

## Summary: Intervention & Options

<b>Department /Agency:</b> <b>Export Credits Guarantee Department</b>	<b>Title:</b> <b>Preliminary Impact Assessment of Letter of Credit Guarantee Scheme (LCGS)</b>	
<b>Stage:</b> Development	<b>Version:</b> 1	<b>Date:</b> 01/05//2009
<b>Related Publications:</b>		

Available to view or download at:

<http://www.ecgd.gov.uk/index/public-information/public-consultation.htm>

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**What is the problem under consideration? Why is government intervention necessary?**

The aim of the LCGS would be to increase the ability of UK exporters to obtain confirmed letters of credit, which would normally be readily available in a well functioning financial market. The scheme should increase capacity for the confirmation of letters of credit opened by overseas banks in favour of UK exporters through risk-sharing between ECGD and UK banks. Government intervention is justified since UK exporters' activities are being constrained, resulting in lost sales, reduced employment and output.

**What are the policy objectives and the intended effects?**

The policy objective of the LCGS would be to ensure that UK exporters, which would have received letters of credit confirmations by their banks in an efficient financial market, regain access for a period of time until the systemic dislocation in financial markets eases. By risk-sharing with ECGD, the scheme would address the lack of capacity of UK banks to confirm letters of credit. This would enhance the availability of letters of credit confirmations as well as help contain their cost and, therefore, sustain and potentially increase export orders for UK companies. The Scheme would only be used temporarily until a degree of normality returns to the trade finance market.

**What policy options have been considered? Please justify any preferred option.**

- i) The provision of partial government guarantees for bank letters of credit
- ii) Do nothing

The preferred option is the provision of government guarantees for bank letters of credit (option 1) since this option would be aimed directly at resolving the source of the decline in the availability of trade finance. In the absence of any government intervention, UK exporters will continue to experience difficulties in obtaining secure forms of payment and as a result be more exposed to buyer default. This is a major source of uncertainty that will inhibit existing export business and prevent them from exploiting new export opportunities.

**When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?**

12 months after the launch of the programme

**Ministerial Sign-off** For SELECT STAGE Impact Assessments:

***I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.***

Signed by the responsible Minister:

.....Date:

## Summary: Analysis & Evidence

Policy Option: 1	Description: Letter of credit Guarantee Scheme
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<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups'  The scheme is expected to be self-financing. Premium income would cover administrative costs and expected risks without being an extra burden on the taxpayer. However, there is a relatively low probability that it could incur costs beyond the expected outturn.
	<b>One-off</b> (Transition)	<b>Yrs</b>	
	£ <b>N/A</b>	N/A	
	<b>Average Annual Cost</b> (excluding one-off)		
	£ <b>N/A</b>	N/A	
<b>Total Cost (PV)</b>			£ <b>N/A</b>
Other <b>key non-monetised costs</b> by 'main affected groups' Costs can only be estimated, since levels of future claims and unexpected losses are unknown (see Evidence Base for estimates).			

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups'  ECGD would receive a fee in proportion to its risk coverage. Total premium income would depend on take-up of the scheme and the risk profiles of markets where eligible UK Banks are seeking to risk-share with ECGD.
	<b>One-off</b>	<b>Yrs</b>	
	£ <b>N/A</b>	N/A	
	<b>Average Annual Benefit</b> (excluding one-off)		
	£ <b>N/A</b>	N/A	
<b>Total Benefit (PV)</b>			£ <b>N/A</b>
Other <b>key non-monetised benefits</b> by 'main affected groups' The effect of the enhanced capacity of letters of credit on the wider economy, and in particular the export sector, cannot currently be assessed.			

<b>Key Assumptions/Sensitivities/Risks</b> Risk: Banks might not be willing to take up the Scheme.
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Price Base	Time Period	<b>Net Benefit Range</b> (NPV)	<b>NET BENEFIT</b> (NPV Best estimate)
Year N/A	Years N/A	£ <b>N/A</b>	£ <b>N/A</b>

What is the geographic coverage of the policy/option?	United Kingdom			
On what date will the policy be implemented?				
Which organisation(s) will enforce the policy?	ECGD			
What is the total annual cost of enforcement for these organisations?	£ <b>N/A</b>			
Does enforcement comply with Hampton principles?	N/A			
Will implementation go beyond minimum EU requirements?	N/A			
What is the value of the proposed offsetting measure per year?	£ <b>N/A</b>			
What is the value of changes in greenhouse gas emissions?	£ <b>N/A</b>			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation <small>(excluding one-off)</small>	Micro <b>N/A</b>	Small <b>N/A</b>	Medium <b>N/A</b>	Large <b>N/A</b>
Are any of these organisations exempt?	No	No	No	No

**Impact on Admin Burdens Baseline** (2005 Prices)

(Increase - Decrease)

Increase of £ N/A

Decrease of £ N/A

**Net Impact**

£

N/A

Key:

Annual costs and benefits: Constant Prices

(Net) Present Value

## Summary: Analysis & Evidence

Policy Option: 2

Description: Do nothing

<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups' The availability of letters of credit is likely to continue to be severely constrained, impacting UK exporters negatively. No specific numbers for this effect are available.
	<b>One-off</b> (Transition)	<b>Yrs</b>	
	£ <b>N/A</b>	N/A	
	<b>Average Annual Cost</b> (excluding one-off)		
	£ <b>N/A</b>	N/A	
<b>Total Cost (PV)</b>			£ <b>N/A</b>
Other <b>key non-monetised costs</b> by 'main affected groups' The wider effects of reduced availability of letter of credits on the UK economy cannot be assessed accurately. The World Bank estimates that of the current fall in trade activity, 10-15% of that fall is due to a decrease in the availability of trade finance <sup>1</sup> .			

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups' ECGD would not face any unexpected losses or contingent liability without a scheme on trade finance.
	<b>One-off</b>	<b>Yrs</b>	
	£ <b>N/A</b>	N/A	
	<b>Average Annual Benefit</b> (excluding one-off)		
	£ <b>N/A</b>	N/A	
<b>Total Benefit (PV)</b>			£ <b>N/A</b>
Other <b>key non-monetised benefits</b> by 'main affected groups' N/A			

Key Assumptions/Sensitivities/Risks

N/A

Price Base Year N/A	Time Period Years N/A	<b>Net Benefit Range (NPV)</b> £ <b>N/A</b>	<b>NET BENEFIT (NPV Best estimate)</b> £ <b>N/A</b>
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What is the geographic coverage of the policy/option?	United Kingdom			
On what date will the policy be implemented?				
Which organisation(s) will enforce the policy?	ECGD			
What is the total annual cost of enforcement for these organisations?	£ N/A			
Does enforcement comply with Hampton principles?	N/A			
Will implementation go beyond minimum EU requirements?	N/A			
What is the value of the proposed offsetting measure per year?	£ N/A			
What is the value of changes in greenhouse gas emissions?	£ N/A			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro N/A	Small N/A	Medium N/A	Large N/A
Are any of these organisations exempt?	No	No	No	No

<sup>1</sup> World Bank quoted in European Commission, 2009, A Multilateral Initiative to protect trade finance, p. 7

**Impact on Admin Burdens Baseline** (2005 Prices)

(Increase - Decrease)

Increase of £ N/A

Decrease of £ N/A

**Net Impact** £ N/A

Key:

Annual costs and benefits: Constant Prices

(Net) Present Value

## Evidence Base (for summary sheets)

### Introduction

1 The severe economic downturn allied to systemic problems in the UK banking sector, triggered by the credit crisis, have led banks to become increasingly risk averse, resulting in a widespread credit tightening across all sectors of the economy; for example, imposing lower loan to value ratios, higher loan spreads and demanding greater collateral. In response to the banking crisis, the Government has intervened directly; for example, through partial nationalisations and the provision of emergency liquidity. Furthermore, the Bank of England has reduced the base interest rate and implemented programmes of quantitative easing to improve domestic liquidity conditions. The Government is also implementing a fiscal stimulus package to support the economy.

2 Notwithstanding these policy measures, bank lending for trade finance purposes continues to be adversely affected by the systemic dislocation in the UK banking sector and the global recession, which has, in turn, reduced export sales. Before the credit crisis, the UK banking sector was able to meet the demand for confirmed letters of credit, in part because UK exporters were trading largely on open account terms – an unsecured form of payment. With increased risk aversion among buyers and suppliers, the demand for secure forms of payments, in particular confirmed letters of credit by UK exporters, has risen sharply. In some cases, this has been driven by the increasing difficulty of accessing trade credit insurance to cover the credit risk of exporting on open account terms as before. Without any form of trade credit insurance, an exporter trading on open account would, therefore, bear the full risk if a buyer is unable or unwilling to pay. Banks' perception of increased risks has led to the cutting back on their risk appetite for certain sectors and countries, specifically emerging markets and developing countries, leading to a decrease in the availability of trade finance and in particular confirmed letters of credit.

3 A recent survey by the International Chamber of Commerce (ICC) on trade finance<sup>2</sup> among 122 banks in 59 countries<sup>3</sup> shows that 47% of the respondents stated that the volume of export letters of credit has decreased. During recessions it is normal for international trade activity to decrease. However, this time, trade has fallen much more quickly than can be justified by the decline in economic activity. Empirical evidence indicates that the decrease in the availability of trade finance has exacerbated the situation - responsible for 10-15% of the fall in global trade according to World Bank estimates<sup>4</sup>.

4 Against this background, the Government sees a possible need for intervention by ECGD to support UK exporters given current conditions in bank trade financing (see detailed rationale outlined below). Under the proposed LCGS, ECGD would share the risk with the bank confirming the letter of credit and receive a premium payment in proportion to its risk coverage. ECGD would provide cover for the risk on the issuing bank's bankruptcy, default and non-payment of its obligations, including any political risks associated with the country of the issuing bank. Note – Documentary risk and non-payment resulting from action/ inaction of the UK bank would not be covered by ECGD.

### Rationale for government intervention

5 The rationale for government intervention is outlined below:

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<sup>2</sup> ICC Banking Commission, Rethinking trade finance 2009: An ICC Global Survey, 31 March 2009

<sup>3</sup> Responses were mainly received from Asia, Europe and North America

<sup>4</sup> World Bank quoted in European Commission, 2009, A multilateral initiative to protect trade finance, p.7

## Failure in the financial market

- a Increased risk aversion among buyers and suppliers has led to higher demand for letters of credit by UK exporters. UK banks have been increasingly asked to confirm these by UK exporters, providing a greater assurance that the exporter will be paid by the overseas buyer. However, banks are reluctant to underwrite the risk of buyer's overseas banks, since they are either unable to establish the financial situation/creditworthiness of the overseas bank and are afraid that this might deteriorate significantly, or they perceive the country of the issuing bank as a risky market. This is limiting the banks' risk appetite and reducing the availability of confirmed letters of credit to UK exporters at a time of rising demand.
- b The risk aversion by banks is also reflected in the collapse of the secondary market for the syndication of trade credits. The secondary market enabled banks to share and diversify their exposure to countries and counterparties by selling part of their portfolio on to other banks. Due in part to the increased risk aversion among banks, they are now unwilling to do this, since it has become more difficult to establish the risks associated with these transactions. As a result, banks' portfolios have also become more illiquid, since they are unable to sell parts of their portfolios to other banks. Therefore, the risk appetite/lending limit for certain companies/countries are reached more quickly, aggravating the effects of the reduced availability of confirmed letters of credits, since there is no possibility to free up capacity by selling some of the portfolio/risk. This implies that UK exporters, who could be supported by the banks if markets were working 'normally', are turned down by them, due to the exhaustion of their lending limits/ risk appetite.
- c Some UK banks have experienced a substantial erosion of their capital bases as a result of the fall-out from the credit crisis, that in turn has reduced their capital adequacy levels. Furthermore, some banks might not be completely sure yet about the size of the losses that they might face in the future on their so-called 'toxic assets'. The main reason is that banks have difficulty in accurately establishing their value given that there is no recognised market. These uncertainties have also raised concerns over capital adequacy. This implies that even if a bank has sufficiently high capital ratios, banks have an incentive to deleverage, de-risk and scale down their balance sheets. This has been manifested at the trade finance level by banks' decisions to withdraw or limit facilities, and the requirement for greater returns on existing lines. As a result, the cost of letters of credit confirmations has increased.
- d The reduction in the availability of trade finance facilities is inextricably linked to the reduction of export credit insurance cover. The presence of export credit insurance cover is often a requirement of an exporters' trade banking facilities. Banks previously took comfort from the fact that the presence of credit insurance was an effective risk mitigant in international trade transactions. But the outright cancellation and curtailment of cover by trade credit insurers witnessed over the past year has substantially eroded the availability of insurance as a mitigant against loss. This factor has only served to reduce the banks appetite and risk capacity for trade finance transactions.
- e A further factor, which is adding pressure on banks to limit or withdraw trade finance facilities, is the more onerous treatment of less risky segments of trade finance such as letters of credit under Basel II<sup>5</sup>. The main reason given by banks is that the capital requirements imposed do not reflect the lower risk of these trade finance products i.e. they are treated similar to unsecured lending in terms of risk. Furthermore, despite trade finance being short-term, under Basel II a one-year maturity floor was introduced for all

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<sup>5</sup> <http://www.bis.org/>

lending facilities. Capital requirements increase with maturity length as well as the capital costs of trade finance. All this reduces the bank's ability to provide trade finance products. These results were established in the survey conducted by ICC United Kingdom. The ICC, however, does not call for the abolition of Basel II but rather for small changes to the current rules to eliminate the problems mentioned above.

6 The aforementioned points are also reflected in recent surveys on trade finance. The results are summarised below.

- a A survey conducted by the IMF/ BAFT in March 2009<sup>6</sup> shows that responding banks (mainly from Western Europe and North America) identified their own increased cost of funds (71% of respondents), increased capital requirements (58% of respondents) and increased risk (39% of respondents) as the three main reasons for the recent increase in pricing of trade finance products. Of the respondents stating increased capital requirements, 40% said that Basel II had no impact on their ability to provide trade finance, but almost as many said it did have a negative effect (33%). The same IMF/BAFT trade finance survey shows that 70% of the responding banks changed their lending criteria with respect to counterparty banks to the trade transaction, mainly due to being more cautious with certain countries (83% of respondents) or certain sectors (77% of respondents), since October 2008.
- b Another survey by the ICC Banking Commission on trade finance confirms that tighter credit conditions contributed to reduced access to trade finance, since 40% of respondents said that their trade credit facilities for corporates decreased and 51% of the respondents stated the same applied for financial institutions in Q4 2008 compared to the same quarter in 2007. As to the main reasons for the reduction in credit lines, the respondents identified more stringent credit criteria being applied, capital allocation restrictions, the exit from certain markets and reduced inter-bank lending. Furthermore, the survey shows that demand for confirmation requests of trade finance products increased among respondents (52% of them) between Q4 2007 and Q4 2008. With respect to the outlook for 2009, 71% of respondents expect to see an increase in demand for trade products.
- c The systemic banking problems in the UK have caused previously unseen financial market failures that have reduced UK trade financing capacity. UK exporters, who would have obtained confirmed letters of credits in a well functioning market, are unable to obtain these now due to the limited risk appetite by banks. For some UK exporters, the inability to obtain letters of credit and fulfil their orders could lead to their total failure, increasing unemployment and delaying the recovery of the UK economy from the current recession. The collapse of key UK exporters can also have implications for the viability of their supply chains. Hence, the loss of export contracts could trigger company failures further down the supply chain.

## **Costs**

7 The cost of the LCGS would be calculated as follows:

- a Precise figures cannot be calculated with certainty, since the scheme would be providing guarantee-type services and, therefore, the level of future claims and ultimate losses are not known yet. However, statistical information on default and loss rates could be used to estimate the likely outcome.
- b Simulation analysis using a Monte Carlo model would be used to generate a loss distribution for the new facility. The portfolio's performance could be measured using, for example, the following indicators:

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<sup>6</sup> IMF – BAFT Trade Finance Survey; A survey among banks assessing the current trade finance environment;

- i *Expected Loss*: this would be the loss suffered if the scheme is performing as assumed when pricing and sharing the risk with the confirming bank for the default of the issuing bank.
- ii *Unexpected Loss*: this is the loss in excess of the expected loss, i.e. claims under the scheme are greater than expected.
- ii *Contingent liability*: this is the maximum amount that could be lost at any point in time.

## Benefits

8 The benefits of the LCGS would be as follows:

- a The main benefit of a scheme would be to increase the capacity of letters of credit confirmations by sharing the risk between the government and UK banks. In turn, UK exporters should be able to provide more products to overseas customers. A sizeable proportion of UK cross-border trade is currently financed using letters of credit but the latter is declining due to insufficient bank risk-bearing capacity. The scheme could reverse this trend and increase actual confirmation capacity, providing benefits to UK exporters and the UK economy by sustaining and potentially increasing export orders.
- b The scheme would provide banks with the ability to share part of the risk with ECGD. On the one hand this would signal to UK banks, that the government considers the shared risk acceptable and, therefore, could encourage banks to undertake similar business on their own again or provide the opportunity for the re-emergence of the secondary market. Hence the scheme would help to reduce banks' risk aversion. On the other hand, the risk sharing for confirmed letters of credit could allow banks to free up capacity to support additional export transactions, thus multiplying the positive effects of the enhanced capacity of confirmed letters of credit.
- c The direct monetary benefits of a scheme cannot yet be quantified for similar reasons as mentioned for the costs above.

## Risks

9 The main risks to this scheme would be:

- a *Potential losses*: As mentioned above, these can only be estimated and losses could still go beyond the estimated level. Moreover, in the first instance, there would be cash outflows to meet claims and, thus, ultimate loss could only be established if and after recoveries have been made. However, traditional trade products such as letters of credit generally have relatively low risk and loss rates compared to other general banking facilities. The ICC survey shows that 86% of respondents think that the risk of traditional trade products is the same or lower than those of general banking facilities and of these 42% think they have a significantly lower risk. Furthermore, 66% of the respondents stated that the level of actual losses associated with traditional trade products were significantly lower (i.e. 50% or less) than losses when using general banking facilities. Furthermore, the risk would be shared with the participating bank, implying that the bank would not participate in transactions with an irresponsible level of risk to themselves and, therefore, ECGD would not support confirmations of letters of credit with an unacceptable risk. Crucially, ECGD would also determine its risk capacity by market and by issuing bank.
- b *Non-participation by banks*: The delivery of a scheme would require the participation by banks. The IMF/BAFT survey also asked what the official sector, defined here as government and international financial institutions, should do to support trade credit financing. Some 29% of the respondents stated they would like to see official bodies, such as ECAs, provide more credit lines, 26% would like to see government schemes that

target trade finance specifically and support trade transactions and 17% said they wanted more government guarantee programmes or stronger guarantees. Hence it is likely that participants in the trade finance market and in particular banks would respond positively to and take part in the LCGS.

## **Summary**

- 10 In summary, the main points related to the proposal to introduce the LCGS are:
- a The financial market is not functioning properly, providing grounds for government intervention.
  - b The LCGS would enhance the capacity for letters of credit confirmations to UK exporters. UK exporters, who would have been able to access letters of credit and obtain confirmations of these by their UK banks in a well-functioning financial market, will have greater opportunity to do so.
  - c mitigate the effects of the global economic recession on the UK and provide a fillip to recovery prospects by preventing company failures and thus rising unemployment.
  - d The measure would only be temporary until financial markets start to work normally again.

**ECGD**

**May2009**

## Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

**Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.**

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	No	No
Small Firms Impact Test	No	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

