ASIA FINANCIAL CRISIS, IMF ASSISTANCE AND U.S. BANK EARNINGS

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The financial crisis domino effect moving from Thailand to Korea, Malaysia, the Philippines, and to Indonesia so far, is raising concerns among bank directors and shareholders about the impact on bank profits. Some bank critics claim that the International Monetary Fund financial assistance is nothing more than a cover up or bail out of the banks for their bad lending decisions in Asia. Neither concern is justified due to the change in the nature of commercial bank's international lending practices since the last major financial crisis in developing countries. Even so, the financial problems in Asia are not the same as the 1994-95 crises in Mexico and may not dissipate as quickly.

Some bankers, directors and shareholders remember the negative impact on bank earnings of the 1982-84 series of country defaults which begin in Latin America and spread globally - except Asia. The 1982-84 financial crises caused substantial losses and write-offs for major multinational banks and the closure of several smaller banks primarily involved in international loan syndications. The impact was so severe that many of these major banks stopped lending to developing countries until the early 1990's - a period of almost 10 years.

The Asian countries with financial problems have been among the fastest growing emerging economies and at least some of them, like Korea, were not believed to be prone to financial problems. U.S bank loan exposure to Asia is about $24 billion which is much less – about a quarter - that the near $100 billion exposed in Latin America at the time of the 1982-84 crisis. In contrast, Japanese banks have almost $100 billion exposure in Asia.

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The financial crises in Asia may not go away soon. Many local banks in Asia are heavily burdened with bad debts of companies that continue to function instead of going bankrupt. The result is that bank debt in some cases continues to rise or since there is no bankruptcy and court enforced liquidation of assets, bank collateral is meaningless. Companies in Korea, Thailand and now Indonesia stop paying principal and interest but continue to operate unprofitably. Banks are left with little choice under regulatory guidelines once interest is past due more than 90 days loan loss reserves need to be established and as the crises has continued these have continued to accumulate as repayment difficulties have become increasingly impaired and doubtful.

Following the 1982-84 debt crisis and resulting spread of global bank failures, Central Banks in 1988 acting under the direction of the Bank for International Settlements, established capital adequacy requirements for bank lending. The objective was to control bank's risky lending by tying it to the bank's capital to insure that a series of bad loans would not spread to other banks creating a banking crisis. The riskier the loan the more capital was required or used to back that loan. However, the capital adequacy requirement is not very discriminating between loans to banks in Europe or Asia, or between companies in Europe or Asia. Because loans to borrowers in Asia are riskier and command a higher return but use the same amount of capital as loans to a more secure but lower interest paying countries the incentive is to lend to the higher risk area. This conserves scarce capital and boosts interest earnings.

It is important to recognize that the BIS distinguishes between capital adequacy requirements for short-term loans which require 10% capital backing or usage and letters of credit which only require a 20% capital usage rate. Thus, the BIS seems to be identify letters of credit as a much less risky type of loan compared to other types of short or term lending instruments.

Banks have attempted to deal with more risky loans by developing sophisticated computer models to measure the default risk and thereby convince regulators that less capital is needed to cover possible losses. Credit derivatives have been developed that allow banks to trade their credit-risk exposures cheaply so as to reduce bad loan risk. Banks have also shifted some their loan portfolio into their trading portfolio that is governed by self-regulated capital adequacy rules. These self-regulating rules are only as good as the computer models that assess the riskiness of the loans analyzed. Furthermore, credit risk models lack daily data

on market value of the bad loans that the bank can recover. Eventually, however, this problem may be overcome but how good the self-regulating risk measuring models are will only be known when a crises hits and then hopefully the models will be accurate.

Resurgence in International Lending

Despite all these issues clouding the riskiness of international lending by banks the character of the lending to developing countries and in many cases to industrial countries has changed in a positive more secure direction. International lending (net of interbank transactions) has grown from about $100 billion increase per year in the early 1980s to an increase of near $500 billion in 1997. By the end of 1997 the total stock of net international bank loans was $5.3 trillion.

The resurgence in international lending since the early 1990's for many banks has been in the form of trade finance instead of international term lending or international loan syndications. In a recent (March 1998) World Bank Report, Global Development Finance, official export credits to developing countries have increased sharply during the 1990s. For example, between 1990-96, flows of official export credit finance to developing countries averaged $110 billion per year compared to $83 billion average per year in the 1980s. Based on past experience, this increase has been mirrored by the expansion in private trade finance provided by commercial banks. The loss record for official export credits since 1980 has been limited to very small amounts in less than a hand full of countries. This compares to the more than 50 counties that have undergone multiple debt defaults, restructurings, and reschedulings of several hundred billions of short- and long-term credits.

This trade credit expansion is the result of more aggressive export promotion by many countries and the changing nature of international finance for developing countries toward project finance and direct investment. Privatization of infrastructure industries primarily power generation, telecommunications and transport contributed significantly to this growth. The Asia financial crises may have resulted in a slower expansion of trade finance in 1997 and growth in 1998 may also be dampened.

Based on a recent survey of banks by the Thunderbird IT&FC about their experience with trade finance lending, particularly "letters of credit," the historic record (1980 to the present), in terms of default or non-performance, has been

extremely good even during the 1982-84 debt crisis. ***The survey results suggest that the Asia crisis will only minimally impact most banks' profits and that banks with a higher share of their international portfolio in trade finance may not be negatively impacted at all in spite of the Asian countries heavy dependence on foreign trade.***

This conclusion is believed to be generally true with respect to the impact of the recent Asian crises on bank profits especially when letters of credit are solely used to measure trade finance lending. However, further research suggests that the nature of trade finance is changing away from the traditional definition of the short-term financing the shipment of goods to longer-term pre- and post-export finance or structured trade finance. This some refinement of the expected impact of the Asia crises on banks to the expectation that banks pursuing trade finance under the traditional definition are expected to see little profit impact from Asia. However, banks that have become more creative with their trade finance instruments may have their profits be somewhat more vulnerable to the Asia financial crises. Even so, they will generally be less vulnerable than banks that have participated in international term lending directly or through syndicates.

Summary of Survey on Trade Finance Loan Losses

This paper is a summary of a survey of banks comparing loan losses by commercial banks on trade finance lending versus international term lending. The purpose of this study is to examine the hypothesis that in international lending, trade finance presents a lower risk of default then does term lending to companies or governments. The results of this study suggest that trade financing, specifically the use of "confirmed letters of credit" or "letter of credit" have a much lower incidence of losses, defaults, reschedulings or restructurings than other normal term international loans whether made to the government or the private sector. The period covered by this study was from 1980 to the present. Of all the credit instruments used in international trade, the confirmed letter of credit has been found to be the safest and most secure form of international lending. Compared to other forms of international commercial loans, letters of credit enjoy a much lower loss record, in fact, international bankers surveyed reported no or minimal losses on letters of credit used to finance trade with countries that defaulted on term bank loans.

Relevance and Purpose of Study

International lending by commercial banks, following a lull in activity since the less developed debt crises in 1982-84, has begun to grow since 1991. This growth in international bank lending activity has raised concerns among bankers and bank analysists that another possible debt crises could adversely affect the earnings of banks involved in international lending. This concern became real with the Mexican peso crises in late 1994, but then dissipated as the Mexico situation calmed with the assistance of the U.S. rescue package. However, the more recent crises in Asia which is continuing to spread among once very “secure” countries (e.g. Korea, Thailand), is again raising concerns about the impact on earnings statements of banks that have expanded their international lending portfolios.

This study is important to the banking industry because of the recovery in international banking activities since 1990. A little over a decade ago, specifically during the 1982-84 period, banks participating in international lending suffered through a major financial crisis in the form of multiple country developing country debt default and restructuring. This came at the end of a long growth period in international lending by commercial banks. The 1982-84 developing country debt crisis was followed by almost 10 years of stagnation in international lending by banks. The results of this study have as the ultimate objective of providing banks with improved historical insights so that another debt crises may be avoided as international lending continues on its rapid recovery.

The criteria for defining a loss takes into consideration that the bank must have appropriate operational capabilities or professionals to perform the transaction and it the bank must also have the ability to analyze country risk as well as foreign bank risk. If the bank is unable to meet these performance assumptions then losses on letters of credit are caused by poor credit decisions by unqualified lending officers. The loan is inherently bad to begin with and should not have been made. Several countries have defaulted on trade finance instruments but commercial banks had little trade finance exposure to these particular countries.

The hypothesis being tested is that as a credit instrument, a confirmed letter of credit is a better (safer) instrument or has experienced a lower loss record or fewer restructurings than other international commercial loans particularly term loans. The implication is, therefore, that commercial banks whose international lending consists of trade finance, in particular letters

of credit, has a safer or healthier portfolio than a bank involved in other types of international lending activities.

It is believed that there were no losses on confirmed letters of credit during the past 16 years (between 1980 to 1996) except for the Dominican Republic, Nigeria, and Iraq, which are all countries that failed to meet minimum country risk standards during the period under review.

The time period of particular interest for this study is 1982 and thereafter, when several heavily indebted developing countries went through a period of defaults, re-negotiations and restructuring/refinancing of their outstanding foreign debts.[2] This period is often referred to as the period of the less developed country (LDC) debt crisis.

Definition of Terms

The foregoing hypothesis is based on the belief that a country will not default on trade finance because such a default would result in that country not being able to import required products to support domestic economic activity and exports. Cut off from required imports, which might also be necessary to generate exports, the country would experience the adverse economic and perhaps political effects quickly. Thus, there is an association between preventing defaults or loan losses on trade credits with immediate need to support critical consumption or productive domestic economic activity.

In contrast, normal international loans are associated with longer-term economic development. A restructuring or renegotiation of a term international loan will not cause the same intensity of immediate hardship to an economy but rather the hardship is felt over a longer period of time. This is not to say that normal international loans are not vital to an economy but only that they do not have the same immediate negative consequences on the economy as do trade finance instruments such as a letter of credit.

Thus, there are two major conceptual differences between international trade finance and international term lending. One difference is the term of the loan. Trade finance is generally much shorter than term lending. Trade finance is different from short-term lending which has no transfer of goods associated with it

[2] See International Monetary Fund, International Capital Markets, and The World Bank, Global Development Finance, various issues beginning in mid-1980s.

which once transferred ends the obligation. The second conceptual difference is that trade finance, whether on the import or export side, is tied to the financing the movement of goods that in some way are immediately necessary to a country's current functioning and economic well-being. In contrast, term lending is related to activities that are necessary to a country's longer-term economic growth and health but not immediately necessary for the country's short-term survival -- so to speak.

These differences -- shorter maturity and related to more vital or immediate needs (survival) of the country -- are the basis for the perception of reduced risk associated with trade finance. The traditional perception is that trade finance loans are less risky because they are more immediately self-liquidating once the goods are shipped and received. This perspective is no longer true and increasingly very much removed from actual practice today.

The survey of bankers and interviews revealed that trade finance was changing. Looking more deeply into contemporary trade finance transactions there is a difference between trade finance for exports and imports -- but do they carry the same risk? Also, does the destination make a difference in terms of trade finance provided for exports. And, within the concept of short-term, does actual maturity (3-month, 6-months, 9-months, 1-year, 2-years, etc.) make a difference. In the past several years, the "basic" trade finance product is becoming less and less generic as international bankers have become more innovative in its use. For example, trade finance now includes pre-export finance and post-export finance. This type of export finance is really more like working capital and/or inventory or operating capital finance. Trade finance is increasingly becoming less pure, not only in the non-trade transactions that are being financed but also in the distinction between short- and long-term transactions for which credit is being provided.

Increasingly, the self-liquidating character of trade finance is becoming uncertain and in some cases far removed from the truth because the lender is not able to close out the trade finance loan and it is becoming more like a revolving credit or long-term loan. Another development in the concept of trade finance is the emergence of accounts receivable trusts which, in some cases, become securitized. Increasingly banks are providing revolving lines of credit to foreign banks in developing countries to be used by the foreign bank to provide trade finance to local companies or government entities involved in trade related activities.

This type of "bulk" trade finance arrangements places the transactions/credit risks evaluation process in the hands of the foreign banks responsible for the individual "trade finance" related loans. In certain developing countries, Central Banks are very free with their definition of trade finance type lending. They encourage this type of loosely defined activity with incentives to accomplish development objectives requiring term lending that may not be permitted by international institutions such as the International Monetary Fund or The World Bank. Furthermore, this type of trade finance may be subject to other concerns that stem from the fact that in certain countries the local banking system is known to have a sizeable bad local loan portfolio. This problem raises concern about the local bank credit review process and the overall health of the foreign bank or commercial banking system in these countries.

Another aspect of trade finance that is increasingly expanding, is structured trade finance that may or may not include securitization of the loan. This type of transaction raises a question regarding the use of trade finance products with a bank versus a corporation.

Data Collection

Data on international lending and associated losses, restructuring and renovations are readily available from the Bank for International Settlements, the International Monetary Fund and The World Bank. Data on trade finance is much more difficult to locate and the loss records on letters of credit are kept only by commercial banks themselves and are not readily available. Therefore, a survey was prepared and sent to about 50 major U.S. banks. It is known that about 20 of these banks are responsible for the majority – more than 90% - of international trade finance and specifically for the provision of "letters of credit." The written survey was followed by phone interviews to the individual banks to obtain additional information, clarification and personal experience insights from international lending officers. Individual banks have asked not to be identified so as to protect the bank so efforts have been made to remove the identity of the participating commercial banks.

In addition to the bank survey, research was conducted regarding the programs of governmental and quasi-governmental institutions that act as guarantors of international trade finance. These efforts included a search of published data, both electronic and paper, together with phone and letter inquires to appropriate personnel institutions having any relationship to trade financing.

Interviews were also conducted with public sector institutions that guarantee trade finance loans. The experience of institutions which guarantee trade finance loans, such as the US Export-Import Bank and the International Finance Corporation, supports the opinion in the banking community that letter of credit default is rare. While no organization makes publicly available the historical record of default on loans underlying their guarantees, they report seeing a substantial decrease in the utilization of such guarantees since the early 1980's. Instead, banks and companies involved in international trade are increasingly using the tools available from the US Export-Import Bank and IFC to mitigate other types of risk, such as political or currency, as opposed to straight credit risk. The rational given by these institutions for this apparent shift is that banks are becoming much more comfortable and experienced in the international trade finance area.

Methodology

There are several different methods for transferring funds to finance international trade. The most secure is the "cash in advance" option. Realistically, however, most firms do not want to take the risk or cannot operate by presenting the cash up front to the exporter. Goods must either be shipped on account or with letter of credit. Shipping on account carries with it the greatest risk. Defaults on accounts payable are common and write-offs are expected in any credit offering institution. Letters of credit, however, carry with them an almost untarnished reputation of quick and reliable repayment according to every banker interviewed.

Customers of banks hesitate to use letters of credit because of the fees involved with them. The fee is similar to an insurance premium that protects the payments to the exporter. The fees vary between banks and depend upon the risk involved and the nature of the goods exported and to what countries they are exported. Letters of credit also carry processing fees. For example, a bank may have general processing fees of $100 or so plus a 2-3% charge on the worth of the shipment depending on the risk involved in the transaction with a specific country.

Survey Results

The twenty responding banks to the survey indicated that for the period 1980 to 1997 there were no or insignificant losses on

"letters of credit" or trade finance in general. Almost all of the international loan losses were on term debt. The following are some of the significant representative comments made by bankers from the responding banks.

Letters of credit are often recommended to exporters who are unsure of their new customers or of the risk involved in the country to which it is exporting. Mr. Senior Vice President of Bank A reported that "Letters of credit are really the only way to go if you're exporting to an LDC or East European country. I have experienced little to no defaults in letters of credit." Letters of credit create a relationship that is split into two separate and secure avenues. The first being the interaction between the exporter and domestic bank, the second being the interaction between the domestic bank and overseas bank. These avenues create a much more trustworthy relationship than one that might exist between two companies that know little about each other's financial health and previous business experience.

In addition, a letter of credit also creates a contractual agreement between the overseas bank and importing company. It is very much in the importing company's interest to pay the amount it owes to the bank. If the importing company were to default, it would essentially be eliminating its access to that bank and its services in the future. Being *persona non grata* in a banking community is a consequence much more worrisome than defaulting on a single payment.

There is a third, built-in security component to letters of credit, which increases their reliability. Since not all banks' letters of credit (L/C) are recognized abroad, there is a screening process involved with every L/C transaction. This screening eliminates fraudulent L/Cs as well as those issued by banks that do not have the power to do so. Mr. Vice President of Bank B said, "We always check the documentation very carefully. Losses that come through L/Cs are almost always due to false or erroneous documents."

There is also a strong, financial benefit to using letters of credit. A bank issuing a L/C may often require its customers to deposit the amount of the transaction (or a percent of it) with them. Although in this setting customers have to have the money on hand prior to receiving the underlying product, they are still securing themselves from exporter's default by not transferring the money to the supplier. Moreover, they can earn interest on the deposit, which would not be possible if the funds had gone to the exporter

right away. The result is a guaranteed payment for the exporter and an ability for the buyer to establish a business and financial reputation with the foreign partner.

Since letters of credit put the burden of payment upon the bank, the potential for default goes down dramatically. Mr. Senior Vice President of Bank C explained that foreign banks he worked with have never defaulted on letters of credit. "If a bank were to default on a letter of credit", he said, "they might as well close up shop. They would get a bad reputation in the banking community and that would effectively destroy them."

Knowing one's customer and trusting them is an essential part of all exporting companies and business. Knowing and trusting one's bank is apparently an even greater concern. Banks will go to great lengths to make sure that their international reputations are spotless. Mr. Senior Vice President of Bank C gave an example of how far a bank will go to preserve its reputation. "Bank C had a disagreement with Country Z over the way they had filled out their forms. We would not pay because of several discrepancies in the documents. Country Z raised high hell with the United Nations and State Department. On top of that, they threatened to black ball Bank C and make sure that everyone knew that Bank C did not honor their L/C's. Under pressure from the State Department and top management, Bank C went ahead and swallowed the fees and the disagreed upon amount and basically did what was necessary to preserve its reputation."

If a bank defaults upon a letter of credit, it is almost always because the bank itself has gone bankrupt. Bank D has only experienced one default on a letter of credit in the last decade. This came when a bank in Turkey failed. But even in this case, Bank D had sufficient cash in the failed institution's account to offset the letter of credit.

One might have expected that there would have been many defaults on letters of credit during the Latin American debt crisis of the 1980's. But the opposite proved to be true. Bank E was very involved in international lending before 1989. Bank E has since oriented itself to global custody and away from international loans. Mr. Vice President of Bank E explained that his bank changed its international outlook after the LDC crisis and the heavy losses it suffered during that time. However, Mr. Vice President added that even during the worst moments of the debt crisis, Bank E did not suffer any losses due to letters of credit. The worst instance with letters of credit that he has experienced has been only delay. He

explained that letters of credit are very often tied to strategic goods (grain, fuel etc.) and international banks are unwilling to risk payment and potential non-delivery of these vital supplies.

Mr. Vice President of Bank F reported that "defaults under a confirmed letters of credit, has, by and large, been excellent over the last 25 years. If you consider that restructurings, like Brazil, are not a credit default in the sense of a 100% write-off, then aside from instances involving documentary disputes, we cannot recall having any situations where we did not have a recovery on confirmed letter of credit transactions." However, a word of caution is added that "once banks pay at sight or accepted drafts or finance by advance letter of credit trade transactions, the ability to later distinguish whether an uncovered deposit account overdraft or unpaid loan started with a letter of credit is not identified, accounting-wise, as a separate type of transaction and cannot then be readily extracted for comparison purposes."

The results of our survey were confirmed by an independent study by a major bank participating in the letters of credit business. In a separate survey of the risk associated with letters of credit compared to term lending by a major bank that is an active participant in the L/C market, found that L/C exposure is generally less riskier than normal loan exposure. The study also revealed that non-accruals for the most active users of L/Cs are generally smaller compared to least active users of L/Cs. However, "our loss history in commercial letters of credit is impossible to determine because we pay the negotiation and book it as a loan and further identification with an L/C is lost. Nonetheless, it is the view of several experienced credit officers that our loan loss experience in commercial L/Cs is extremely low."