leverage ratio requires banks to set aside 100% of capital for any off-balance sheet trade finance instruments, such as L/Cs, which is five times more than the 20% credit conversion ratio used for trade finance in Basel II. An informal survey by BAFT-IFSA revealed that Basel III may raise trade finance costs by 18–40%, making it less profitable.

Given the turmoil in Europe, slowing economic growth in China and International Monetary Fund (IMF)'s warning about a global slowdown, the near-term outlook for trade finance appears gloomy. A research conducted jointly by the International Chamber of Commerce (ICC) and the IMF earlier this year also showed a pessimistic outlook for trade finance products. However, on a positive note, confidence among exporters and importers has not deteriorated. HSBC's Trade Confidence Index, a semi-annual survey of exporters and importers in 20 countries, stood at 113 in June 2012. A reading above 100 indicates a positive view.

The twin challenges of stringent regulatory norms set in Basel III and expectations of a global slowdown are concerning. However, due to their strong fundamentals, banks in the MENA region and emerging markets are well placed to not just address the issues, but also use the opportunity to enhance presence in the niche trade finance market.

INTRODUCTION

Trade finance is the engine of an estimated USD18 trillion in annual global commerce. According to the World Trade Organization (WTO), trade finance supports nearly 90% of global trade, making it vital to economic prosperity. The inability to finance trade contributed significantly to the drop in international trade in 2009. The dollar value of world merchandise trade declined 22.3% to USD12.5 trillion in 2009 from USD16.1 trillion in 2008.

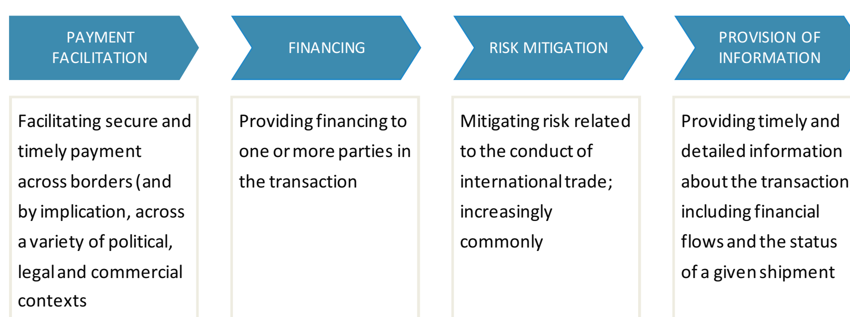
What is trade finance?

Trade finance is a specialized area of finance that deals with short-term financing of import and export transactions

Trade finance is a specialized area of finance that deals with short-term financing of import and export transactions. Traditionally, only major banks, international financial institutions and government agencies have been involved. Trade finance covers a wide spectrum of payment arrangements between importers and exporters. Products available include letters of credit (L/Cs), import financing, guarantees, L/C confirmation, pre-shipment export financing, invoice financing, and documentary collections.

Regardless of the term involved, trade finance fundamentally comprises four aspects: payment facilitation, financing, risk mitigation, and the provision of information about the status of payments or shipments.

Exhibit 1: Four elements of trade finance



Source: North Star Trade Finance

Importance of trade finance

Trade finance is extremely important for world merchandise trade

International trade benefits strongly from a well-developed and functioning financial environment and vice versa. In 2011, the dollar value of world merchandise trade advanced 18.9% to USD18.1 trillion, surpassing its previous peak of USD16.1 trillion in 2008. However, the inability to finance trade contributed significantly to the 22.3% decline in world merchandise exports during the recent financial crisis.

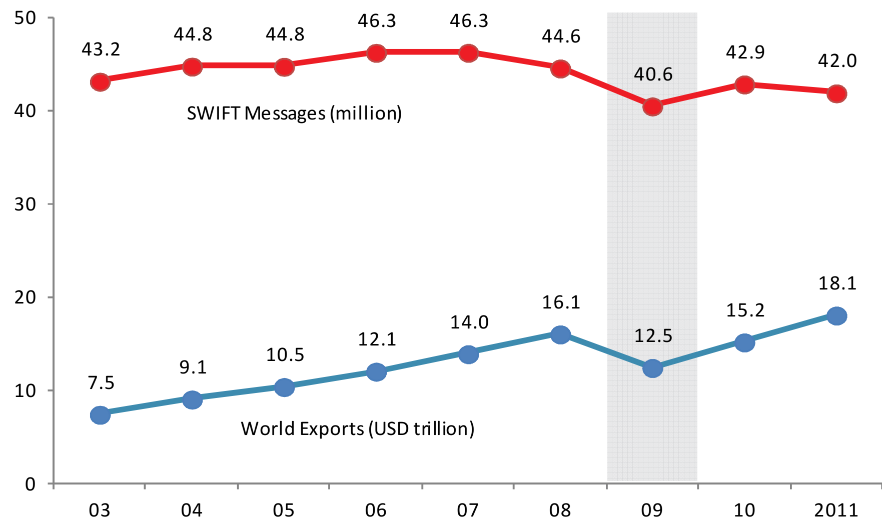
The importance of trade finance was clearly demonstrated during the economic crisis of 2008–09 when the global credit crunch magnified the slowdown in exports. In 2009, the number of SWIFT[1] messages (often used as a proxy to understand the trend in trade finance volumes) fell 9.1% to 40.6 million as global merchandise exports dropped 22.4% to USD12.5 trillion.

[1] Society for Worldwide Interbank Financial Telecommunication

Both exports and SWIFT messages have recovered significantly since, with merchandise exports up 45% and the number of SWIFT messages 3.7% from the lows of 2009.

The importance of trade finance was clearly demonstrated during the economic crisis of 2008–09

Exhibit 2: World exports and SWIFT transactions



Source: UNCTAD, SWIFT, Al Masah Capital Research

Trade finance helps mitigate three main areas of risk relating to international trade: micro, macro and product.

Micro risks, observed at the individual customer level, are confined to the financial (credit) and operational risks associated with the business. On the other hand, macro risks pertain to external factors such as political, foreign exchange, transportation and industrial uncertainties.

Exhibit 3: Risks in international trade and methods of mitigation

Risk category	Economic	Exchange rate	Transportation	Political		
				Foreign policy	Domestic policy	Economic policy
Examples	Importer is not willing or unable to pay Importer does not accept merchandise Exporter does not deliver on time or products agreed	Floating exchange rates: variations in rates Fixed exchange rates: risk of devaluation	Damaged goods Loss of goods	War Embargo Restrictions	Revolt Civil war	Prohibition to transfer foreign exchange Currency declared non-convertible
Methods of mitigation	Private insurance or public export credit agencies Letters of credit Bank guarantees	Banks provide hedging facilities Public exchange risk insurance	Private insurance	Export credit agencies or private insurance		

Source: Trade, Finance and Financial Crises (WTO)

TYPES/INSTRUMENTS OF TRADE FINANCE

Fundamentally, two types of trade finance instruments cater to business and personal needs: traditional and new.

Traditional instruments

Traditional trade finance products are typically short-term (less than one year), self-liquidating transactions

Traditional trade finance products are typically short-term (less than one year), self-liquidating transactions. The most basic of these are documentary in nature, and in most cases these transactions are contingencies that remain off balance sheet.

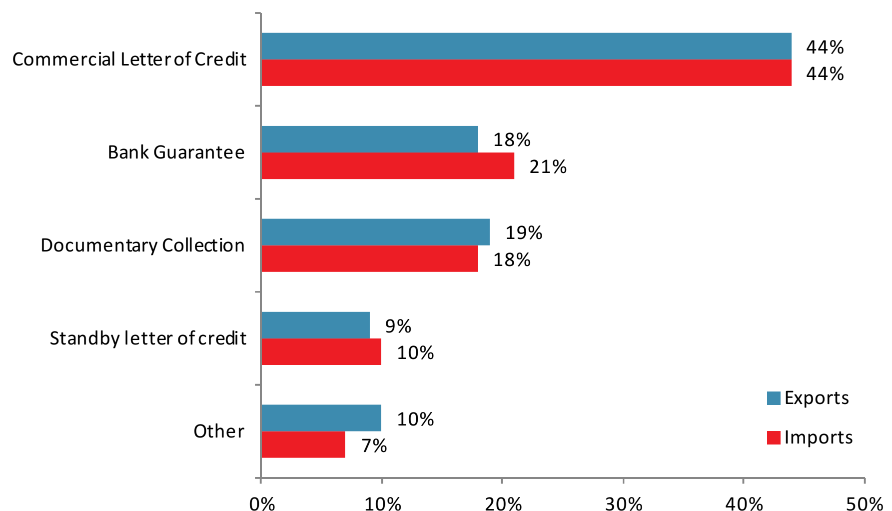
Documentary collection: A documentary collection is an arrangement in which the bank, at the request of the seller (exporter), releases to the buyer (importer) stipulated documents on payment, or guarantee of payment, on terms consistent with the collection instruction. The documents presented for collection may be financial (promissory notes and checks) or commercial (invoices and transport documents).

Letters of credit: A letter of credit (L/C), the most widely used trade finance instrument, is the simplest and most effective way for banks to finance export and import trade. An L/C is a document issued by a bank (issuing bank) stating its commitment to pay a seller (beneficiary) a stated amount of money on behalf of the buyer on condition that the seller provides the bank with the documents that correspond all the regulations of L/C. The two main types of L/Cs are Commercial (or Documentary) and Standby.

Bank guarantee: A bank guarantee (BG) is a written undertaking by a bank (guarantor) to pay the beneficiary the amount of money stated in the guarantee in the event that the principal (a bank customer ordering the bank to issue a guarantee) defaults under the obligations secured by the guarantee. A BG is very similar to an L/C, in that it guarantees payment to the beneficiary on behalf of the client. However, a BG is usually used in the event of risk (or high risk) of default.

Letters of Credit, Guarantees and Documentary collections are the most preferred trade finance products

Exhibit 4: Generally preferred traditional trade finance products



Source: ICC Global Survey, Al Masah Capital Research

There are several other traditional trade finance instruments

Forfaiting: Forfaiting denotes the purchase of obligations due at some future date, arising from deliveries of goods and services (mostly export transactions) without recourse to any previous holder of the obligation. The forfaiter deducts fee (discount) in advance for the whole period of credit and releases the net proceeds immediately. In simple words, forfaiting is the sale of an export receivables transaction to a third party for immediate payment at a discount.

Pre-shipment finance: An exporter with a confirmed order from a quality buyer (importer), supported by documentary credit, can seek pre-shipment finance in the form of working capital loan to produce and ship the goods.

Post-shipment finance: An exporter who has shipped goods to a customer (importer) can seek advance payment from a bank by providing all the documentary evidences/invoices.

Import loans: Banks typically provide flexible short-term borrowing facilities linked with import transactions. The two types of facilities are loans against imports and clean import loans.

Export loans: Similar to import loans, export loans are flexible short-term borrowing facilities linked with export transactions.

New instruments

Supply chain finance and structured trade finance are the new instruments

Supply chain finance: This refers to a set of solutions for financing specific goods and/or products moving from origin to destination along the supply chain. It features trade loans, inventory/warehouse finance, working capital financing, real-time monitoring and tracking of accounts payable or receivable and streamlined purchase order processing, among others.

Structured trade finance: Structured trade finance is a specialized activity to provide businesses with greater security and improved opportunities to manage cash flow built around individual company trade cycles. These transactions are structured around the supply chain and commercial terms of customers, usually involving large bilateral strategic relationships.

RECENT DEVELOPMENTS/TRENDS IN TRADE FINANCE

Open account trades being preferred over L/Cs

A growing share of world trade is being carried out through open account transactions

A growing share of world trade is being carried out through open account transactions, wherein goods are shipped and delivered before payment is due. Despite being highly risky for an exporter, open account transactions are gaining ground as they offer more efficiency through lower fees and less paperwork. Additionally, due to intense competition in export markets, many foreign buyers have been demanding for open account terms from exporters, doing away with banks as intermediaries.

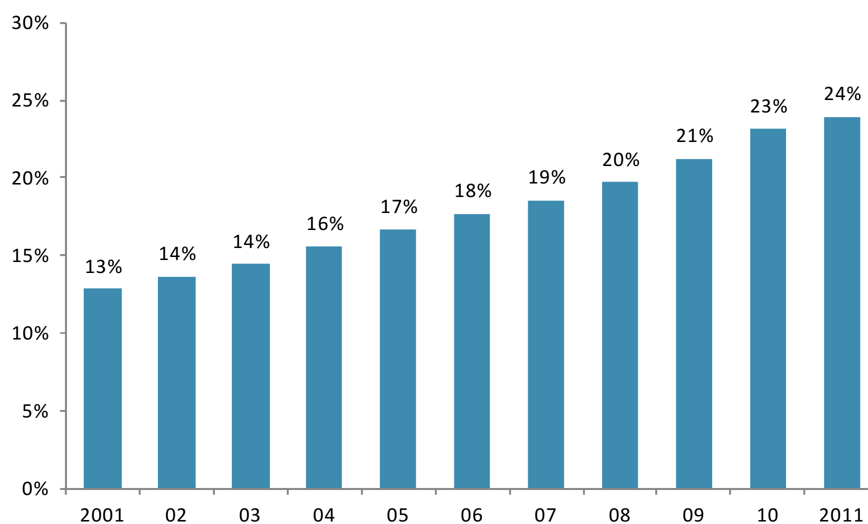
Open account trading currently represents 85% of the global trade transactions, reducing the role of traditional trade finance to about 15%[2].

Exports now driven by South-South trading activities

The United Nations Conference on Trade and Development (UNCTAD) figures show that South-South trade (or trade between developing countries) reached USD4.3 billion, or 24% of the total world trade, in 2011 (13% in 2001). Between 2001 and 2011, growth in South-South exports averaged 18.6% per year compared to 11.4% for world exports.

Exports now driven by South-South trading activities

Exhibit 5: South-South exports as a percentage of world exports



Source: UNCTAD

European banks, major players in trade finance, deleveraging

European banks, the dominant forces in the trade finance market, are pulling back from assisting companies in international trade. Hurt by the Eurozone crisis, stricter capital norms and low reserves of US dollars, European banks are busy cleaning up their loan books, making way for competitors to gain foothold in the trade finance market.

According to a Reuters report[3], banks such as HSBC, Standard Chartered, JP Morgan, Citigroup, Wells Fargo, Sumitomo Mitsui and Mitsubishi UFJ Financial are actively pursuing

[2] Supply Chain Finance: A new way for trade banks to strengthen customer relationships

this opportunity to capture the void left by European banks, notably French ones. In fact, a few days back, Citigroup launched a commodity trade finance business to capitalize on the deleveraging by European lenders such as BNP Paribas, Société Générale and Crédit Agricole.

Increased use of structured trade credit insurance

There is an increase in the use of structured trade credit insurance

According to a Marsh & McLennan report[4], European banks are compelled to retreat from Asia's lucrative trade finance market due to the regional debt crisis. This augurs well for other players. However, European banks, in fear of losing potential earnings from a growing market, are seen turning to structured trade credit insurance policies to retain some hold.

Structured trade credit policies insure against non-payment risk from a buyer of goods and services or a borrower or trade-related loans. These usually cover transactions with credit risk exposure between one and seven years. The types of insurable transactions range from a simple seller-to-buyer sale on credit terms to more complex structured credit transactions. Trade finance banks, exporters and trading companies are the main buyers of structured trade credit insurance.

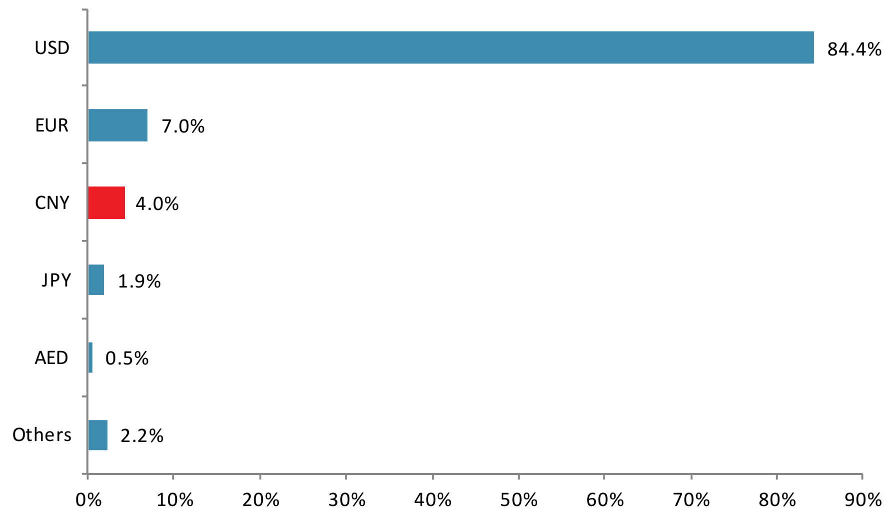
Structured trade credit insurance is recognized as regulatory capital under the Basel III rules in many European countries, which increases its attractiveness.

Growing use of renminbi

The Chinese renminbi is finding increasing international use in trade finance

The Chinese renminbi is finding increasing international use. According to SWIFT, the renminbi, which accounted for just 0.34% of all international payments this year, was responsible for 4% of the global issuances of L/Cs. Consequently, the renminbi has now become the third biggest currency for L/Cs, after the US dollar and the euro.

Exhibit 6: Renminbi is the third top currency for trade finance



Source: SWIFT RMB Tracker, May 2012

[3] Europe's banks leave room for rivals to fund world trade (April 16, 2012)
[4] Eurozone Crisis Threatens Asian Trade Finance Capacity (July 2012)

HOW BIG IS THE TRADE FINANCE OPPORTUNITY?

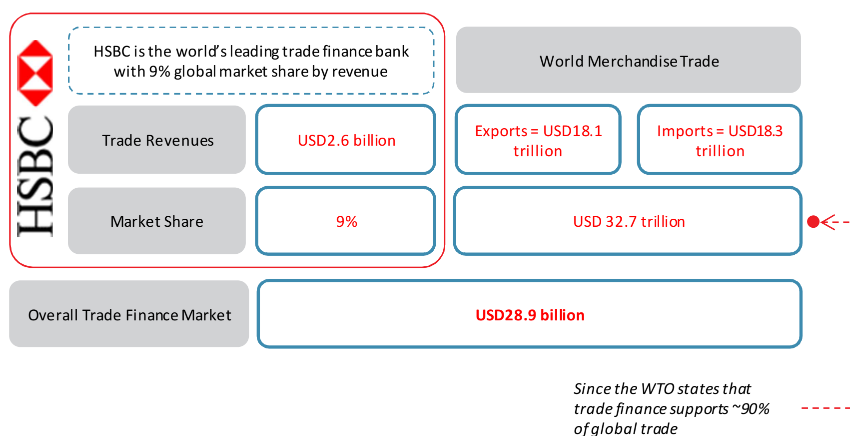
Trade finance market valued at USD29 billion in 2011…

We estimate the value of trade finance market at USD29 billion in 2011

We estimate that the global trade finance market generated USD28.9 billion in revenues in 2011. Our estimates are based on HSBC's investor presentation, June 2012. According to the presentation, HSBC was the world's leading trade finance bank in 2011 with 9% market share by revenue.

In 2011, HSBC clocked trade revenues of USD2.6 billion, capturing 9% of the global market share. Accordingly, we calculated the overall global trade finance market to be worth USD28.9 billion in 2011.

Exhibit 7: Global trade finance valued at USD29 billion in 2011



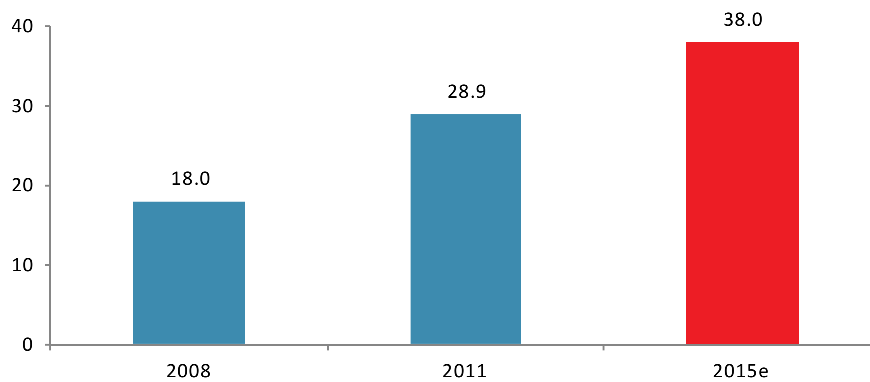
Source: HSBC, UNCTAD, Oliver Wyman, Al Masah Capital Research

…to reach USD38 billion in 2015

Global trade finance market could be worth USD38 billion by 2015

The opportunity for trade finance is large and growing. International management consulting firm Oliver Wyman projects the global trade finance market to be worth USD38 billion (in revenues) by 2015.

Exhibit 8: Global trade finance to reach USD38 billion by 2015



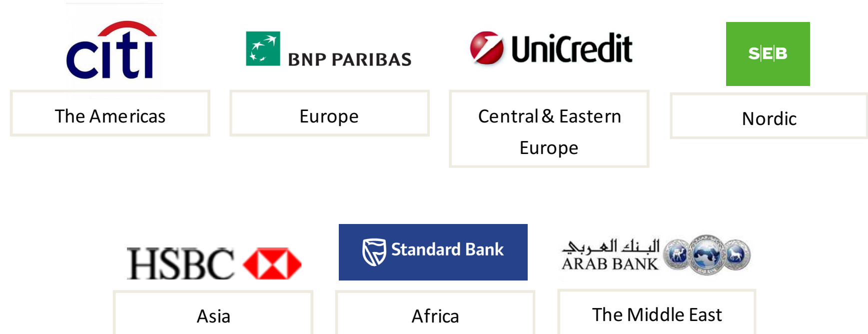
Source: HSBC, Oliver Wyman, Al Masah Capital Research

Major/Best players

Citibank, BNP Paribas, UniCredit, Arab Bank, SEB, HSBC and Standard Bank were listed as the world's best trade finance banks in 2012 by Global Finance magazine.

Citi is seen viewed as the best trade finance bank across the world

Exhibit 9: Best trade finance banks across various regions



Source: Global Finance magazine

Similarly, Arab Bank, Emirates NBD and QNB Bank were listed among the best trade finance banks in the MENA region by Global Finance magazine.

Seen here are some of the best trade finance banks across the MENA region

Exhibit 10: Best trade finance banks in MENA

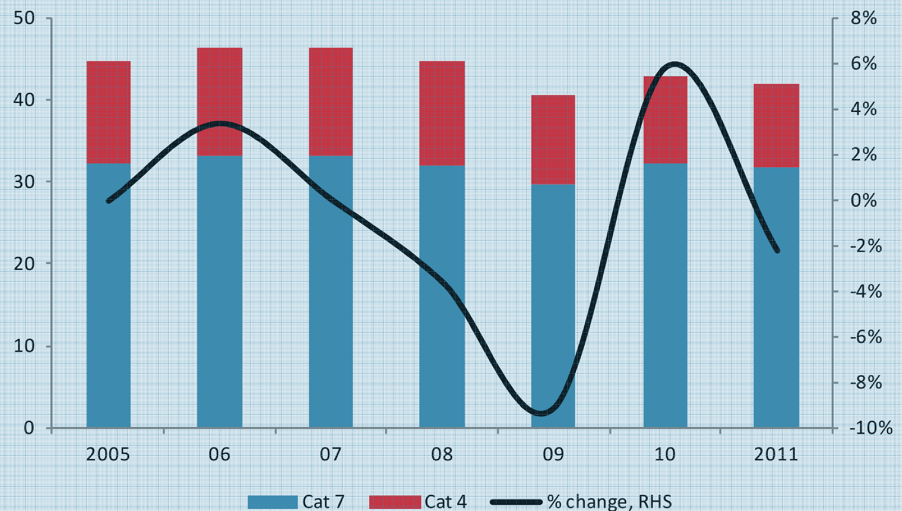
Source: Global Finance magazine

SWIFT trade traffic analysis over the years

Statistics on trade finance are generally scarce. However, tracking the SWIFT trade traffic serves as a good proxy to understand the trend in trade finance volumes. SWIFT volumes fell 9.1% to 40.6 million in 2009, confirming a global slowdown due to difficulties in financing.

As global trade rebounded in 2010, so did the figures for SWIFT trade traffic, confirming that the downtrend in volumes in 2008 and 2009 had been breached. As many as 42.9 million SWIFT transactions were registered in 2010, up 5.8% year-on-year.

Exhibit 11: SWIFT trade traffic from 2005 to 2011



Source: SWIFT

Note: SWIFT category 4 messages are flows for documentary collections, while SWIFT category 7 messages are flows for commercial and standby letters of credit and guarantees.

In 2011, SWIFT trade traffic declined 2.2% due to fewer category 7 messages (documentary credits), which represent 75% of the overall traffic. Asia-Pacific and the Middle East are the two largest intra-regional trade areas using documentary credits. Further analysis of the SWIFT trade traffic revealed the following:

- **Export traffic**: Asia-Pacific continued to register far greater volumes for received (export) messages with 52% of the world traffic in 2011. It was followed by Europe – Eurozone (16%) and North America (9%).
- **Import traffic**: Asia-Pacific continued to register the majority (41%) of the world traffic volumes for sent (import) messages in 2011. It was followed by Europe – Eurozone (20%) and North America (13%).

POTENTIAL FOR TRADE FINANCE IN MENA

MENA economies are growing rapidly

The MENA economy is expected to grow 5.3% in 2012, while the global economy is estimated to expand 3.3%

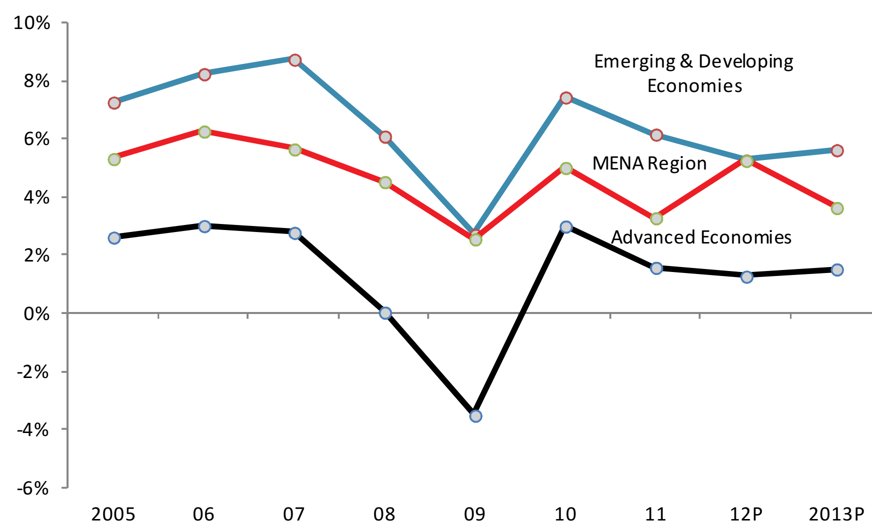
The MENA economy is expected to grow 5.3% in 2012 and 3.6% in 2013. In October, the IMF revised upwards its economic forecast for the MENA region from 4.2% for 2012 and 3.6% for 2013 (in its previous release in April 2012). The region's GDP grew 3.3% in 2011.

The upward revision of forecasts for the MENA region is a positive sign, especially when the projection for the global economy was slashed to 3.3% for 2012 from 3.5%. The IMF warned that the global economic slowdown is worsening as downside risks have increased. According to the IMF's chief economist, emerging markets in Asia, including China, are slowing largely due to the spillover effect of the deepening debt crisis in Europe.

Even as growth prospects for the global economy remain challenging, countries in the MENA region (especially GCC nations) are enjoying high growth due to the rebound in economic activity and higher oil production. With oil prices near historically high levels and increased export volumes, revenues from the hydrocarbon sector are expected to boost GDP growth in oil exporting countries such as Iraq, Qatar, Kuwait and Saudi Arabia. The IMF estimates oil prices to average about USD106.2 per barrel in 2012 and USD105.10 in 2013.

This year, the MENA region could grow about four times faster than advanced economies

Exhibit 12: GDP growth projections in 2012 and 2013



Source: IMF WEO

The chart above shows that the MENA region's economy is expected to expand 5.3% in 2012, at the same pace as emerging and developing economies, but about four times faster than advanced economies.

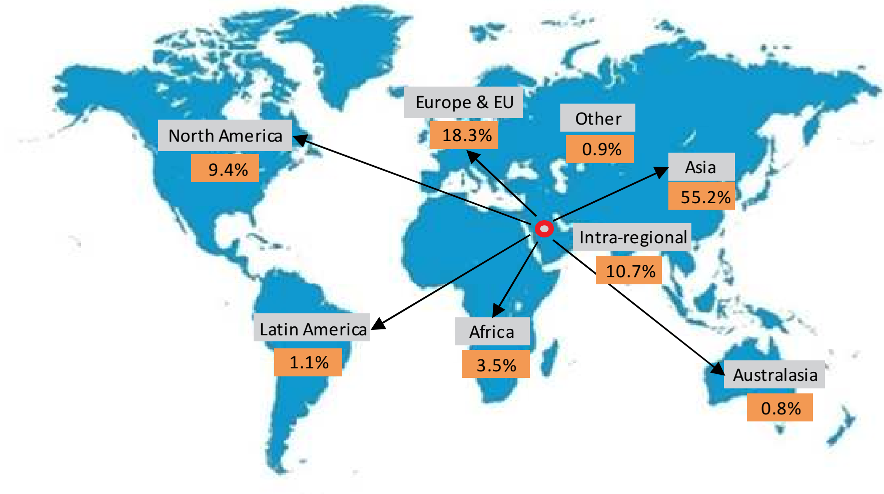
MENA/GCC is home to major trade hubs

The MENA/GCC region is well situated for North to South, East to West and intra-regional trade flows. It is also a major center of trade as well as a re-export market with several multinational companies having set up their bases in free trade zones in the GCC region. The

local arms of these multinationals import goods from their parent companies and sell them in the regional market.

The MENA region has close ties with Asia, Europe and North America

Exhibit 13: MENA Major Export flows - 2011



Source: HSBC Middle East & North Africa Region Investor Presentation, Al Masah Capital Research

The UAE has grown to become one of the world's most preferred trade and logistics hubs. The World Bank Doing Business Report for 2012 ranked the UAE as the 5th best country (among 183 nations) in terms of ease of trading across borders.

The World Bank study goes on to suggest that the country serves as a benchmark globally in terms of speed and cost of importing and exporting. For instance, in the UAE, it takes seven days to export a container at a cost of USD630 and an equal number of days to import at a cost of USD635. In comparison, in the US, it takes six days to export a container at a cost of USD1,050 and five days to import at a cost of USD1,315.

The UAE has become a world standard bearer for speed and cost of importing and exporting

Exhibit 14: Speed and Cost to Trade

Indicator	Details	UAE	United States	World*
Documents to export	(number)	4	4	7
Time to export	(days)	7	6	23
Cost to export	(USD per container)	630	1,050	1,412
Documents to import	(number)	5	5	7
Time to import	(days)	7	5	25
Cost to import	(USD per container)	635	1,315	1,668

Source: World Bank Doing Business Report

The world average for exporting and importing a container is 23 days (USD1,412) and 25 days (USD1,668), respectively.

Trade in MENA region is expected to grow at a fast pace

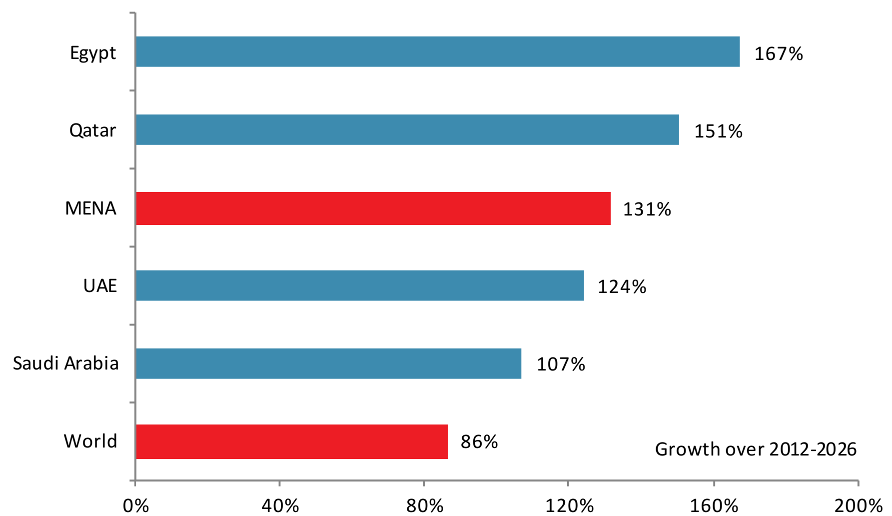
Trade in the MENA region is expected to grow 131% by 2026, faster than global trade, which is estimated to increase 86% over the same period, according to a study by HSBC[5]. It is assumed that growth in trade in the MENA region would be largely driven by hydrocarbons, while the US, China and India would be its major partners. However, HSBC believes that the MENA region should not be viewed as a pure hydrocarbon story while considering long-term trade.

The study reveals that the MENA region's initiatives to diversify from hydrocarbons are likely to boost growth in several sectors. These include commodities (such as iron ore, lead, rice, and wheat) for which the region is increasingly being used as a trade route; infrastructure (iron and steel products, among others, that are required for construction); fertilizers; and electronic products such as integrated circuitry. Furthermore, Oman, Libya and Qatar are likely to emerge as key trade partners within the region, while Malta, Poland and Brazil would be its major partners in the international market.

According to the study, Egypt would register the fastest growth in exports and imports in the region over 2012–26. The country's trade is estimated to expand 167% by 2026, with flat rolled iron and steel emerging as its largest and most rapidly growing export sector.

Exhibit 15: Trade in MENA region is expected to grow at a faster rate than global trade

Trade in the MENA region is expected to grow 131% by 2026



Source: HSBC, Delta Economics

Saudi Arabia's trade is estimated to increase 107% by 2026. The Kingdom is expected to register 5.5% and 6.9% growth in exports and imports, respectively, over the next five years led by infrastructure-related expansion. The UAE's trade activity is likely to grow 5.5% annually over the next 15 years; overall, its trade is estimated to expand 124% by 2026. Growth is expected to be led by electrical apparatuses, jewelry, aircraft, and oil and oil-based products. Qatar's trade is forecasted to grow 151% by 2026. The estimate is based on its strong economic position compared to other countries over the past four years. Qatar fared well throughout 2011, despite the global economic downturn and the Eurozone debt crisis.

[5] HSBC Trade Connections report

MENA has a strong appetite for Islamic trade finance

Islamic trade finance is nothing but trade financing solutions based on accepted Islamic Shariah principles. The key difference between Islamic and conventional trade finance is the prohibition of interest under the Shariah.

Murabahah is the most widely used Islamic trade finance product

Various Islamic trade finance products are available in the market. Discussed below are some of the most commonly used ones.

- **Wakalah**: Shariah-compliant letters of credit are based on the principle of Wakalah, where a bank acts as an agent on behalf of the client. The bank is paid fees and commissions in place of interest for the services provided.
- **Murabahah**: Under this product, the bank imports goods at the request of the client and sells the same to the client on a Murabahah basis. The selling price includes a mark-up or profit and the repayment terms are agreed upon on the date of the Murabahah transaction. The bank utilizes its own funds to open the letter of credit. Murabahah is the most widely used Islamic trade finance product.
- **Musharakah**: Under this product, the bank enters into a partnership agreement with the client for the sale and purchase of goods whose specifications are provided by the client. The cost of goods is divided between the parties. The profits or losses emanating from the venture are distributed according to a pre-agreed formula which need not be the same as the capital proportion.

Exhibit 16: Islamic trade finance products

IMPORT FINANCING	EXPORT FINANCING
1. Documentary Credit	1. Inward Letter of Credit
2. Wakalah	2. Islamic Factoring
3. Murabahah	3. Islamic bankers Acceptance
4. Musharakah	4. Islamic Credit Export Financing
5. Shipping Guarantee	5. Islamic Export Credit Refinancing (pre-shipment)
6. Murabahah Working Capital	6. Islamic Export Credit Refinancing (post-shipment)
7. Islamic bankers Acceptance	7. Accepted Bills-I
8. Foreign inward Bills for collection FIBC-I	8. Foreign Outward Bills for Collection-I
9. Domestic inward Bills for collection DIBC-i	9. Domestic Outward Bills for collection-I
	10. Debt trading working capital financing

Source: Kaplan Financial

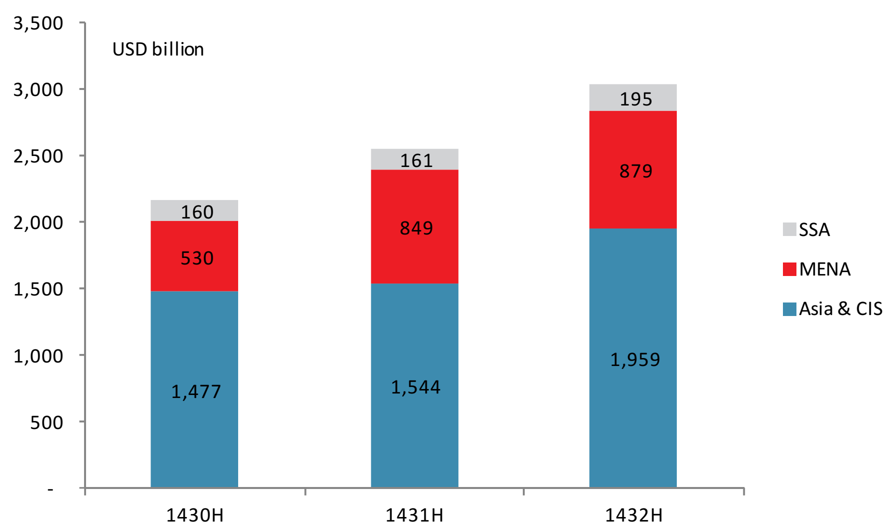
Egypt's state petroleum authority signed a USD235 million Murabahah agreement recently

Many Islamic trade finance deals were concluded recently. In October 2012, Egypt's state petroleum authority, EGPC, signed a USD235 million Murabahah agreement with the International Islamic Trade Finance Corporation (ITFC) to import gasoline, diesel oil and butane gas. In August 2012, the ITFC signed a USD40 million financing agreement with Tajikistan to import gasoline and diesel. Murodali Alimardon, Deputy Prime Minister of Tajikistan and Waleed Al-Wohaib, CEO of ITFC signed the agreement at the Islamic Development Bank headquarters in Jeddah. During the same month, Standard Chartered Bank arranged a one-year, USD35 million Islamic structured trade finance facility for Pakistan International Airlines (PIA). The facility is structured as an offshore transaction under an Islamic mode, which uses an innovative Services Ijara concept based on purchase and distribution of airline seats.

The Islamic trade finance sector is rapidly growing; ITFC approved transactions worth USD3.0 billion in 1432H

The Islamic trade finance sector is growing rapidly. Saudi Arabia-based Islamic Trade Finance Corporation, a non-government entity promoting Islamic trade, approved transactions worth USD3.0 billion in 1432H, reflecting 19% growth over 1431H. The value of approved transactions stood at USD2.6 billion in 1431H and USD2.2 billion in 1430H. According to the ITFC annual report, the Asia/CIS region held the largest share (65%) of the total approvals in 1432H, followed by the MENA region (29%) and Sub-Saharan Africa or SSA (6%). Although ITFC approvals increased across regions, Asia/CIS and Sub-Saharan Africa reported the largest growth (27% and 21%, respectively, during 1432H). Despite the unprecedented turmoil, approvals in the MENA region grew 3.5% in 1432H.

Exhibit 17: Trade approvals by region



Source: Islamic Trade Finance Corporation

Islamic trade finance also has a big opportunity in the form of OIC trade

Islamic trade finance also has a big opportunity in the form of trade by the Organization of Islamic Conference (OIC), especially intra-OIC. Global trade by the 57 OIC member states stood at USD1.59 trillion in 2010 with an intra-OIC trade rate of 17%. According to Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), global trade by OIC members is expected to reach USD4 trillion by 2012, with an intra-OIC trade rate target of 20% by 2015.

Exhibit 18: Intra-grouping trade in OIC is low

	2008	2009	2010
European Union	65.44%	66.61%	67.19%
NAFTA[6]	41.27%	36.48%	48.09%
ASEAN[7]	26.80%	24.00%	24.56%
OIC	16.60%	16.65%	17.03%

Source: Islamic Centre for Development of Trade

Given the high level of regional integration in the European Union (67%), the intra-OIC trade rate target of 20% by 2015 seems achievable.

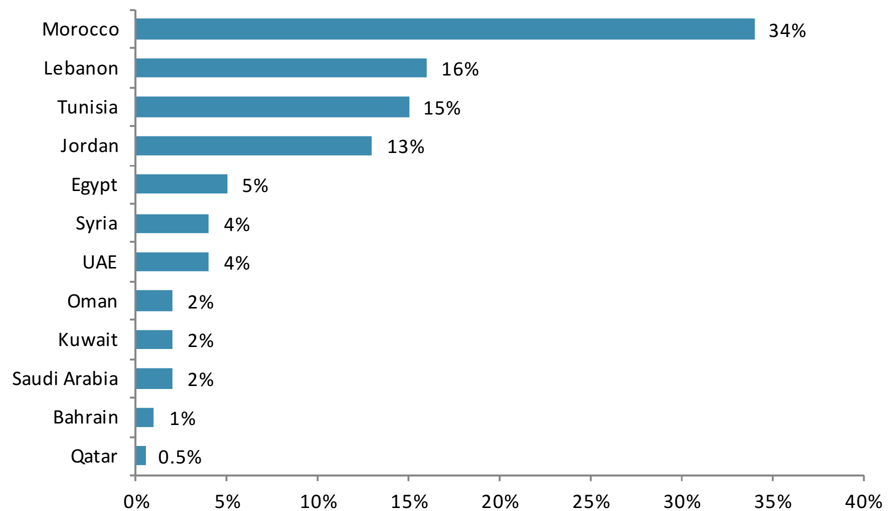
[6] The North American Free Trade Agreement
[7] The Association of Southeast Asian Nations

MENA SMEs hold immense potential for trade finance

Small- and medium-sized enterprises (SMEs) are the backbone of any country. There are approximately 9–11 million SMEs across the Middle East[8]. However, half of these companies are not able to obtain adequate funding from banks or other lending agencies for business activities. A study by the World Bank suggests that SMEs' access to finance is highly constrained in the MENA region, with only one in five having a loan or line of credit. This lack of access to capital is a key factor that hampers the ability of SMEs to utilize their full potential as well as contribute to economic growth and job creation.

Access to finance for SMEs is highly constrained in the MENA region, with only one in five having a loan or line of credit

Exhibit 19: SME lending penetration in the MENA/GCC region is quite low



Source: Bank lending to SMEs in MENA Survey Report, World bank and Union of Arab banks, 2010

Few banks have launched funds specifically for SMEs

Recognizing the business opportunity, few banks launched funds specifically to cater to the cross-border trading requirements of SMEs in the MENA region. In May 2012, HSBC Bank Middle East launched an AED1 billion HSBC International Trade SME Fund; this is its third fund to meet the needs of SMEs in the UAE. Within three months of its launch, HSBC announced that over half of the fund had been allocated successfully.

International Finance Corporation (or IFC, a member of World Bank Group) has been working to develop solutions to close the financing gap for SMEs—it is collaborating with 38 financial institutions across 14 countries in the MENA region. As of June 2010, IFC committed a total of USD1 billion to finance SMEs in the region.

New instruments could replace traditional instruments

The MENA region has traditionally used documentary credits and documentary collections in trading

Contrary to the developed world, which has moved away from traditional trade finance instruments such as letters of credit and documentary credits to documentary collections and open account (as they do not require credit facilities per se), traders in the MENA region continue to use them. According to Emirates NBD[9], documentary credits account for more than 60% of cross-border trade flows in the MENA region. Amid falling credit standards and

[8] The 2nd Middle East SME Forum 2012

[9] Adjusting to a changing landscape, Emirates NBD, Lakshman Ranganathan and Sharad Agarwal

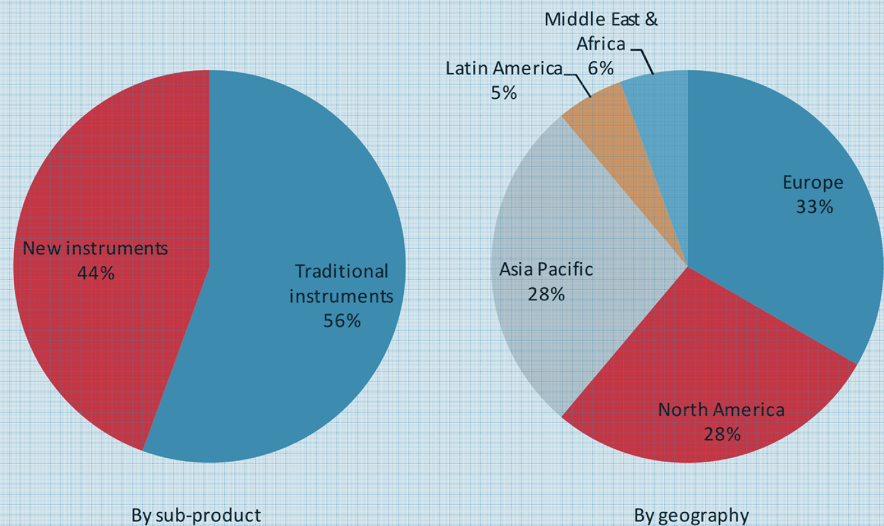
increasing possibility of payment defaults by buyers, the use of documentary credits as a tool to settle payments in domestic and international trade transactions has risen. This is because these instruments are considered to reduce risks substantially for both the exporter and importer.

On the other hand, the scenario is likely to change as supply chain financing solutions such as factoring are expected to help in managing working capital and cash flows more efficiently.

Traditional products continue to rule

According to a report by Oliver Wyman, an international management consulting firm, traditional trade finance products, such as documentary collections, L/Cs and confirmations, continue to form a major portion of the revenues from global trade finance. New instruments, such as supply chain finance solutions and structured trade finance products, account for a smaller portion of the revenue pool.

Exhibit 20: Revenues from global trade finance



Source: Oliver Wyman

In terms of revenues from trade finance by geography, Europe leads with a 33% share, followed by North America (28%), Asia-Pacific (28%), Latin America (5%) and the Middle East and Africa (5%).

CHALLENGES

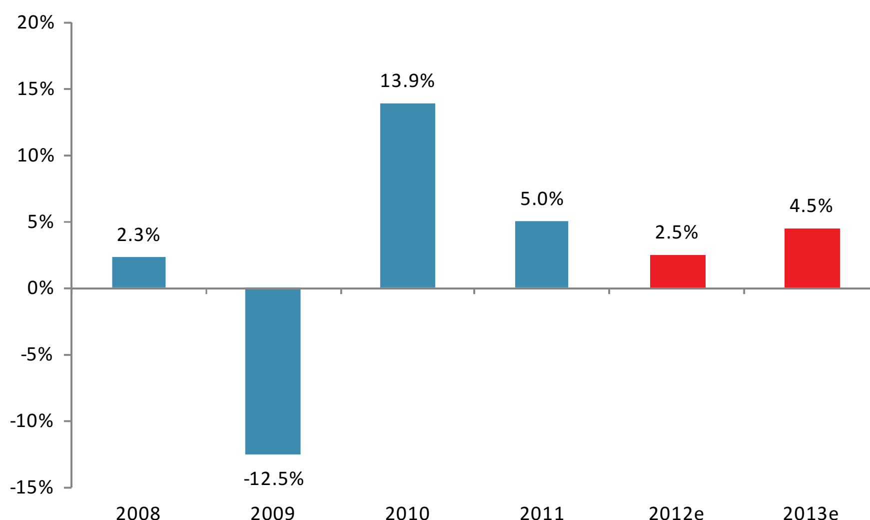
As the global economy recovered from the financial crisis of 2008–09, new obstacles in the form of the Arab spring, Japanese earthquake and Eurozone debt emerged. The market for trade finance suddenly seemed gloomy and difficult. Stringent capital reserve requirements in the form of Basel III regulations, enacted in response to the credit crisis, made trade finance professionals jittery.

Slowing global trade

Growth in global trading volumes is expected to decelerate to 2.5% this year from 5% in 2011

According to the WTO, growth in global trading volumes is expected to decelerate to 2.5% this year from 5% in 2011. This growth estimate for world merchandise trade is much lower than the long-term average of 6% during 1990–2008. Pascal Lamy, Director General at the WTO, said the expected further slowdown in trade in 2012 implies high downside risks and that fiscal pressure still exist.

Exhibit 21: World merchandise trade (annual % change)



Source: WTO

A steeper-than-expected downturn in Europe, financial contagion due to the sovereign debt crisis, rapidly rising oil prices, and weak growth in the US and China are likely to be the main drags on the global economy.

Implementation of Basel III rules on capital requirements

Implementation of Basel III rules could hurt trade finance

The world banking system went into a tailspin during early 2008, ushering in a financial crisis that shook the global economy. Consequently, the Basel Committee began re-evaluating its regulations. In September 2010, the committee established a new framework of tighter standards under Basel III. The new rules aimed at mitigating the risk of bank failures by restricting unhealthy and imprudent practices; however, these had some negative implications on trade finance.

According to the new rules, banks must maintain higher capital reserve against trade finance deals, which is their biggest concern. The proposed leverage ratio would require banks to set

aside 100% of capital for any off-balance sheet trade finance instruments, such as L/Cs, which is five times more than the 20% credit conversion ratio used for trade finance in Basel II. An informal survey by BAFT-IFSA revealed that Basel III may raise trade finance costs by 18–40%, which would ultimately be passed on to corporate clients.

Survey reveals that Basel III may raise trade finance costs by 18–40%

Exhibit 22: Impact of Basel III on trade finance

•	The proposed calculation for leverage ratio requires a 100% credit conversion factor for certain off-balance sheet items, including standby and trade L/Cs.
•	The Basel Committee rejected the proposal to lower the 20% CCF under Basel II standardized and FIRB for short-term, self-liquidating L/Cs.
•	Tenor: The Basel Committee provides an exemption from the one-year maturity floor to L/Cs, permitting the calculation on the effective maturity. Other trade finance products may be exempted, subject to national discretion.
•	New liquidity measures fail to recognize trade finance instruments as liquid assets.
•	Asset value correlation for trade finance products (short-term, self-liquidating) is not separate from other corporate banking products.

Source: Baker & McKenzie, JP Morgan

Potential effects of Basel III on the MENA region

Although Basel III requirements would be implemented over several years (from 2013 to 2019), the implications are immediate. From the MENA/GCC perspective, the new regulations could hinder funding for projects, especially those with longer-term maturities. This is because the regional capital markets are not yet fully developed to enable financing for such ventures, resulting in strong reliance on banks.

Although banks in MENA/GCC (known to be generally conservative and well-capitalized) are better placed than many of their international counterparts to achieve a timely transition to the new regulatory environment, they could face slowdown due to deleveraging and increased cost of capital. For GCC, in particular, where international trade activity is extremely high due to oil exports and imports of foodstuff and other consumable items, Basel III requirements could make trade finance less profitable. This is because banks cannot choose to ignore the large customer base requiring such services, and hence may not be able to pass on the increased cost of capital resulting from Basel III.

Small- and medium-sized enterprises or SMEs, which usually face great difficulties in securing adequate funding, could take a further hit by Basel III norms. As mentioned earlier, banks in the MENA region have been reluctant to lend to SMEs due to the associated higher risk. SME loans typically account for more than 25% of the banking sector's portfolio in high-income OECD countries, but are much lower in the MENA region. A study by the World Bank suggests that just one in five SMEs in the MENA region has a loan or line of credit. In fact, loans to SMEs in GCC countries are even fewer (less than 5% of the banking loan portfolio).

SMEs play an important role in the economy by enabling job creation, growth and diversification. SMEs in Saudi Arabia, for instance, account for a fourth of its gross domestic product, 63% of employment, and 98% of all enterprises.[10] Lack of jobs was one of the root causes of the recent bout of uprisings in the Arab world.

The Basel III capital requirements come into effect on January 1, 2013.

[10] Saudi SME opportunity, Zawya (Sep 19, 2012)

Margins under pressure

The profit margins in trade finance could be squeezed in the near future

Revenues from trade finance amount to just 4–5% of corporate banking revenues[11]. The trade finance business always drew little attention of banks due to its low margins and better revenues in other complex and risky derivative products that boosted bank profitability. Various factors led to lower profit margins in trade finance, including:

- Shift of global trade from traditional trade finance products, such as L/Cs and guarantees, to open accounts that require less banking intervention
- Reduction in the average value of trade finance transactions due to increased activity of small- and medium-sized enterprises (SMEs) in international trade

CONCLUSION

Given the turmoil in Europe, slowing economic growth in China and the IMF's warning about a global slowdown, the near future for trade finance does not seem bright. A research conducted jointly by the International Chamber of Commerce (ICC) and IMF earlier this year also showed a pessimistic outlook for trade finance products. However, on a positive note, confidence among exporters and importers has not deteriorated.

HSBC's Trade Confidence Index, a semiannual survey of exporters and importers in 20 countries, stood at 113 in June 2012. A reading above 100 indicates a positive view. Almost 71% of respondents believed that trade would either remain stable, or grow over the next six months. Not surprisingly, the two MENA countries with high scores on the index were the UAE (124) and Saudi Arabia (137).

On the flip side, there are two major factors behind the negative outlook for trade finance: (i) deleveraging of European banks that has decreased credit in the market; and (ii) stringent regulatory norms set in Basel III. The challenges are big; however, due to their strong fundamentals, banks in the MENA region and emerging markets are well placed to not just address them, but use the opportunity to increase presence in the niche trade finance market.

[11] McKinsey & Co.

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