

LAW AND ORDER

Five top trade lawyers discuss some of the biggest issues in trade finance.

THE PANEL



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Q1. How are your clients adapting to the changed economic climate in terms of their approach to transactions and their structuring?

Grant Eldred – Thomas Cooper

The crisis brought with it wide price-elasticity in a number of markets, which did provide short-term opportunities for the brave. Generally, however, there was a move towards more tangible security and more basic structures. The outlook of clients depends very much on whether they think the liquidity pumped into the system throughout the world has had a genuinely stabilising effect or whether it has just brought forward demand to the short-term.

Celia Gardiner – Watson, Farley & Williams

Obviously, among banking clients, there has been a mood of caution, manifesting itself in higher pricing, concentration on stronger borrowers, fuller security structures and shorter tenors. We have also seen some restructuring of deals that have really tested documentation, and lessons learnt from that process have been incorporated into the drafting of the new transactions. There is some very careful negotiation by borrowers, who are not particularly trusting of the banking sector at present. In fact, we have seen an extreme situation where a borrower was forced into severe difficulties when its Icelandic bank lender became insolvent. Whether this approach will last and, if so, for how long, is very

difficult to predict. Ultimately, the approach to deals reflects the wider conditions of the market, which, as we have seen over the past 18 months or so, can take everyone by surprise.

David Lacey – Stephenson Harwood

Finance providers generally have become much more conservative, both in terms of their selection of customers and the types of facilities they will make available. It will be some time before we see the return of the highly-leveraged corporate transaction. This conservatism is driven by a number of factors, including the on-going shortage of liquidity in the market, uncertainty over the future economic prospects of potential customers, a growing aversion to risk, and stricter credit assessments and compliance procedures.

However, finance providers still need to earn a living in this market, as in any other, and are under political pressure to restore commercial financing. Fewer transactions and less liquidity mean that margins have increased significantly and lenders will require greater equity contributions and security than they would have required in earlier times. Borrowers that may have obtained quite generous terms when there were a number of banks competing for their business now find new terms are much less favourable. One of the main consequences of a default now is a significant increase in the margin in exchange for a waiver.

The shortage of buyers in the market means that banks are often reluctant to enforce their security, since enforcing security only



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GEOFFREY WYNNE, DENTON WILDE SAPTE

makes sense if the assets can be sold to generate cash to repay the debt. If, in practice, the only buyer would be the existing customer, then the bank may as well restructure the loan with that customer, albeit on terms more favourable to the bank.

Banks also recognise that what may have started out as a debt reward for a debt risk now represents an equity risk for which the banks will expect an equity return. Thus, banks may look for debt-for-equity conversions, both to restore the borrowers' solvency and to provide the bank with some equity upside. Where the bank does not wish to own equity for regulatory or balance sheet reasons, phantom equity structures can be used to give the bank the economic effect of an equity interest without the ownership of an equity interest.

Robert Parson – Reed Smith

A common feature across trade finance banks and major corporates has been to adjust their 'diet' to take account of the natural hesitance of the banks to commit participation to some of the big projects that previously enjoyed widespread support. Banks have been happy to commit substantial funds to some major bilateral deals, while feeling their way on going back into the syndication market. There is plenty of business being done across MRPA's where the risk money being put out is digestible.

It is not a state of affairs that will last forever, of course. For the right deal – for example, with sovereign oil production at its heart – there is clearly an appetite and confidence is starting to build.

Geoffrey Wynne – Denton Wilde Sapte

Clients have reacted differently. Some have become very conservative and very risk-averse to the extent that they are tempted only by tried and trusted structures with well-known customers. Others are being somewhat more adventurous, particularly on a bilateral basis. Structuring is very much in focus as are difficult questions from credit committees and requirements that there is more security in transactions. What is interesting is that borrowers are much more prepared to accept these requirements than they have been before.

Q2. How have attitudes to trade finance among clients changed over the past year or two?**Celia Gardiner – Watson, Farley & Williams**

For our trading house and producer clients, the attitude to trade finance is fairly consistent: they need it and, in some cases, provide it to others in the supply chain and have reacted in various ways to the difficulties in obtaining facilities as a result of the banking crisis. Banks have obviously been influenced by wider considerations as to whether this is an area of their business that they wish to prioritise. Out of our banking client base, we have seen a range of banks, from major international players to the very small specialist financial institutions, dedicate resources to making this area a key part of their business. Those banks with stronger balance sheets have found this past year a period of opportunity.

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GRANT ELDRED, THOMAS COOPER

Grant Eldred – Thomas Cooper

Traders and corporates need liquidity and cashflow and are looking carefully at receivables and supply chains to achieve efficiencies. Banks and financial institutions have products and solutions to offer but, perhaps understandably (bearing in mind recent events), corporates seem hesitant to accept advice on liquidity and working capital requirements from the banks!

David Lacey – Stephenson Harwood

Trade finance is often described as counter-cyclical. Customers who, in the good years, raised money by the issue of a eurobond or an unsecured group facility now seek finance based on commodities that can be readily sold, to ensure that the bank has an effective means of repayment.

However, the trade finance market is affected by the lack of liquidity, just as other markets. Creative bankers will look to tap different liquidity pools within their bank and may, for example, look to use an Islamic finance structure where the bank has a

designated liquidity pool for these structures (even if neither the bank nor its customer is at all concerned about the Shari’ah compliance of the transaction).

Nonetheless, commodity transactions continue to be popular because they provide what is perceived to be a reliable repayment route for the bank. If there is a problem with the borrower, the bank hopes to sell the commodity and recover its debt. Obviously, the more ‘generic’ the commodity and the bigger the demand, the easier it is to finance.

Banks will also look to other ownership-based structures, such as invoice discounting (where the bank purchases invoices due to its customer) and inventory repo transactions (where the bank purchases inventory from its customer and then re-sells that inventory to its customer as needed). The better the payment history of the receivables and the larger the market for the inventory, the easier this finance is to arrange.

Robert Parson – Reed Smith

There has undoubtedly been a shift in attitudes towards trade finance, which vary depending on the underlying connection to trade in the particular financial institution. Banks that always majored in commodity-focused and secured lending (rather than participating/leading performance-based facilities) have struggled to make the new market, with its increased concentration on control and accountability for the underlying goods to reduce risk weighting, work for them.

There has inevitably been a flight to quality, which has left some businesses underfunded and put some hitherto well-established names in certain sectors in a very difficult position and unable to maintain their current operation – and certainly vulnerable to a spike in oil prices.

Geoffrey Wynne – Denton Wilde Sapte

Most clients still believe that well-structured trade finance transactions are more secure than most. What has happened is that there have been some high-visibility transactions, such as UC Rusal, and problems with some of the banks in the CIS that have rocked confidence in trade finance. However, in many of these cases, the transactions became less structured and the structures themselves, to the extent they existed, were loose – some might say too loose. Couple this problem with reductions in certain commodity prices and it becomes easier to see why there have been a greater number of problems than there had been historically. As confidence and structure returns, so the attitude will become more positive again.

Q3. How big an issue are the events surrounding BTA and Alliance Bank?**David Lacey – Stephenson Harwood**

The New Restructuring Law of Kazakhstan was introduced in response to the deteriorating loan portfolios of a number of banks, including BTA Bank. BTA issued restructuring options to its creditors under that law.

As part of that, there has been considerable debate about whether trade finance obligations should be included in the restructure. Trade finance creditors sit on the steering committee and have expressed dissatisfaction with trade finance debt being included in the general restructuring plan. It also raises the prospect that other Kazakh-based banks will find it more difficult to raise trade finance in the future if BTA Bank includes trade finance in its debt restructuring.

Reports indicate that non-government trade finance will be settled with a new revolving credit facility. This restructuring of trade finance obligations represents something of a break with tradition. Trade finance has traditionally been excluded from debt restructuring of emerging market debtors and sovereigns. Trade finance is often viewed as a different business from general corporate lending and is seen as providing a contribution to the economy, and facilitating the export of goods and generating foreign currency revenues.

There is a risk that by including trade finance in the restructuring, other Kazakh banks will find it more difficult to arrange trade finance facilities in the future. An impact on letters of credit will also adversely affect the normal flow of commerce with the potential for a significant increase in costs if Kazakh importers need to arrange foreign letters of credit. The burden is likely to fall hardest on local businesses rather than the oil or mineral sectors, which tend to involve large companies with significant independent financial capabilities.

However, there is an argument for saying that a trade finance liability is no different in principle to any other payment obligation and that it would be unfair for one group of creditors to be insulated from the effects of the financial problems of BTA. It certainly means that trade finance banks dealing in emerging economies may have to rethink their implicit reliance on being insulated from debt restructure. It will also mean higher costs for Kazakh business for some time to come, even if the government is confident that any short-term prejudice against Kazakhstan as a place to invest will be overcome in the longer term.

Geoffrey Wynne – Denton Wilde Sapte

We are advising the Steering Committee on Alliance Bank and so I need to be a little circumspect in my comments. Clearly, however, the level of potential losses and the complexity of the restructuring is having an effect on confidence that international bankers will have providing finance to these banks in Kazakhstan. This may well have implications in the financing of other banks in other CIS countries in particular.

It will be interesting to see the effect this has on the trading of secondary market debt of these institutions and whether it has an impact on the secondary debt trading in bank names. For example, there were many who believed that all financings to banks like these would be considered trade debt and, consequently, would be exempt from rescheduling. As things stand at the moment, this is not the case in all circumstances. I would foresee a general review of how financings are put together and some pressure being put on central banks to create special categories of exempted trade finance debt.

Q4. To what extent do you think that banking regulation has affected – and will continue to affect – trade finance transactions?

Grant Eldred – Thomas Cooper

Unlike exotic synthetic structures, trade finance structures – with genuine underlying assets – can attract favourable capital adequacy treatment and, to a large extent, there should be no reason why increased capital adequacy and liquidity requirements should not favour trade finance solutions.

Celia Gardiner – Watson, Farley & Williams

It is generally considered that the current regulatory capital requirements for trade finance are disproportionately high when the actual loss profiles of trade finance transactions are compared to certain other fields of banking. This means that, at a time when banking capital is scarce, there has been an incentive for banks to concentrate on other areas, and we have seen some banks reduce their trade finance activities as a result of this. There is activity in the market to try to reform the regulatory requirements to redress this and we will clearly follow those negotiations with interest.

“...the current regulatory capital requirements for trade finance are disproportionately high when compared with the actual loss profiles of trade finance transactions..”

CELIA GARDINER, WATSON, FARLEY & WILLIAMS

David Lacey – Stephenson Harwood

Banking regulation shows no sign of abating in the near future, and regulation and compliance will be a major part of the financial markets for the foreseeable future. This is not necessarily a disadvantage for trade finance transactions since an emphasis on due diligence, on-going monitoring and well-established operating and performance histories fit well with the risk-averse culture of today's financial markets.

Trade finance transactions may also provide a positive political angle to the extent that they are facilitating the export of products from developing countries and international trade, which is often seen as a more positive way of facilitating regional development than aid packages. That is not to say that trade finance transactions will escape unscathed in this new environment, but the continuing shortage of liquidity is likely to be a much more important factor than the imposition of new banking regulatory standards.

Robert Parson – Reed Smith

The impact of Basel 2, although not regulation in the traditional sense strictly speaking, continues to grow. This is principally because in times of tightened credit, reduction in risk weighting becomes an absolute necessity to free funds for the business rather than an ideal.

We see many more banks revisiting their established products and practices with a critical eye to see how these can be explained internally to risk and credit committees and, ultimately, to the authorities.

Whether there will be a serious impact on trade finance from the expected wave of post-crunch regulation remains to be seen. Given the track record of commodities finance, both before and through the crunch, this market would be an inappropriate target for regulatory zeal.

Geoffrey Wynne – Denton Wilde Sapte

It is interesting that Basel II did not dictate to trade finance banks structure and the taking of security in the way that many of us had anticipated it might. Thus, transactions were still completed, despite not enjoying the beneficial treatment under Basel II they arguably ought to have had.

Equally, in any event, a number of banks would not have benefited from better treatment under bank regulation created by Basel II. Going forward, the best way to assist banks in trade finance transactions would be for a more flexible approach to be taken under Basel II. This would encourage structures outside of the rather narrow exemptions currently granted under Basel II specialised finance.

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ROBERT PARSON, REED SMITH

Q5. How do you think the banking crisis will affect the legal environment and the structures of trade transactions in the longer term?

Grant Eldred – Thomas Cooper

Structures will increasingly have to be tested against regulatory requirements as well as commercial requirements. Those jurisdictions that provide certainty in their regulatory rules (as well as their legal systems) will be favoured. Those that do not, will lose out.

Celia Gardiner – Watson, Farley & Williams

The main change to the legal environment will be regulatory: it is too early to say at this point how this will specifically affect trade finance. So far as deal structures are concerned, these are driven by the legal tools in particular jurisdictions and the amount of competition there is in the market among providers of finance. As liquidity returns to the market there will be pressure for structures to be watered down and, no doubt, pressure on pricing. It will be interesting to see whether the banking market changes profoundly in the trade finance area as a long-term result of the crisis.

David Lacey – Stephenson Harwood

The banking crisis has accelerated the growth of the regulatory and compliance burden on the financial markets. Risk and compliance

issues are now very much centre-stage, with more influence on transactions. They also contribute to a general sense of caution, with transactions taking longer to implement. Transactions that might once have been structured as an unsecured corporate facility will now need to be secured and ownership-based structures will become more attractive, despite the increased overheads and operating burden.

The banking crisis means less liquidity and an increasingly conservative outlook by bankers, not to mention the impact (whether explicit or implicit) of the effective nationalisation of many of the larger banks and the actual nationalisation of smaller ones. This will influence the facilities that are made available (and decisions to withdraw facilities). Trade finance transactions may be seen as ‘politically positive’ on the basis that they facilitate the export and import of useful goods and commodities rather than general lending that could be used for a range of purposes, not all of which may be considered worthy. Thus, trade finance transactions should be free of much of the political influence that might otherwise affect lending structures.

The shortage of liquidity means banks are less willing to join syndicated transactions and has meant a significant growth in bilateral facilities. Bilateral facilities are, by necessity, smaller than syndicated deals and will involve customers setting up more complex inter-creditor arrangements where they have multi-bank financing (particularly as banks recognise the risk that the same asset has been charged twice, and some may not be charged at all). Shareholders are likely to find greater pressure on them to contribute equity or subordinated loans to fund the operations of the borrower. Banks are also more likely to look to established commodity markets, and have less appetite for the more exotic products unless financially strong and well-established off-takers are available.

Robert Parson – Reed Smith

The principal effect has been to alert banks to the wisdom of retaining the skillsets that will enable them to closely structure transactions to the underlying commodities and goods traded. Risk and credit personnel will be scratching around for a part of the market that they can confidently survive in. Banks will increasingly lift the lid on ancillary contracts and service providers to see how their status and performance affects the overall risk.

When money supply does finally ease it will find a different and more cautious set of users.

Geoffrey Wynne – Denton Wilde Sapte

If you look at whether the lessons of history are ever learned, you would say that in the short-term there will be tightening of structures and the taking of security, and this will be followed by lengthening of repayment terms, less structure and less security. The real question is how long the benefits of good structuring will be allowed by borrowers. This will depend on whether banks rejoin the market or enter the market and weaken structures in order to complete transactions. Only time will tell whether the cycle of tightening and relaxation is shorter or longer than usual. □