The Importance and Commercial Rational of Structured LCs in African Trade Finance

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Summary

Structured or 'Synthetic' LCs are sometimes seen as a bit of a dirty little secret in Emerging Market Trade Finance. They are not well understood outside the circuit of the Global Traders who facilitate them, the international confirming banks who discount them and the EM banks who rely on them for their USD Treasury liquidity. Their recondite nature and the suspicion they foster is (wrongly) intensified by both a relative lack of transparency concerning the product and uninitiated developed market trade purists who dismiss them as not 'real trade'.

ITFA has drafted a white paper to demystify Structured LCs which appears to be the only published detailed exposition on these instruments and many of the ITFA ARC banks participate in them as an essential part of the African trade ecosystem. The hope is that a clear explanation of why and how they are needed and used for frontier trade finance will help foster more market-wide tolerance and participation in EM trade liquidity facilitation which was desperately needed in developing African economies before Covid and will make all the difference in the aftermath.

The truth is that they are a form of 'trade refinance', a species of viable short term hard currency lending EM banks use to fund their trade portfolios in Exchange Control countries whose Central Banks have limited foreign currency reserves and need to protect their economies' exchange and inflation rates. They are a clever innovation, made necessary by the Global Trade community's unfortunate inability to obtain appropriate trade permissions from Global Regulators.

Commercial purposes/role in market

Each of the three counterparties participating in Synthetic or Structured LCs (SLCs) has their own clear commercial motives associated with their roles in the transaction which enhance their economic position.

The product has evolved since its Commodity Trader genesis in the 1990s and there have been many inventive permutations on the theme engendered over the last three decades which alter the operational mechanism, relative geographies, nature of the underlying security and the use of the lending it generates. However, fundamental commonalities in the commercial rationale persist throughout the different species of SLCs for each of the transacting parties.

At a high level, the traders' purpose is purely economic whereas the banks' motivation comes from their attempts to navigate increasingly the stifling unintended consequences of Global investment bank regulation on trade finance and Emerging Market developing economies.

The Parties:

1. The 'Trader': often the 'originator' and the 'distributer' of SLCs is typically a non-bank, Corporate Commodity Trader, (now sometimes a Global Corporate) with significant merchant trade activities with billions of dollars of unmonetized cargoes on the ocean, at any given time;

2. The 'Issuing Bank': usually an Emerging Market Financial Institution which needs improved access to USD liquidity and pricing, has a trade platform capable of issuing LCs and correspondent trade relationships with international banks willing to take their risk through LC confirmations;

3. The 'Confirming and Discounting Bank': is the, usually, Developed Market correspondent bank with trade risk appetite on the LC Issuing Bank and access to well-priced short-term trade dollar liquidity.

The Commercial Purpose of the Parties:

The Trader: Risk-Free Revenue

The Trader is simply intending to monetize billions of dollars of cargoes they have on the water as they prosecute their normal global trading activities by intelligent and innovative use of Documentary Credit instruments and their global banking relationships to generate substantial risk-free revenue.

The source of this risk free revenue is the 'arbitrage' differential in price they pocket between the deposit rate they charge the EM Issuing Bank and the cost of the confirmation and discount rate of the LC from the Discounting bank, minus the negligible costs of the collateral (cash or 'A' rated bank SBLC/guarantee they must post for the few days prior to issuance of the instrument to presentation of copy documents) and the enforceability, tax, legal and compliance opinions.

They may use interest rate strips and fixed/floating swaps with the banks to generate another, fully hedged revenue stream out of the transaction, as well.

The Trader may only make 10-50bppa but across billions of dollars of LCs annually this amounts to considerable risk free leveraging of previously 'lazy' cargos, at great returns.

There are three flavours of Trader motives:

i) In its purest form, they are using the risk-free revenue to subsidize the cost of financing the LC's subject cargo or other extremely finely priced flows to gain a competitive pricing advantage on its vanilla financing flows;

ii) As a pure financing intermediation transaction, which constitutes the overwhelming motivation underlying this market, the Traders are acting as quasi-banks, lending millions of dollars of well-priced, short-term trade liquidity to EM banks, without having to use any client deposits or suffer any Basel regulatory capital and liquidity costs of actually being a bank;

iii) There is a much rarer, 'non-trade' and potentially more difficult version where the Traders don't own the cargos, which are not intercompany, use the LC as a financing device and the applicant and beneficiary arrange with the Issuing Bank to lend the dollars to intermediary companies to buy the bank's NPL books to improve their ratios – at best this is Issuing Bank Working Capital but not 'trade finance': The

Traders' motive is still revenue but its source is rented cargos and there's more collusion in the non-trade use of the dollars.

Their 'Structured Trade Desks' entire purpose in life is to originate LC issuance from dollar hungry EM banks and distribute the confirmations and discounting to dollar long International Banks, apply pricing pressure to the willing banks and innovate the structures into an increasingly competitive marketplace.

The Issuing Bank: Short-Term Trade Portfolio Liquidity

Excessive Cost of Emerging Market Trade Liquidity

EM banks, often in Exchange Controlled countries, suffer extremely high cost of funding hard currencies, particularly USD.

Their Central Banks often are not able to maintain sufficient foreign currency reserves to meet their USD denominated import requirements as their economies don't generate enough USD exports. This creates shortages and pricing inflation for FX liquidity, spiraling sovereign risk premiums and a reluctance for international banks lending 'wrong-way risk' dollars to these EM commercial banks.

EM trade finance is typically funded in USD: the international exporter wants to be paid dollars immediately at sight and the EM importer needs three to six months or more to receive, condition, distribute, and sell the goods in local currency, requiring their EM bank to fund USD for the tenor of the underlying cash conversion cycle.

When the EM banks attempt to fund these short-term trade dollars, they inevitably find their returns are lower than their cost of equity and value destroying as their net margin, after the inflated cost of funding, over the Basel 2 inflated capital RWA costs the regulations force them to hold against their poor credit quality EM corporate and SME obligors, renders the business unprofitable.

This is exacerbated by the Basel 3 liquidity regulations flattening the shorter end of the dollar liquidity curve. Even if dollar clearing banks will lend short term dollars to EM banks trying to fund their trade books in the Money Markets, the LCR, NSFR, and HQLA costs make it so expensive their Treasuries might as well use five year Syndicated Loans or Eurobonds to fund 60 day trade transactions.

In some African jurisdictions, EM banks can use repos and basis swaps to borrow the dollars they need to fund their short-term trade portfolios. However, there are natural limitations to the market depth of their Eurobond and local currency government bonds and bills and substantial haircuts must be applied to cover the FX and Market risk, custody fees (EM Government bonds are generally not Euro clearable) and tenor mismatches between the collateral, funding and underlying trade assets. There are legal enforceability concerns in many African markets for GMRAs, ISDAs and CSAs. And even in those currencies which have basis swap markets, there is limited depth and the basis can cut both ways.

This over or outpricing of short-term dollar trade liquidity forced by inappropriate regulation is unsustainable and one of the root causes of the 'African Trade Gap'.

Trade Refinance

Fortunately, there is a species of trade lending from international banks to EM banks which can significantly improve the cost of short term, dollar trade financing which can considerably improve the net revenue and the returns on the trade assets to profitability.

Under Basel 2 AIRB (Advanced) methodology, sophisticated international lending banks can use lower Loss Given Default (LGDs) for assets designated as 'Trade' which this results in considerably lower RWA Capital costs, the benefits of which can be shared with the EM borrowing banks in lower pricing.

Also, USD 'Trade' financing is not technically deemed to be 'wrong way risk' as it involves a self-liquidating, real flow of hard currency denominated goods into the country.

Unfortunately, 'Trade Refi' can only usually be used for large, lumpy, long tenor assets as, to qualify as 'Trade' and receive the LGD relief, the borrowing bank must 'prove' its 'Trade' by rendering up all the details of the transaction: importer, exporter, goods, tenor, shipping, ports, nominal, etc. and sometimes even copies of some or all of the underlying documents.

This is just completely unusable for the vast majority of real EM trade finance: there are huge numbers of very small, very short tenor, randomly drawn and maturing and revolving assets which all have to be funded at uneconomic, unprofitable rates out of the EM banks' Treasuries and they are impossible to refinance because the dynamics of these assets makes marshalling the necessary information and administration required by the lending banks to prove they are 'trade' completely impossible.

Structured LCs Solution

SLCs are the perfect answer for the EM Issuing Banks: they can effectively obtain Trade Refinance loans to fund their real trade portfolios at economically viable rates, without having to achieve impossible feats of data management and operational risk to prove the money is being used for 'Trade': SLCs automatically qualify as 'trade' for capital purposes because they are based on full disclosure of the LC itself and all relevant documents. They are not **RE**finance but pure vanilla trade finance as the financing bank is a party to the instrument.

When solicited by the Traders' origination desks, their Trade Businesses and Treasury can order placement of sufficient tenor matching dollars to fund their entire trade book on a revolving basis at viable pricing and simply issue the Structured LCs.

The cost of this liquidity is limited to the deposit rate, sized at a suitable present value discount, subtracted by the Trader placing the dollars back with them on presentation of compliant documents after generating the dollars from discount by the Confirming Bank. Most EM Banks enjoy zero risk weight and capital costs on the deposited cash collateral under Basel 2 Standardized and those on Advanced can delimit the capital costs of the maturity payment liability through substantial LGD reduction of the security or use prepayment variants.

While they neutralize much of the self-inflicted regulatory cost problems, EM banks don't want to 'lift their skirts' to all and sundry around their Treasury needs and operations – hence some of the secrecy and 'embarrassment'. As with LCs, SLCs are bilateral arrangements between banks and completely undisclosed to the rest of the market like derivatives. There is nothing nefarious in this – it is prudent 'need to know' information management.

Trade Finance Purpose?

Although not an exact science, there are tell-tale features for spotting SLCs but since all dollars are fungible, whether the commercial intent of the Issuing Bank's Treasury is 'trade finance', Working Capital or something else is only known to their Treasurer and unknown to all the other parties:

It might be that the EM Banks intend to simply swap the dollars into local currency, buy T Bills and lock in a substantial 'risk free' interest rate or window-dress their balance sheet but all EM banks with a significant trade book have this real need. Central Banks, governments and developing economies benefit from the improved liquidity and actively regulate against "bad behaviour" but conspicuously refrain from 'banning' their banks from issuing Transit or intercompany LCs indicating a tacit acceptance of these structures.

For Central Banks in Africa, SLCs dramatically increase desperately needed USD liquidity in their economies without depleting their FX Reserves Import Cover or putting selling devaluation pressure on their currencies. They provide an essential buffer to float their dollar liquidity as the dollars don't have to be bought by the importer's bank from local currency sales of USD imports: the extra dollars are just placed with the issuing banks as prepayment or deposits in the first place…

However, well priced for EM banks, commercially, it is bad business to just raise short-term liquidity without matching it with a pipeline of short-term, self-liquidating (overwhelmingly trade) assets: without immediately deploying them to tenor matched assets, Treasuries are forced to lock-in losses by placing the dollars overnight at considerably lower prices than they raised them or run nasty tenor mismatch risk of borrowing short and lending long. SLCs avoid this problem.

The Confirming and Discounting Bank: Profitable Utilization of EM FI Trade Appetite

Profitable Trade Finance

The international banks who actively (and knowingly) participate in SLCs because they are able to access a shrinking pool of EM trade through regarding them as UCP 600 compliant, irrevocable payment obligations of EM banks, with observably excellent product default characteristics, they would otherwise not be able to access.

Wrong way risk is curtailed through tightening of country limits and EM risk appetite and some can't access the Trade Refi Market as their Basel 2 Advanced methodologies don't permit 'trade' LGD relief for 'trade loans'.

Their sanctioning committees and regulators, persuaded by all the ICC empirical data in the Trade Registers are content with more risk and allow lower RWA costs for 'proven' short-term, self-liquidating vanilla trade finance but the price discovery is collapsing as the Market recognizes the empirically tiny PDs and the competing confirming banks are herded into fewer Documentary LCs as even much EM trade has shifted to Open Account.

Structured LCs provide a rich source of Credit and Capital digestible trade assets as 'LCs' which enjoy all of the possible benefits and drive profitable utilization of their EM trade bank lines through satisfying the Issuing Banks' thirst for economically priced Portfolio Refi Trade Loans.

This utilization of EM limits affords, empirically very safe, deployment of short-term liquidity with an EM premium, which is attractive in the search for yield, whilst restricting obligors to regulated banks who publish audited financials without exposure to the EM corporate and SME risk.

Banking the Global Traders offers a huge opportunity to EM and Global Banks across all their businesses in Transactional Banking, Markets, M&A etc. Aside from the direct economic benefits of facilitating SLCs, there are obvious cross-sell and up-sell opportunities to the Traders and the Issuing Banks through participating in their programmes.

Trade academics and theorists who decry SLCs as against the orthodoxy of 'real trade' are usually not actual practitioners who have to contend with the harsh realities of real EM trade finance: they do not need them and not having used them, they generally don't really understand their technical details or the markets they have evolved within.

There are real but manageable compliance and legal risks around their validity and enforcement and the case law (as set out in the ITFA White Paper) suggests that proper disclosure of the nature and purpose to all the parties, full UCP600 compliance, documentation and a valid underlying cargo, indicates that SLCs are likely to enforced in the same way as traditional LCs.

Conclusion

Hopefully, the ITFA White Paper and this article will foster more regulatory and trade community understanding and tolerance of SLCs and the essential role they play in very challenging African markets. Innovation and diversity should be embraced, particularly by policy makers and influencers who truly sponsor African development through Trade Finance. We all should have done a better job of getting appropriate regulatory treatment of EM trade but if that ship has sailed, it behoves us all to embrace inventions, like Structured LCs, which will progress African Trade Finance and economic development.

The vast majority of cross border trade, including all that promised under the AfCTA will require exactly the kind of EM short-term USD liquidity which was so challenged in the Pandemic, has been hampered by poor regulation and can be supplied by innovations like Structured LCs.