European Banking Federation
Chief Executive

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The Commissioner for Trade
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Email

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Dear Commissioner,

Funding conditions in export credit markets: 2014 edition

We would like to congratulate you warmly on your appointment to the College of Commissioners.

We write concerning the EU's export financing capability, an issue deserving close attention in light of the importance of trade to the European economy. More specifically, we report to you here on conditions in the market for financing EU export sales of high-value goods and services. This information is accompanied by policy proposals for fostering the environment for export financing.

Our paper is the third in a series of annual reports, previous editions of which were submitted to your predecessor.

Over past decades, EBF members (Europe's banks) have developed trade and export finance mechanisms to support the needs of European exporters pursuing opportunities in the most challenging markets. Your election as Commissioner comes at a time when the peak of the crisis in export finance lies behind us, but when the regulatory framework imposes some constraints on commercial banks' ability to fulfil their role in financing Europe's exports efficiently.

Here we explain our members' role, identify the most serious regulatory constraints, and point to the advantages of making better use of capital markets. We highlight the need for better coordination among Export Credit Agencies (ECAs) within Europe and world-wide, and comment briefly on current liquidity conditions.

We would hope that the paper will contribute to discussion of the problematic of longer-term financing, stimulated by the Commission's "Communication on long-term financing of the European economy" of March this year.

The importance of exports – and their financing – to the EU economy

Europe's economic future, as the world's largest trading block and the largest exporter of manufactured goods and services, is profoundly connected to the outside world. The latest forecasts published by your services underscore the fact that its export sector is continuing to be a vital prop for growth and employment, at a time when other factors of demand have been weak or stagnant. The scale of its contribution is striking. In 2013, while real GDP growth was flat, exports contributed 0.9% (Autumn 2014 European Economy Forecast).[1] Looking forward to 2015 and 2016, global output is expected to accelerate, which should present new opportunities for our economy.

[1] http://ec.europa.eu/economy_finance/eu/forecasts/2014_autumn_forecast_en.htm

For centuries, world trade flows have depended heavily on financing instruments. As trade has expanded globally, the need to protect the parties to a transaction against risk has likewise grown. Credit institutions have developed trade and export finance mechanisms to meet this need. The mechanisms provide protection against commercial, political and other risks. They ensure that payments across borders can take place in a secure and timely manner, and that the importer and exporter are kept informed of the physical and financial flows. Last but not least, financial instruments may provide liquidity and credit to the parties to the transaction. The financing element is a particularly valued part of the package in times of crisis and recession, as we have seen in recent years.

Commercial banks as facilitators for exports, in trade and export finance

A core function of banks is to ensure that exporters obtain the necessary finance to compete on international export markets. Banks help to finance the essential day-to-day commercial needs of SMEs, through secure short-term trade financing instruments such as letters of credit. They also work with larger companies and Export Credit Agencies (ECAs) to facilitate high-value, longer-term export contracts, with so-called "export credit".

The support provided to international trade through insurance and associated finance is very significant in scale and in its influence on global trade flows. The Berne Union – the International Union of Credit & Investment Insurers – has reported that its members (both ECAs and private insurers) facilitated cross-border transactions of US$ 1.9 trillion in 2013, a record level. Berne Union members insured more than 10 % of international trade in that year. [2]

The transactions supported by export credit are normally sales of capital goods, for example in renewable energy, oil and gas, petrochemical and telecommunication projects. These supply contracts are typically of high value. They may require financing support of long duration, from 2 to 10 years, or even more in rail and renewable energy projects for example. The companies which benefit from these financing contracts are not only larger multinationals, but also smaller enterprises, through the supply chain.

In providing finance, European banks work closely with ECAs, which are private or governmental institutions. These are mandated by their Sovereign to support export activity, largely through guarantees and insurance. In the EU, there has been a long-standing division of labour between the two parties. The banks normally supply the financing for the sale and associated local costs, alongside advice and local knowledge. They are also fully responsible for credit administration and monitoring, implying less work and cost for the ECA which would come into play in case of default. Where ECAs offer direct loans on their own account, they must support the cost of creating and maintaining a fully functioning banking architecture.

There is a complex eco-system supporting companies which operate on world markets. This requires a stable framework in which commercial banks can operate alongside government-supported ECAs, as reliable financing partners to EU firms. The system is of immense value to the European economy.

[2] At year-end 2013, some $1,092 billion of exposure consisted of Short Term Export Credit Insurance, and $716 billion of Medium and Long Term Export Credit Insurance. http://www.berneunion.org/statistics/

Indeed, the ability of the financial system to channel funds to such longer-term investments will be essential to achieving sustainable growth.

Need for a regulatory framework which enables banks to fulfil their role

The new regulatory framework will help to stabilise financial markets, but it may have unintended side-effects which could put pressure on export finance. The Capital Requirements Regulation (CRR), and its provisions on leverage and liquidity in particular, could reduce banks' willingness to devote cash resources to longer-term export finance transactions. If a number of banks were to withdraw from export finance activity, less funding would be available to the export industry.

For the time being, it is unclear to what extent credit institutions will refrain from this business. There is already a tendency to focus on selected key clients only, as capital and human resources are scarcer. On the other hand, following the lessons learned from the financial crisis, many banks have been re-focusing their activities on corporate banking, including export finance, and plan to grow in this area. To those banks staying in the export finance arena, the business has some major attractions: it offers an avenue to consolidate business relations, while benefiting from a low loss record and the inherent credit enhancement of ECA cover.

Since the export finance business model is so sensitive to the regulatory backdrop, the EBF welcomes the Commission's intention - expressed in the recent Communication on Long-Term financing - to report on the CRR requirements in relation to long-term financing.

An important concern in the new capital requirements framework is the impact of the proposed **Leverage Ratio** on ECA-covered export finance. Finance for trade, of short and long duration, has a good loss record, which may to some extent be reflected within the Risk-Weighted Asset (RWA) calculation for measuring balance sheet capital adequacy. However, within the Leverage Ratio, there is no recognition of the risk-mitigation benefits of guarantees or insurance. This means that in many cases the capital requirements for ECA-backed export credits will be determined by this ratio - which would typically be significantly higher than the RWA-based capital requirement.

In the past it has been difficult for banks to substantiate their experience of the low risk of their export finance activities. Yet for a bank to suffer a loss on such a loan, not only the borrower but also the state-backed ECA would have to default. This year, a milestone was reached with the publication by the International Chamber of Commerce (ICC) on 19 June of the **ICC Trade Register Report**. For the first time, the report included comprehensive empirical evidence of outcomes under banks' medium and long-term export credits, based on figures provided in confidence by 16 contributing banks (representing the bulk of the market), on 26,000 transactions. In its conclusions, the ICC estimated the Expected Loss for medium and long-term products - including export credits - to be of approximately 2 basis points. In other words, the level of risk is much lower than for 'vanilla' corporate lending.[3]

If an important constraint such as the Leverage Ratio ignores the quality of export credit assets, it will in effect penalise one of the lowest risk and most productive – and government-sponsored – bank activities. The EBF therefore proposes that the ECA cover be recognised as credit enhancement also within the Leverage Ratio. This would follow the example of the treatment under the Ratio of trade finance and off-balance sheet export credits (such as undrawn commitments), where the credit conversion factor has been reduced to 20% or 50% depending on the product.

[3] http://www.iccwbo.org/Products-and-Services/Trade-facilitation/ICC-Trade-Register/

As far as liquidity is concerned, the EBF strongly recommends that the European legislator calibrate the **Net Stable Funding Ratio (NSFR)** in a way which takes full account of the economy's longer-term financing needs.

Among other difficulties that have emerged during the introduction of the new rules, is a provision in the CRR which could be an impediment for this business. EBF members are concerned that **CRR Article 194.1** could raise serious difficulties for trade and export credit deals. This article requires that an independent legal opinion be obtained in order for a credit mitigation technique (such as a guarantee) to be acceptable. This apparently routine provision raises various questions, notably concerning: its scope of application; the definition of "independent"; and the source and frequency of the opinion. For our export and trade-financing bankers, who are often dealing with a number of ECAs in one transaction, this could cause delay and uncertainty. In the worst case it could prevent recognition of the full value of ECA cover. Currently, EBF members are coordinating approaches to the issue among our member banks, with the aim of setting up similar procedures for speedy handling of the legal opinion around the different EU markets.

Make use of capital markets

Another welcome aspect of the Commission Communication on long-term financing was the recognition that, while banks will continue to play a significant role in corporate finance, the diversification of funding to include more capital markets-based financing is important to improve the availability of financing. From the perspective of financing trade, the EBF welcomed the Commission's plans to advance work on developing Europe's covered bond and securitisation markets.

Meanwhile, banks themselves have started to explore the possibilities offered by the capital markets and to develop financing structures which integrate institutional investors looking for new investment opportunities. The EBF encourages regulators and ECAs to be open to this development and **encourage private market initiatives** that could support the longer-term needs of export finance without using public funds. Progress in this direction should also help reduce inequalities between EU Member States' ability to finance their export industry.

Enhanced cooperation among ECAs

EU Member States' ECAs are an important vehicle for administering their economic and industrial policies. The structure of support provided by ECAs in the EU reflects the heterogeneous nature of Europe's economies, their different histories, challenges and priorities. With the growing decentralisation of production and the increase in multi-sourcing projects where different ECAs are involved, the EBF believes that **better coordination and cooperation between them is necessary**. We look forward to the Commission report on this issue, announced in its afore-mentioned Communication on long-term financing of the European economy, and hope that it will be possible to provide advice. Steps in this direction, perhaps involving the European Investment Bank, should help the EU to achieve a more level playing-field in export financing capacity among its Member States.

World-wide, competition in the export credit market has become increasingly fierce, as national authorities have boosted support for export credits in order to increase market share. Competition with countries which do not subscribe to the OECD framework of rules - the Arrangement on Export Credits - presents a particular challenge in the achievement of orderly markets. The EBF strongly supports the current outreach efforts of the EU authorities and the OECD to encourage wider adherence to these rules.

Current liquidity situation

We are pleased to report that the liquidity situation has significantly improved over the past year. The greater liquidity, alongside competition, has led to a decline in margins and increased choice for exporters and importers. Thanks to a variety of support schemes which were set up during the crisis, and increased activity in capital markets, export finance continues to work well in most EU countries. In general, provided a project is economically viable, financing is now available, in both US dollars and euro.

Despite this positive development since our last report, we believe that, given regulatory constraints such as the Leverage Ratio, the trend towards greater use of club deals and broad syndications for large projects will continue. Individual banks' reduced lending capacity has created a more fragmented and labour-intensive business model.

Recent changes on the markets, and the increasing diversity of national ECA practices, have led to debate about the calibration of the OECD Arrangement's system of Commercial Interest Reference Rates, CIRR, which sets minimum interest rates for official financing support for fixed rate loans. This discussion is likely to continue in the coming year.

The EBF is making available, on request, a detailed Annex to this letter. This reports on funding options for export finance in 2014, country-by-country, and on post-crisis initiatives taken by national ECAs to address market needs.

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The economic and financial crisis affected the ability of the EU financial sector to channel funds to the real economy, in particular to long-term investment. Today, the situation has significantly improved, but work remains to be done.

Banks are committed to serving the needs of their clients, large and small, and to supporting growth and jobs. They are keen to ensure that policy is framed with knowledge of conditions on the front line of the export business. We hope that this letter will contribute to your policy discussions. Last but not least, we wish you every success in the exercise of your mandate.

Yours sincerely,

Wim Mijs
Chief Executive

Ralph Lerch
Chair of the Export Credit Working Group