PROJECT EVALUATION DEPARTMENT
Special Study

REGIONAL TRADE FACILITATION PROGRAMME: Fostering transition through documentary credit

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SPECIAL STUDY: REGIONAL TRADE FACILITATION PROGRAMME

PREFACE

Project: Regional Trade Facilitation Programme
Banking FacilityPurpose: Issues guarantees on behalf of Issuing Banks in favour of Confirming Banks to enable confirmation of documentary letters of credit. Makes loans to Issuing Banks to finance trade transactions. (See Box 1 on page 1 for a full description).

Participating banks: Issuing Banks in the countries of operations and Confirming Banks within and outside the region.

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Field work: PED visited Issuing Banks and other parties in Russia, Kazakhstan, Kyrgyz Republic and FYR Macedonia, and Confirmng Banks in the UK, Germany and Belgium to gather information on-site during 2002.

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Fostering transition through documentary credit

Executive Summary

The EBRD's Regional Trade Facilitation Programme (TFP) is a network of banks[1] that uses EBRD guarantees to reduce risk in international trade. Since 1998 the EBRD has guaranteed over 900 documentary credit transactions worth €650 million. This Special Study by the EBRD's Project Evaluation Department (PED) **confirms the success and the positive transition impact of the TFP network and recommends improvements.**

I. REFORMING THE REGIONAL TRADING SYSTEM

While the quick opening of central and eastern Europe (CEE) to Western trade, following the fall of communism, has been much noted, trade in the Commonwealth of Independent States (CIS) has been slow to develop. The 1990 demise of the USSR's Council for Mutual Economic Assistance left a void not yet filled by trade between private firms of the CIS. Also, commercial banks were to replace the International Bank for Economic Co-operation and provide cross-border payments. But acute country and business risks slowed the access CIS banks had to hard currency payment systems, crippling the transition in trade. Eleven years on, the documentary credit instruments and skills that underpin Western trade payments remain limited in CIS banks and firms.

Regional pre-payment practice is discouraging trade. To address the country and business risks present in the market, most exporters demand cash in advance. However, such pre-payments expose importers to high risk.

Documentary credit can reduce settlement risk in international trade. Settlement risk is the risk that the exporter will not receive payment for delivered goods, and that the importer will pay for but will not receive ownership of the goods ordered. A LC guarantees payment against transfer of ownership of the goods, protecting both exporter and importer against settlement risk. As an additional guarantee, exporters often request that these LCs are confirmed.

> PED recommends that Letters of Credit (LCs) should be adopted across the region to facilitate trade and replace pre-payments.

Confirming Banks are exposed to business and country risks. The EBRD guarantees the Confirming Bank that the Issuing Bank in an EBRD country will honour its LC under all conditions. The TFP bank network provides confirmed LC services to firms across the globe. It has let exporters in 50 countries benefit from confirmed LCs.

II. TRANSITION IMPACT OF THE TFP

The TFP fosters transition through documentary credit by:

- reducing country risk disruption and supporting sustainable transition in trade payments;
- imposing *formality* and s*tandards* on trade transactions, for "bottom-up" institutional development;
- *connecting banks and firms* in the *entire region* to well-governed global payments and trade credit networks, fulfilling the Bank's mandate to help the region "become fully integrated into the international economy".

[1] Issuing Banks: 68 in 20 countries; Confirming Banks: 177 in 61 countries at November 2002. This study ignores credit lines, not linked to documentary credit, which TFP grants to 11 Issuing Banks.

In this way, the TFP complements "top-down" national-level transition tools such as privatisation and regulatory reform. The programme also provides the EBRD with an opportunity to foster transition in countries that demonstrate slow reform, or whose economies offer few viable projects to finance.

The TFP supports sustainable transition in trade payments. The TFP can help connect Issuing Banks to Confirming Banks and the international LC system during times of crisis. The TFP can also reduce the impact of country risk on transition, such as during the political crises in FYR Macedonia in 2000.

> PED recommends that the Bank should bring the TFP's crisis response potential to the attention of other international financial institutions, which could replicate the programme world-wide and build a global safety net for documentary credit that serves broader development goals.

LCs help formalise trade through documents that are subject to sound, global standards. Documentary credit is governed by standards, promoted by the International Chamber of Commerce and enforced by Confirming Banks, which reinforce transparency in trade and the market.

The more transactions, the greater the cumulative transition impact from the TFP. Doing more transactions with more firms and banks will do more for transition than fewer, larger deals. Through the issuance of thousands of guarantees, the EBRD can foster transition through documentary credit across the CIS.

III. IMPROVING THE TFP's SUCCESSFUL PERFORMANCE

The TFP's network creates over 12,000 pairs of banks that can "twin" to produce a confirmed LC.[2] The TFP's network enables Issuing Banks to work with 15 times as many banks as normal, and assists thousands of firms trade with the region, without costly cash collateral. This strong global network is key to the TFP's success.

The TFP has been successful overall, but needs to take bigger steps to meet its intra-regional objective. Most of the underlying trade from the TFP has been with the West. Only 8 per cent of TFP LCs linked region-based exporters and importers and promoted intra-regional trade. To date, a few Western Confirming Banks have dominated TFP LC confirmations. For example, EU-based banks confirmed 78 per cent of TFP deals. By contrast, only 24 of the 93 region-based Confirming Banks have confirmed LCs, which accounted for only 4 per cent of all TFP deals. The Bank could, with the help of technical cooperation funding, assist more local banks to take on the confirmation role and benefit transition.

> PED recommends that management incentives should reward new twinning partnerships and greater quantities of TFP deals should be rewarded, more than the value of TFP deals.

The EBRD should deepen its overall commitment to documentary credit. The Bank can foster transition through documentary credit by taking policy steps that reach beyond the TFP.

> PED recommends that the Bank should promote documentary credit as part of its transition strategy for the region. The EBRD should encourage best practice in documentary credit in all of its activities and projects, and by all of its clients.

More specific recommendations are contained in Appendix 3 of this Special Study.

[2] 68 Issuing Banks times 177 Confirming Banks equals 12,036 unique pairs of banks.

SPECIAL STUDY:
REGIONAL TRADE FACILITATION PROGRAMME

1. INTRODUCTION

1.1 This Special Study assesses the performance and potential of the EBRD's Regional Trade Facilitation Programme (TFP), launched in December 1998. The study reviews the TFP's transition impact and presents recommendations for further enhancing the programme.

The TFP grew out of a series of seven less successful EBRD programmes, developed between 1993 and 1998, to facilitate trade. The new programme streamlined these for better success and removed the constraints blocking progress under the earlier versions.

1.2 The TFP is a network of banks

Through the Trade Facilitation Programme, the Bank has created a single network of commercial banks. These banks are connected to the EBRD by standard legal agreements. The network permits any *Confirming Bank*, within the network, to work with any *Issuing Bank,* within the network. This greatly increases the number of potential trading partnerships and each bank's ability to meet trade finance needs in the real sector. To increase the number of banks participating in the network, the EBRD has cut the cost of membership by dropping untenable commitment fees. By eliminating mandatory risk sharing, the Bank has also opened the network to the earliest transition countries, which have scant commercial access to letter of credit confirmation facilities.

The development of a single network of commercial banks has been instrumental in the TFP's success. Earlier versions of the programme linked too few banks to attract active use. To be successful, the TFP must maintain a critical mass of both Issuing Banks and Confirming Banks. In fact, the more of each, the easier it is for Western Confirming Banks to use the TFP and transfer know-how to Issuing Banks. However, keeping a critical mass of banks linked to the network need not slow graduation[1] of Issuing Banks that outgrow the need for TFP. There is also scope for greater risk sharing to promote graduation from TFP support (see Section 7.2.12).

The TFP has helped banks and their customers reduce risk in their international trade deals with the region and to foster transition through documentary credit. Trade facilitation[2] under the TFP is defined as "contributing to the creation of the specific financial and institutional infrastructure for trade." A key instrument of that financial infrastructure is the documentary Letter of Credit (LC)[3].

The TFP eases the use of documentary credit by exporters and importers. It issues guarantees that allow Confirming Banks to accept payment risk under Letters of Credit on Issuing Banks in the region. No other bank or export credit agency offers a similar global service via a single network.

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[1] "Graduation" means the gradual withdrawal of TFP support from an Issuing Bank in response to market conditions.
[2] Note: The UN, WTO and other bodies define "trade facilitation" as the removal of administrative barriers to trade, mainly those posed by tariff, customs, taxes, regulations, procedures and other bureaucratic constraints that governments and banks impose on commercial transactions.
[3] A Letter of Credit is a promise by a bank to make a payment on behalf of a customer in accordance with specified conditions. These are frequently used in international trade to make funds available in a foreign location.

Exporters in the West usually ask their house bank to confirm (guarantee) the LCs offered by Issuing Banks in the following circumstances:

- the Issuing Bank is unknown to the exporter;
- the Issuing Bank is located in a country featuring high country risk;
- the seller knows and prefers to deal with its house bank as Confirming Bank.

Box 1: The role of Issuing Banks, Confirming Banks and the TFP

Issuing Bank
An Issuing Bank is a bank in one of the EBRD's recipient countries. Its role is to:
- identify customer needs for LCs and other trade services;
- assess the customer's credit risk and approve a credit line for the LC;
- sign a credit contract with the customer, obliging it to pay;
- issue the LC in favour of the beneficiary abroad;
- handle documents that govern the sale;
- communicate with the Confirming Bank that confirms the LC.

Confirming Bank
A Confirming Bank may be based either outside or inside the region. Its role is to:
- identify customer needs for LCs and other trade services;
- assess the credit risk of the Issuing Bank and approve a credit line for the LC;
- take the risk without security, or get cash collateral, or ECA or an EBRD guarantee
- add its confirmation to the LC, guaranteeing the beneficiary that it will pay the LC even if the Issuing Bank fails to pay;
- handle documents that govern the sale.

EBRD Trade Facilitation Programme (TFP)
The role of the TFP is to:
- assess the credit risk of the Issuing Bank and approve a credit line for the guarantee;
- assess the documentary trade capabilities of the Confirming Banks;
- sign guarantee facility agreements with the Issuing Banks and Confirming Banks;
- issue guarantees in favour of a Confirming Bank on behalf of the Issuing Bank.

This also applies to exporters in the region whose house banks can confirm, through the TFP guarantee, the LC offered by Issuing Banks in the region. However, as discussed later in this Special Study, the TFP's Confirming Banks in the region have made little progress in LC confirmation business.

2. RATIONALE FOR THE TFP

2.1 The TFP has attempted to address the collapse of intra-regional trade.

The collapse of the USSR, with its close trading ties with central and eastern Europe, severely damaged intra-regional trade in the transition economies. Most significantly, it saw the dismantling of the Council for Mutual Economic Assistance (CMEA) in 1990. As one prominent economist recently observed:

"While exhilarating politically, the rapid dismantling rather than restructuring of CMEA appears to have been economically costly for the transition economies. While Western advisers did not argue for the elimination of CMEA, and many pointed out the benefits of maintaining some form of trading area, more advice probably could have been given to the

policy makers in the former Soviet bloc on how to restructure CMEA and prevent the collapse of trade within the region."[4]

CMEA's trade payments infrastructure, which involved settlements through the International Bank for Economic Cooperation (IBEC), also fell apart. Up until that time, the IBEC had used the "transferable rouble" as the unit of account. However, following the collapse of the Soviet Union, the international payments infrastructure, which includes private networks of banks that clear in leading hard currencies, failed to fill the gap in the market. To this day, the banking systems in the Commonwealth of Independent States (CIS) have remained weak by international standards and still have limited access to basic payment and documentary credit services in hard currency.

The EBRD's 1995 strategy for trade facilitation correctly identified this problem:

"Foreign trade developments in the early years of the transition have been mixed in some countries, disastrous in others. Everywhere, intra-regional trade has collapsed. The fall in trade has been a major contributor to recession. ... There was much unnecessary destruction and prevention of trade, and a vast unfulfilled potential remains. There is a need for immediate action."

Unfortunately, while the quick opening of central and eastern Europe (CEE) to Western trade has been much noted, the situation in the CIS appears to have progressed very slowly. (This study does not assess the changes in intra-CIS trade over the transition period; such a study would be useful for the EBRD's Office of the Chief Economist to consider.) The Bank responded to the problem by establishing the TFP. The programme has had a positive demonstration effect, illustrating that guarantees can help Issuing Banks get better access to Western Confirming Banks. The TFP still, however, faces the major challenge of helping repair the damage to intra-regional trade (see Section 6.4).

2.2 CIS pre-payment practice is discouraging trade.

Fieldwork by the Project Evaluation Department (PED) has confirmed that the LC is scarcely used in the CIS, but greatly needed. Russian and other CIS producers demand pre-payments from their customers, both foreign and domestic. They require full cash payment in advance from importers, not only to cover risk but also to comply with the unusual working capital requirements in the CIS. Russia also demands advance payments from exporters, particularly those based in the CIS, as shown in the case study below (see Box 2). In addition, many Western exporters to the region demand advance payments. As a result, large numbers of potential trading partners are avoiding the region as the mandatory pre-payments system is exposing importers to high levels of risk. In well-ordered markets, LCs are routinely used to address this problem.

[4] "Assistance to the Transition Economies: Were There Alternatives?", p. 30, Jan Svejnar, The William Davidson Institute, June 2002

Box 2: Retail company in central Asia

A large retail company in central Asia stocks its shelves with imported goods. It uses documentary LCs to curb purchasing risks and to time payments to match retail sales. The company's Asian suppliers have accepted LCs for years. The company would like potential Russian suppliers to do the same.

Russian firms have welcomed the advances of the company by requiring pre-payments. After long talks, they have agreed to accept "sight" letters of credit for payment against receipt of goods. Their Asian suppliers have permitted "usage" LCs, allowing payment 90 days after receipt of goods and matching the company's sales cycle.

While the TFP has successfully helped banks in the region access LC services for imports from the West, it has had much less success with intra-regional trade or with convincing banks to supply confirmed LCs to exporters. There is wide scope for introducing the LC to reduce risks from intra-CIS trade, which is currently undertaken on a pre-payment basis.

- In 2000, one third (US$ 14 billion) of Russia's imports came from other CIS countries;
- 44 per cent (US$ 15 billion) of all CIS countries' imports came from Russia;
- The other CIS countries traded over US$ 34 billion among themselves.

Despite these facts, no bank is actively confirming LCs in the CIS. SBER Bank, the only large network bank in Russia, does not have an active LC confirmation business and has yet to accept the EBRD's invitation to become a TFP Confirming Bank. This suggests that nearly all the intra-CIS trade, and much of Russia's exports, are done on a pre-payment basis. Also, patterns and trends in SWIFT trade services messaging (see Section 5.3.2 on SWIFT) show that inter-bank trade services between CIS banks are still in early transition and heavily centred on Russia.

2.3 Documentary credit has reduced settlement risk in international trade.

A key risk in trade is *settlement risk*: the risk that the seller will not receive payment for delivered goods, and the risk that the buyer will not take ownership of the goods per the sales contract. The documentary LC *guarantees payment against transfer of ownership* of the goods or services, protecting the buyer and seller against settlement risk. LCs ensure that the buyer will not pay until they take ownership of the goods, and that the seller will be paid if they deliver the goods.

2.4 Working capital shortages have caused pre-payments in international trade.

In the West, suppliers provide working capital to customers. They allow the customer time to pay for goods after delivery. In the CIS, the opposite happens: suppliers demand pre-payment, with customers required to supply working capital prior to delivery. Commercial banks in the West provide external working capital finance to suppliers, allowing them to grant normal payment terms to customers. In the CIS, the banking systems remain largely inoperable, supplying little working capital to the supply chains. Thus, domestic pre-payment practice has stretched to cross-border trade as well, where it is reinforced by the need to avoid the added risks of international trade.

Some banks within the region finance importer's pre-payments in international trade. In most cases, however, a sounder solution would be to provide importers with LCs. The TFP supplies revolving credit facilities to certain banks in the CIS, encouraging the provision of working capital and supporting cross-border trade. The TFP's numerous small and medium-sized enterprise (SME) lending programmes could also do this, but helping to finance the international trade LC needs of small business is not an objective of the SME programmes.

2.5 When replacing pre-payments with LCs, exporters still require working capital finance.

Providing a LC in lieu of pre-payment should transfer the problem of financing working capital from the importer to the exporter, and from the customer to the supplier. It should also help normalise the flow of working capital. Two problems, however, remain:

- The exporter will still require working capital finance, which will no longer be supplied by the importer through pre-payment. This increases the need for commercial banks to meet the working capital finance requirements of exporters. Banks will have the option to lend against the LC supplied by the importer's bank, linking the deal closely to the trade transaction and its cash flows.

- A LC will release working capital tied up in pre-payments only if the Issuing Bank does not, in turn, demand cash collateral from the importer. The importer's LC Issuing Bank may require cash collateral, as credit security, from the importer. This occurs when the Issuing Bank is unwilling to extend credit to the borrower, due to its limited lending skills. Instead of advancing cash to the exporter as a pre-payment, the importer must block their cash collateral with the Issuing Bank. The collateral will tie up the importer's cash, but it will also keep the cash out of the hands of the exporter and protect the importer from settlement risk (see Section 2.3).

Appendix 1 of this report presents this case. It establishes that a LC, by itself, does not relieve the working capital needs of either the importer or the exporter. Opening a LC is an extension of credit to the importer, and in this sense does not differ from a loan. Only skilled commercial bank lending based on cash flow, using skills promoted by the EBRD's SME programmes and other loan programmes, can address the working capital needs of the parties to a trade transaction.

3. OVERALL ASSESSMENT OF THE TFP

3.1 The TFP has had a positive effect in the countries of operations.

PED largely concurs with the TFP banking team's positive assessment of the Trade Facilitation Programme. The TFP has, however, fallen short of its main objective to help restore intra-regional trade (see Section 6.4). The programme relieves the obstacles posed by country risk, a persistent barrier to trade and economic development, as well as transition. The TFP's model network of banks has the potential, if replicated by other regional development banks, to relieve trade obstacles globally and on a sustained basis. Also, through documentary credit, the TFP is able to foster transition, connecting banks, through transparent transactions, to networks that are governed by sound standards.

3.2 Promising transition impact

The TFP's support of documentary credit has excellent transition impact potential. EBRD has allocated limited resources to the TFP despite its excellent potential for transition impact and its capacity to produce cover its costs out of its own profitability. Also, the Bank could broaden its commitment to documentary credit beyond the TFP, both by promoting documentary credit use across all Bank activities, and by doing new projects that connect banks to other well-governed global networks (see Section 8).

Assessment of transition impact	
Verified transition impact of TFP:	*Good*
Transition impact potential:	*Excellent*
Risks to transition impact:	*Medium*

Verified transition impact: *Good*

The TFP has helped foster transition by accelerating the adoption of documentary credit practices among banks and firms in the region. Several Issuing Banks have gained material experience in issuing LCs thanks to the TFP. Table 9 lists the best performing Issuing Banks. Note, however, that only two of the TFPs Issuing Banks have confirmed LCs as Confirming Banks. This shows that the Issuing Banks have not applied the skills learned from issuing LCs to build broader payments, trade services and correspondent banking businesses.

Transition impact potential: *Excellent*

The TFP's strong network of commercial banks has the potential to permit the sustained transfer of documentary credit skills to banks and firms in the region, via thousands of future transactions. Through the programme, Issuing Banks (for importers) have the opportunity to become active Confirming Banks for exporters. This would help build the payments infrastructure for intra-regional trade. The TFP also has the potential to further transition across the region, but its impact on broader transition issues is limited. The programme can complement, through bottom-up facilitation of market transactions, the more fundamental work of top-down institutional and market reforms. However, the TFP cannot, by itself, deliver systemic reform.

Risks to transition impact: ***Medium***

The main risks to realising the transition impact potential of the TFP come from within the Bank. They include:
- lack of Bank-wide commitment to documentary credit as a transition impact channel;
- full sources of the TFP transition impact not being identified and pursued across the Bank;
- risk of falling commitment to the TFP in times of financial crisis;
- limited use of technical cooperation (TC) funds to support the success of the TFP and develop Confirming Banks;
- lack of attention to the terms of credit, that may rely too heavily on collateral and not enough on cash flow, offered by Issuing Banks to their LC clients;
- aversion to credit risk in providing the TFP facilities to Issuing Banks;
- distraction by larger deal size and tenor and by loans to banks;

- limited risk mobilisation;
- limited communication of successful transactions to promote demonstration effects.

3.3 Overall Performance

Based on the above, the TFP has been rated ***Successful,*** given its young life and resource limitations that have constrained its impact.

4. ADDITIONALITY[5]

4.1 The TFP has provided additionality in four respects:

- It fills gaps in trade finance support for countries where ECA and international bank sources of credit are tight or absent (see Box 3);

Box 3: Gaps in trade finance

All Issuing Banks have stated that:
- they lack sufficient international bank lines of credit on satisfactory terms and conditions to conduct their trade finance business, and
- the TFP has enabled them to do business on an unsecured basis, which otherwise would have required them to post cash collateral.

- It offers longer-term (1 to 3 year maturity) trade credit support when commercial sources of trade finance are limited to 90 to 180 days terms;

- The TFP enables IB transactions that are larger than the amounts available under international bank lines of credit;

- It creates a banking network that would not have existed otherwise and helps banks build normal correspondent bank relationships.

4.2 The Bank has assumed that Issuing and Confirming Banks would not go to the trouble of using the TFP and paying its fees if the programme did not provide additional value.

To test this assumption, the Bank must monitor the terms and conditions of ECA and international bank lines of credit to countries and banks served by the TFP. This information will ensure that the TFP bank credit limits are used efficiently when other sources of finance on reasonable terms are not available.

Recommendation: Issuing Banks should regularly report their lines of credit by tenor, amount and collateral from commercial banks. This will enable the EBRD to better assess and defend the additionality of the TFP.

[5] "Additionality" refers to the requirement that EBRD must not provide financing in situations where financing is available from the market on reasonable terms.

5. THE TFP'S TRANSITION IMPACT

5.1 The TFP fosters transition by:

- reducing country risk impacts and providing a safety net for trade payments;
- imposing transparency and standards on trade operations through documentary credit;
- connecting banks in the recipient countries to well-governed global payments and trade credit networks;
- enabling the institutional development of Issuing Banks through the enhancement of documentary credit skills.

Together, these sources give the TFP excellent potential for transition impact; achieving that potential requires sustained commitment by the Bank over many years with due regard for graduation of Issuing Banks through risk sharing and through converting Issuing Banks into Confirming Banks.

5.2 The TFP fosters transition through documentary credit between hundreds of banks and firms.

The present network spans the globe, creating thousands of twining pairs of Issuing and Confirming Banks. The programme fosters Western documentary credit practices in the region by making it easier for LCs to be confirmed cross-border. Country risk is high and banking systems are weak in the early transition countries. LCs have been rarely used in the region and most cross-border trade flows outside the banking system. Most deals are done on a pre-payment basis, creating risks that could be avoided using LCs. In addition, most banks in the early transition countries need to post cash collateral to ensure their LCs are confirmed by other banks.

5.3 The TFP reduces trade disruption from country risk

5.3.1 The TFP has responded strongly to the risks of cross-border trade and the fear of country risk held by banks outside the region. Country risk shuts off most of the world's countries, including most of the early transition countries, from the international LC system. Country risk is present on all cross-border transactions, even between rich countries, because a state may block foreign currency payments at any time.

LC confirmations are exposed to:

- Business risk: the importer's and its Issuing Bank's capacity and willingness to pay;
- Country risk: the risk that the sovereign may seize the importer's cash flow or block the conversion of cash into foreign currency or transference of cash abroad.

5.3.2 Excessive fear of country risk causes credit rationing by foreign banks to LC issuers in emerging markets and the region. Table 1 on US banks shows the limited amount of credit extended to countries in the EBRD's region.

Table 1: LC exposure of large US banks to banks outside the US

	$US millions	Per cent of capital
Total foreign LC exposure	22,214	7.4
Africa	708	0.2
Central and eastern Europe	364	0.1
Russia (in CEE)	83	0.03
Early transition Asia	52	0.02

Source: Country Exposure Lending Survey, Federal Financial Institutions Examination Council

The LC exposure of US banks to Issuing Banks in the EBRD's region is less than two tenths of 1 per cent of the capital of the large US banks. If necessary, US banks could write-off this exposure and it would go unnoticed. The smallness of this exposure, however, is no accident: it is the result of credit rationing borne out of acute risk aversion, a persistent structural feature of the international economy. Rationing plays an integral part in the creation of multilateral financial institutions designed to respond to this type of market failure. Proving that rationing exists, however, is beyond the scope of this special study.[6]

Banks ration both LCs and loans. BIS Consolidated International Banking Statistics, that report only loans, show how tightly Western banks ration credit to banks in developing countries and the region (see Table 2)

Table 2: Cross-border loans to banks by the 24 BIS reporting country banks
(US$ millions at December 31, 2001)

Total loans to all banks in:	37,766,103	Per cent of total
Developing countries	228,817	6.00
Africa	38,977	0.10
EBRD region	44,050	0.12
Accession Zone	22,258	0.06
Russia	18,118	0.05
EBRD early transition countries	3,674	0.01

Source: Country Exposure Lending Survey, Federal Financial Institutions Examination Council

Early transition country banks receive less than one one-hundredth per cent of loans. Banks in developing countries attract only 6 per cent of all loans to banks, a strong sign of structural credit rationing. But less than 2 per cent of BIS loans to banks in developing countries go to banks in the EBRD's early transition countries, which suffer from severe credit rationing in cross-border finance.

Confirming banks react to crises by cancelling credit lines. Fearful banks react quickly to bad news, deepening crises by running from them as in the case of Russia (see Table 3).

Table 3: US bank LC exposure to Russian banks

US$ millions at 31/12

1997	1998	1999	2000	2001
170	*278*	*126*	*102*	*83*

[6] OCE should consider studying the severity of cross-border credit rationing and its impact on the additionality of the Bank.

The banking system responds to a country in crisis by suspending its access to LC system and blocking the local banks' and firms' access to normal channels of international trade. To address this structural weakness, the TFP has developed a network of commercial banks to reduce the impact of high country risk on trade and on the transition process.

The Asian crisis shows that no region is immune to trade credit rationing. The 1998 Asian financial crisis provoked intense cross-border credit rationing.

Box 4: Trade credit rationing in south-east Asia

"Not only domestic depositors lost confidence. Foreign banks cut back lending and *became reluctant* to roll over credit facilities or *to accept letters of credit written by banks in the region*. This led to a lack of trade finance…"

Source: J. Hawkins, Bank restructuring in south-east Asia, Bank for International Settlements. Italics added.

Country risk dominates commercial risk. However, building strong relationships between Confirming and Issuing Banks, a goal of the TFP, cannot overcome this dominance. All Issuing Banks are vulnerable to state weakness, which disrupts confidence and limits banks' access to external credit. For example, the domestic political crisis in FYR Macedonia in 2000 did not result in a financial crisis. But it still saw foreign banks reportedly cut off all their clean lines of credit to FYR Macedonian banks.

More often, a weak state provokes a financial crisis that entangles both sovereign and banks in a web of risk from which all foreign banks flee. Rationing of trade credit because of country risk predates the collapse of the USSR. It is a structural, rather than a transitional, feature of the system. The TFP has demonstrated a practical, systematic way to overcome structural credit rationing to the CIS.

5.3.3 The TFP serves as a financial crisis safety net for trade payments. The Financial Sector Operations Policy of July 1999 states: "A key challenge in transition is to strengthen crisis-response measures." The TFP has the potential to have a crisis response role: it reduces vulnerability to crises, consistent with Bank policy, to the extent that credit limits can be kept open.

Finding better ways to reduce vulnerability to crises remains high on the official agenda. A leading central banker said recently: "The main lesson I would draw from the recent events is that strong public intervention is necessary when markets fail to work properly."[7]

The TFP can provide a safety net that keeps Issuing Banks connected to the international LC system during crisis. The safety net can moderate the impact of country risk events on trade finance if lines remain open; this requires pre-crisis planning and enhanced risk sharing and structuring to be viable during the crisis.

The TFP's global network is a useful innovation. It is simple and it works. It can keep LC markets open continuously, softening crises and sustaining transition. It can help shield entrepreneurs from crises that would otherwise cut off their access to foreign markets. And,

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[7] Tommaso Padoa-Schioppa: Reflections on Recent Financial Incidents, speech delivered at the Third Joint Central Bank Research Conference on Risk Measurement and Systemic Risk, Basel, 8 March 2002.

Issuing Banks can invest more in building documentary credit business thanks to sustained access to Confirming Bank lines of credit.

IFIs in general seem to have given little weight to the role of trade payments and finance in crisis vulnerability and response. Countries and their Issuing Banks depend on Confirming Bank lines of credit, but so far nobody tracks bank access to this essential resource. The IMF (see Box 6) has called for better data on trade finance for vulnerability analysis, adding force to the view that the TFP has a strong role to play in crisis response.

Box 6: IMF calls for more data on trade finance

"The increased focus on vulnerability and appropriate policy responses has further highlighted the importance of addressing gaps in the data required for these purposes. The Special Data Dissemination Standard (SDDS) already provides an agreed framework for the availability of data on reserves and external debt. *Other data needed for vulnerability assessments include those on … countries' financing needs --- including their degree of reliance on rollovers, trade finance, and bond finance*."

Source: IMF, Report of the Managing Director to the International Monetary and Financial Committee: The Fund's Crisis Prevention Initiatives, November 14, 2001. Italics added.

Recommendation: The EBRD should bring the TFP's crisis response potential to the attention of:
- the IMF, which might value its crisis response features;
- the IBRD, which might value its contribution to sustainable development; and
- the regional development banks for replication in their region of operations.

The international financial institutions could seek to replicate the TFP world-wide to help build a global safety net for documentary credit. Regional development banks could replicate the TFP and connect the networks to build a global TFP network.

Lack of a crisis response plan puts the TFP's transition impact at risk. The main risk to the TFP's transition impact is that the Bank itself may suspend the TFP during a financial crisis, a time when it is most needed. Planning ahead would reduce that risk (see Box 7).

Box 7: The TFP as trade finance safety net

"A most important benefit of the TFP is its provision of a trade finance safety net for countries of the region during periods of economic and financial crisis. The value of this feature cannot be overestimated. It is likely that countries in transition will face crises in the future. The TFP should be prepared in advance with the resources necessary to support the essential trade needs of these countries when they get into difficulty."

Keeping access to the TFP open during a banking crisis requires enhanced approaches to risk management. The Bank may have to mobilise donor funding to share the risks of issuing TFP guarantees during such crises.

Recommendation: The Bank should prepare a crisis response plan for the TFP, based on the estimated trade credit needs of the countries during crisis. The plan should define crisis response credit lines for each Issuing Bank and ways to share risk with donors or other parties.

5.4 Fostering transparency and standards through documentary credit

5.4.1 The TFP fosters transition through well-governed networks. The programme promotes and reinforces transparency and global standards of market practice in real sector international commerce. This is achieved through documentary credit whose global standards foster transparency by requiring formality. In particular, documentary credit requires forms of documents that are **standard market practice (such as bills of lading, certificates of origin, letters of credit, etc.) and that are** standardised by international agreements and recognised by national and international courts and arbitration institutions.

Documentary credit is able to break down unnecessary bureaucracy by driving superior standards into the market place. The TFP drives transition at a grassroots level through market transactions. The global standards which are incorporated into these transactions should enable importers, exporters and their banks to resist unnecessary bureaucracy that is not already required by the international trading system.

Documentary credit formalises trade through documents that are subject to sound, global standards. Documentary trade credit:

- promotes transparency and participation in the formal economy, relying on documents that the real sector prepares and Issuing and Confirming banks check.

- enables mainly-Western Confirming Banks to supervise the transactions and act as a principal to the deals. Their role creates a de facto twinning partnership on each TFP deal. This arrangement ensures that two additional parties, the documentary credit experts at the Issuing and Confirming Banks, review the documentation of a trade deal. The TFP network serves to support many twinning partnerships, among both banks and firms.

- adopts universally recognised standards of international commerce by using:

    - *Uniform Commercial Code* and *International Chamber of Commerce* trade finance standards that are globally accepted (e.g. UCC 500). LCs issued and guaranteed by the TFP meet this standard (see Box 8).

    - *SWIFT* messaging standards among banks for trade and other payment transactions. (see Box 9).

Box 8: International Chamber of Commerce (ICC)

ICC has unrivalled authority in making rules that govern the conduct of business across borders. These rules are voluntary, but they are observed in countless thousands of transactions every day and have *become part of the fabric of international trade*. ICC also runs the *ICC International Court of Arbitration*, the world's leading arbitration institution.

ICC members are at the forefront of *business self-regulation*. ICC is world leader in setting voluntary rules, *standards* and codes for the conduct of international trade that are widely accepted. ICC members developed *the Uniform Customs and Practice for Documentary Credit (UCP 500)*

Source: ICC's website www.iccwbo.org. Italics added.

5.4.2 The TFP has fostered the adoption of SWIFT, UCC and Basle standards. SWIFT trade finance messages are a means and measure of banking system transition. The TFP encourages banks to communicate via SWIFT messages. SWIFT reports the number of messages sent by its users: the number of documentary credit (Category 7) messages sent by a country is one indicator of the degree of standardisation of a country's trade finance system. Unsurprisingly, earlier transition countries send fewer SWIFT documentary credit messages than more advanced ones. (See Table 4)

Box 9: Society for World-wide Interbank Financial Telecommunications (SWIFT)

Founded in 1973, SWIFT is an industry owned co-operative supplying secure messaging services and interface software to over 7,000 financial institutions, including all leading documentary credit banks, in 197 countries.

SWIFT supplies messaging standards, a secure and reliable messaging platform, and promotes Straight Through Processing. SWIFT offers a common platform of advanced technology and access to shared solutions that enable each member to build its competitive edge.

Many international trade messages are still exchanged via paper, or by unstructured telex or fax. SWIFT's Trade Finance messages (Category 4: Collections and cash letters; and Category 7: Documentary credits and guarantees) support customer's business requirements and *adhere to regulations issued by the International Chamber of Commerce.*

Source: SWIFT's website at www.swift.com. Italics added.

Table 4: Volume of SWIFT messages

Earliest transition countries ranked by SWIFT messages	Number of SWIFT documentary trade messages in 2001
Tajikistan	26
Kyrgyz Republic	205
Armenia	937
Turkmenistan	1,491
Albania	1,646
Azerbaijan	2,727
Belarus	5,135
Bosnia and Herzegovina	10,500
Uzbekistan	10,790
Ukraine	13,055
Serbia and Montenegro	13,275
Russia	68,890
EBRD 26 median	10,625
Accession median	23,191
EU member median	310,818

SWIFT messaging practice sheds light on banks and the degree of transition of the banking system to Western practice. The data show some surprises, too. Belarus, Uzbekistan and Ukraine sent more messages than did some of the smaller accession countries. In addition, accession countries lag behind EU members by a large margin.

The Bank's recipient countries outside the CIS already showed a robust level of messaging in 1992, doubling that level by 2000. The CIS countries started from a very low level and have grown their messaging rapidly. Only 24 per cent of messages sent by CIS countries went to CIS countries. Russia remains at the centre of CIS trade, as indicated by CIS SWIFT trade services activity in 2001:

- Russia sent 60 per cent of all the SWIFT trade messages sent by CIS banks;
- Russia was the only CIS country to both receive from and send messages to every CIS country;
- 8 of 12 CIS countries sent messages to no more than 4 CIS countries;
- 8 of 12 CIS countries sent over 60 per cent of their CIS-bound messages to Russia.

The above facts show that interbank trade services between CIS banks are still in early transition, and heavily centred on Russia.

Recommendation: Due diligence and monitoring should report patterns in the SWIFT messaging practices of banks.

Recommendation: The Bank should encourage the use of Category 7 and other specific SWIFT messages to deepen the impact of SWIFT standards on the banks in the region.

Recommendation: The Bank should deepen the TFP's links to ICC and SWIFT. For example, TC could help the TFP's Issuing Banks attend the training programmes on trade offered by ICC and SWIFT. These training programmes may be more cost-effective than those that the Bank can organise.

Recommendation: The Bank should encourage Issuing Banks to test new systems, such as ICC's Paction, to deepen links with ICC global standards and cut errors and delays in LC processing (see Box 10). (Paction is the ICC's model international contract on the Web. Its software lets buyers and sellers prepare, negotiate and sign contracts for international trade, online. ICC designed Paction for the smaller trader, perhaps new to international trade. www.modelcontracts.com)

Box 10: Manual processing hampers settlement of LCs.

"Research in the UK showed that, half the time, LC documents needed to secure settlement were rejected because of defects that did not conform to the terms of the LC. Not surprisingly, the cause was manual processing and the re-keying of data."

Source: Compendium of Trade Facilitation Recommendations, prepared by UN Centre for Trade Facilitation and Electronic Business, 2001

The TFP promotes standards in legal transition and capital management. The TFP introduces Issuing Banks to two EBRD loan terms that link to global standards:

- *UNCITRAL* arbitration rules for resolution of trade disputes (see Box 11).

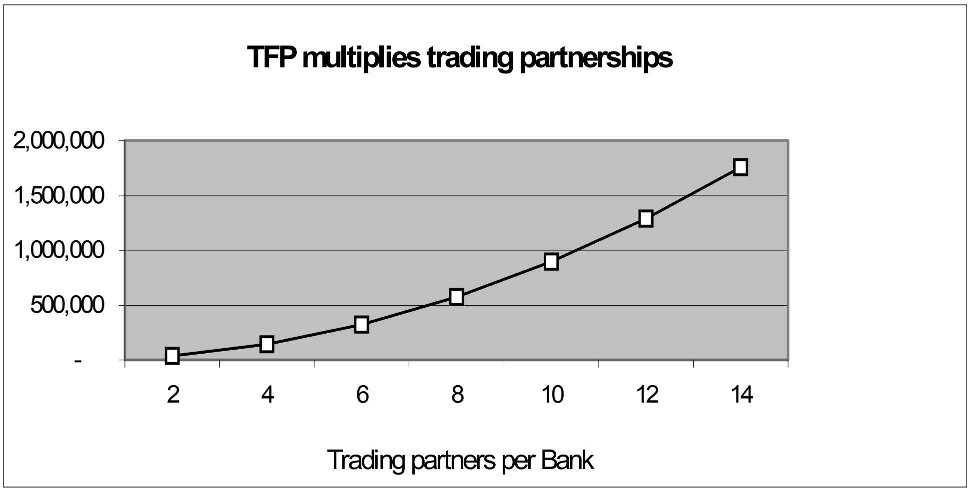
- *Basle Capital Accords* that govern the calculation of capital ratios in loan covenants.

Box 11: UNCITRAL arbitration rules – A global standard

The United Nations Commission on International Trade Law (*UNCITRAL)* Model Law on International Commercial Arbitration is a "universally acknowledged and accepted regime" of legislation suited to the needs of international commercial arbitration. The UNCITRAL Arbitration Rules, adopted in 1976, are "among the most successful instruments not only in the area of arbitration, but *also in the entire field of trade law.* They have fostered good arbitration practices, contributed to a more uniform understanding of arbitral procedures and are proven to function well between parties from different legal traditions."

Source: EBRD's "Law in Transition – Focus on contract enforcement." In the article by Jernej Sekolec, Secretary of UNCITRAL

5.4.3 **Multiplicity of deals beats deal size for transition impact.** The TFP delivers transition impact through each individual transaction. The number of transactions across more firms and banks, will foster greater transition than fewer, larger deals. Each TFP deal, regardless of size, drives compliance with transparency and global standards of best practice.



The TFP can greatly increase real sector trading partnerships. If each of the 68 Issuing Banks has four importers and each of the 177 Confirming Banks has four exporters, this makes 192,000 potential trading partnerships. The graph shows the power of the TFP's network to generate new trading relationships across the globe. The TFP makes it possible for a Russian supplier to add 10 to 100 new customers across the globe. For example, the retailer refered to in Box 2 may buy goods from a Russian supplier to make one unique trade partnership. The company may also import from four other suppliers, creating four more unique trade partnerships. The Russian supplier may export to 10 firms besides the Box 2 retailer, creating 10 additional trade partnerships.

The TFP network of banks and firms enables the development of many trading relationships and still greater numbers of transactions. For example, if there are four trading partners per bank, and only 1 per cent of them become active, that's 1,920 active trading partnerships or 12 of the 192,000 potential trading partnerships (see previous paragraph). If each partnership does three LCs per year, that's nearly 6,000 LCs. If 3 per cent of the partnerships are active, that will make 18,000 LCs per year.

Box 12: Top ten TFP countries by number of LCs weighted by the EBRD's Office of the Chief Economist's (OCE) transition indicator rating:

1. FYR Macedonia
2. Bosnia and Herzegovina
3. Moldova
4. Russia
5. Ukraine
6. Kazakhstan
7. Belarus
8. Uzbekistan
9. Georgia
10. Romania

The number of LCs guaranteed is a good measure of transition impact. The lower a country's transition rating, as determined by the EBRD's Office of the Chief Economist (OCE), the higher the transition impact of an LC deal. The countries that have received the most benefit from the TFP since 1999 are ranked in Table 5.

Table 5: TFP Impact

EBRD countries*	Number of TFP transactions	Countries with no or low TFP impact
Turkmenistan	0	Turkmenistan
Belarus	35	
FR Yugoslavia	8	FR Yugoslavia
Uzbekistan	35	
Bosnia and Herzegovina	50	
Tajikistan	0	Tajikistan
Azerbaijan	11	Azerbaijan
Ukraine	59	
Russia	62	
Albania	2	Albania
Armenia	1	Armenia
Kyrgyz Republic	18	Kyrgyz Republic

**Ranked by lowest OCE transition indicator rating*

The TFP has delivered transition impact in most of the right areas: i.e. early transition countries where the TFP's deals are needed to drive reform. But some gaps still exist. A number of the slowest reformers have yet to register transition impact potential for the TFP (see Table 5). In 2002, Armenia, Albania, Turkmenistan, Tajikistan and Uzbekistan take part in the TFP in 2002.

The TFP differs from other EBRD projects with financial institutions, which mainly support domestic intermediation. The TFP links banks across borders, mobilising cross-border risk capacity for trade payments and finance. It focuses mainly on international payments, not domestic intermediation. The programme addresses the persistent challenge posed to cross-border payments by country risk. The perception of country risk can be improved but not eliminated by the demonstration effects of the TFP. This is why the TFP has a long-term, dynamic role in the transition process. Even a strong domestic bank, with strong international banking relationships, can lose access to foreign bank credit because of a change in country risk.

5.4.4 Weak trends have appeared in some key low transition countries:

Table 6: Guarantees in low transition countries

Lagging low transition countries	Guarantees in 2002	Guarantees in 2001
Belarus	3	19
Russia	17	26*
Kazakhstan	9	14**

* plus 13 advance guarantees under revolving credit lines
** plus 15 advances guarantees under revolving credit lines

There is little evidence that Russia or Belarus are using more LCs than in the past. The small network of Russian Issuing and Confirming Banks, and a weak documentary credit culture, are limiting progress in the country.

6. TFP PERFORMANCE

6.1 Evolution of the TFP

The TFP replaced seven previous trade facilitation programmes, developed by the EBRD between 1993 and 1998. The new version streamlined these programmes for better success. The TFP removed constraints that blocked progress under the earlier versions, including:

- mandatory risk sharing by the Confirming Banks on each transaction;
- untenable commitment fees for facilities which depended upon uncertain, spontaneous demand from clients of network members;
- matching only one Issuing Bank to several Confirming Banks, limiting twinning and the pairs of banks that would find themselves in demand.

6.2 The TFP has expanded its network of Issuing and Confirming Banks vigorously.

As shown in Table 7, the network now links 68 Issuing Banks in over 21 countries of the region to177 Confirming Banks in over 50 countries. With the TFP further targeting these countries, the number of transactions should grow. Russia's Sberbank and its large branch network should be an important partner for the TFP. However, as yet, they have not signed a Confirming Bank agreement.

Table 7: The TFP Network

Year	No. of Issuing Banks	No. of new Confirming Banks
1999	23	61
2000	24	64
2001	18	19
2002	3	33
Totals	**68**	**177**

The TFP network creates over 12,000 pairs of banks that can twin to produce a confirmed LC.[8] The network allows any Confirming Bank to confirm a LC for any Issuing Bank. Normally, the Issuing Banks in a trade facilitation programme would work with less than 10 Confirming Banks, and only against cash collateral. The TFP, however, allows them work with 15 times that number and helping even more firms to trade with the region.

The TFP's capacity utilisation is low; increasing this is a challenge for the future. The TFP's network permits over 12,000 trade partnerships between participating banks, and thousands more between their trading clients. Less than 200 of these TFP twins have used a TFP guarantee: intensity of twinning is about 2 per cent. A few Confirming Banks have dominated the TFP's business, causing the low rate of twinning. Activating more twins would spur competition and integrate the Issuing and Confirming Banks and their clients into more markets.

[8] 68 (Confirming Banks) multiplied by 177 (Issuing Banks) equals 12,036: the number of unique pairs of banks. This form of network benefit is studied in the economics literature.

6.3 The TFP has nearly doubled the number of guarantees issued each year between 1999 and 2001.[9]

The TFP has issued over 900 guarantees[10] for over €700 million (see Table 8).

Table 8: Guaranteed Transactions

Year	No. of guarantees	Total TFP trade transactions guaranteed (€ million)
1999	40	98
2000	198	192
2001	368	368
2002	491	254

Several factors drive the number of transactions that can be completed, and hence the size of the TFP's cumulative transition impact:

- the number of Issuing Banks in the countries (potential to add more)
- the number of Confirming Banks outside the region (weak in the US and Asia)
- the number of Confirming Banks within the region (underdeveloped)
- total credit facilities available for Issuing Banks (constrained)
- mobilisation ratio (potential to grow from fractional to a multiple of TFP facilities)
- limited TC-funded expert support to help Issuing Banks do TFP deals (much potential to develop)

6.4 The Bank implemented the revised programme with energy, skill and consistency.

The agreements signed and transactions completed, the speed of response to inquiries (usually less than 24 hours), and the strong focus on the needs of Issuing and Confirming banks, all point to strong performance in managing the early phases of the programme.

However, rapid growth and ever-tighter resources have caused the slighting of objectives, such as the fostering of trade acceptances, activation of intra-regional links (only 20 per cent of volume and 8 per cent of deals), and mobilisation (only 20 per cent of volume). Also, raising the number of active trading partnerships to reduce idle network capacity could become a new objective.

6.5 The TFP has been successful overall, but needs to take new steps to meet its intra-regional objective.

Only 8 per cent of TFP deals linked exporters and importers in the region. This is because only a few Confirming Banks dominate the TFP's business: EU-based banks confirmed 78 per cent of TFP deals, led by three German-based banks that confirmed 27 per cent of deals.

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9 The TFP performs new transactions daily. These are reported to EBRD management and the Board at irregular intervals. The TFP also adds new banks to the programme during the year. The reader should rely on these reports for the latest data on the TFP.

10 Some of the TFP guarantees listed are, in fact, cash advances under revolving credits. Hence, the number of guarantees is somewhat less than the totals reported.

In contrast, only 24 of the 93 region-based Confirming Banks confirmed a LC, totalling only 4 per cent of TFP deals. The programme needs to develop, with the help of TC funding, more local Confirming Banks to serve the exporters of the CIS, not usually targeted by Western banks. A good example of the TFP's successful development of the near-regional network is Turkey: five Turkey-based banks have confirmed 83 (7 per cent) of TFP deals since 1998.

Recommendation: The EBRD should place higher importance and reward, through staff incentives, new twinning partnerships and greater quantities of TFP deals than the value of TFP deals booked at year end.

6.5.1 **The TFP has helped introduce documentary credit skills to banks in the region.** Table 9 lists the Issuing Banks that have shown excellent commitment and gained the most experience in opening LCs in the TFP.

Table 9: Leading TFP Issuing Banks

Issuing Bank	Country	TFP LCs opened	TFP LCs confirmed
Bank 1	FYR Macedonia	230	0
Bank 2	Bosnia and Herzegovina	75	0
Bank 3	Ukraine	70	0
Bank 4	Moldova	54	0
Bank 5	Romania	49	0
Bank 6	Georgia	39	0
Bank 7	Belarus	36	0
Bank 8	Moldova	36	0
Bank 9	Croatia	26	0

All of the banks in Table 9 - except for the banks in Ukraine, Moldova and Romania - are Confirming Banks, as well Issuing Banks, for the TFP. However, none of these banks have confirmed a LC for the TFP.

6.5.2 Banks in which the EBRD holds part ownership have shown mixed performance as TFP banks. The EBRD owns direct equity in several TFP banks. It could be expected that the Bank's ownership would improve the performance of the TFP in these banks. Some of the banks featured in Table 9 have performed poorly as Issuing Banks. With regards the EBRD's Confirming Banks, limited steps have been taken. Banks in Estonia, Hungary, Slovenia and the Czech Republic have confirmed 9 LCs between them, leaving great room for improvement. Furthermore, many investees have yet to confirm a single LC in their role as TFP Confirming Banks.

In this context, the EBRD and its board representatives need to address some specific questions to investee banks:

- What roles do international correspondent banking, documentary credit and trade services play in the future strategy of these banks?
- How do they build sustainable corporate banking businesses if they do not cross-sell these trade services, a core transaction-banking service, to their corporate clients?
- How much would building and cross-selling such services contribute to shareholder value?

Recommendation: The EBRD should ensure that its representatives on the boards of investee banks promote the growth of documentary credit businesses at the banks and good performance under the TFP programme.

6.5.3 **The EBRD SME partner banks have under-performed in the TFP.** Table 10 shows the performance by Issuing Banks, and Table 11 the performance of Confirming Banks, participating in the EBRD-sponsored SME loan programmes. The data show the low cross-sell of TFP LC issuance and confirmation at banks where the EBRD has been promoting, with large amounts of TC funding, small business lending.

Table 10: SME partner banks' performance as TFP Issuing Bank

	Issuing Bank	Country	TFP LCs opened	SME loans
				EU/EBRD SME
Bank	**1**	Bulgaria	13	791
Bank	**2**	Romania	1	284
Bank	**3**	Latvia	0	1,709
				KSBF Small Loans
Bank	**4**	Kazakhstan	8	113
Bank	**5**	Kazakhstan	18	193
Bank	**6**	Kazakhstan	3	277
Bank	**7**	Kazakhstan	Not a TFP Bank	163
Bank	**8**	Kazakhstan	Not a TFP Bank	78
Bank	**9**	Kazakhstan	0	61
				RSBF Loans
Bank	**10**	Russia	29	36,142
Bank	**11**	Russia	1	17,897
Bank	**12**	Russia	Not a TFP Bank	2,367
Bank	**13**	Russia	Not a TFP Bank	1,147

Table 11: SME partner banks' performance as TFP Confirming Bank

	Confirming Bank	Country	TFP LCs confirmed	SME loans
				EU/EBRD SME
Bank	**1**	Bulgaria	1	791
Bank	**2**	Bulgaria	Not a TFP Bank	177
Bank	**3**	Romania	Not a TFP CB	284
Bank	**4**	Romania	1	406
Bank	**5**	Romania	Not a TFP Bank	50
Bank	**6**	Poland	Not a TFP Bank	2,461
Bank	**7**	Poland	0	1,330
Bank	**8**	Poland	0	614
Bank	**9**	Poland	0	68
Bank	**10**	Latvia	0	1,709
Bank	**11**	Slovenia	Not a TFP Bank	116
Bank	**12**	Slovenia	Not a TFP Bank	106
Bank	**13**	Czech Republic	0	484
Bank	**14**	Lithuania	Not a TFP Bank	388
Bank	**15**	Estonia	0	435
Bank	**16**	Slovakia	0	188
Bank	**17**	Hungary	2 (Romania)	127
				KSBF Small Loans
Bank	**18**	Kazakhstan	5	277

The poor performance of the leading EU/EBRD SME Finance Facility banks, in their role as TFP Confirming Banks (listed in Table 11), is concerning. Why have these banks not used the TFP to meet the trade services needs of their export customers? They are unlikely to be more willing than Western banks to take confirmation risk on CIS banks without the benefit of collateral or guarantees. Bankers that PED met confirmed that their exporting customers usually require pre-payments rather than LCs. Hence, the banks have yet to develop a trade services business that focuses proactively on the export collection and LC needs of exporters.

Exporters in the region demand pre-payments, and the importers in the region often accept these terms. But every exporter is selling to an importer in another country, meaning that the Issuing Banks also have not focused well on the LC needs of the importers who agree to make the risky pre-payments. The Issuing Banks are mainly reactive; they react to importer requests for LCs after the importer has been required to issue a LC by the exporter, usually in a Western country. The Issuing Banks need to develop trade services businesses that identify future import financing needs. They should also advise their customers to use LCs instead of pre-payments to reduce settlement risk. These LCs will require confirmation, which in turn will increase the opportunities for confirmation in the region.

Banks participating in the EBRD's SME programmes should be encouraged to issue LCs on behalf of small businesses. SME banks may be putting their scarce cash at unnecessary risk by lending money to importers who are using the proceeds to pre-pay imports putting the importers' scarce cash at unnecessary risk. The routine demand from CIS exporters for pre-payments may also be discouraging prudent SMEs in the enlargement zone from importing from the CIS. The LC has the ability to reduce this source of discouragement. Therefore, settlement risk for SMEs could be reduced if SME banks searched for LC opportunities and extended LCs to SMEs importing through pre-payments.

Recommendation: The Bank should modify the loan eligibility rules of its SME finance facilities to include issuance of LCs as part of the programme's performance measurements. Opening a LC involves the same types of credit risk, and develops the same types of credit skills, as making a loan. In addition, SMEs often require a loan to finance payments under the LC.

The TFP has 23 banks that figure as both Issuing and Confirming Banks. Only two of these have issued and confirmed LCs for the TFP. This successful dual role has demonstration effect value for other Issuing Banks who should follow in the footsteps of KKB and UBB. One of these banks has confirmed LCs issued by TFP banks in the Kyrgyz Republic, marking welcome teamwork between banks in the neighboring countries.

Recommendation: The Bank should establish why the successful Confirming Banks in the region have taken up the challenge of confirming intra-regional LCs and whether they view this as a sustainable business.

7. IMPROVING TRANSITION IMPACT VIA DOCUMENTARY CREDIT

7.1 The Bank's overall commitment to documentary credit should be deepened. The Bank can foster transition impact through documentary credit by taking policy steps that reach beyond the TFP.

Recommendation: The Bank should adopt promotion of documentary credit practice as part of its transition strategy for the region.

Recommendation: The Bank should encourage best practice in documentary credit in all of its activities and by all of its clients.

Some of the areas where documentary credit could be applied, include:

- *Board approval documents:* the Bank should add a paragraph that describes how the client should use documentary credit.

- *Portfolio monitoring reports*: the Bank should add a module that updates how the client should use documentary credit.

- *Covenants*: standard loan covenants should require Bank clients to use best practices in documentary credit in international trade, thereby avoiding pre-payments.

- *Investee policies*: the Bank's board representatives should promote best practice in documentary credit, discouraging pre-payments.

- *Project implementation risk management*: all projects requiring international trade should follow best practice in documentary credit, discouraging pre-payments.

- *Cross-sell to SMEs*: the Bank should incorporate documentary credit into the SME programmes. If 1 per cent of Russia Small Business Fund clients used a TFP-guaranteed LC, that would result in more deals than the TFP has done in Russia since being established.

7.2 Strengthening the TFP

The Bank should consider further improving the TFP's transition impact. The programme has built a valuable TFP network, but this has yet to be used at its full capacity. The Bank should activate dormant banks and trade partnerships, intensify twinning, and do more deals for greater transition impact.

7.2.1 The demonstration effect must be communicated. The TFP and its benefits are not widely known. For example, in April 2002, a global firm did not know that LCs were available under the TFP to cover exports to Ukraine. At present, the company relies on pre-payments.

The programme can only have demonstration effect if it is publicised. The Bank should more vigorously inform the public about TFP deals. Each deal should be a media event, no matter how small. Every EBRD deal involves four parties: an importer, an exporter, and two banks. Each deal covers at least two countries. Even the smallest ones tell an interesting story about improving life in the countries of operations.

Recommendation: The Bank should draft a communications plan for the TFP. Among other things, the Bank should publicise descriptions of *each week's deals* through the appropriate media channels.

Recommendation: The Bank should team with an industry media group, such as trade finance magazines, to create a TFP league table. A broad range of awards should be given to push competition and maximise transition impact. Possible awards could be: best TFP Issuing Bank in each country, as measured by the number and size of deals; the most innovative bank in each country; and the best deal in each country. Other awards could recognise the Issuing Bank that does the most deals with the greatest number of Confirming Banks. Similar awards could apply in all categories to the Confirming Banks.

Recommendation: The Bank should use SWIFT's annual SIBOS trade fair to better promote the TFP to correspondent bankers. SIBOS is the leading annual trade convention for correspondent bankers who manage most relationships between banks.

7.2.2 **The TFP's objectives should be defined and its performance reviewed.** Although the EBRD reports many TFP transactions, the Bank has not set out objectives or milestones to compare these with (see Box 13).

Box 13: Communicating transition impact

The TFP's reports have provided a satisfactory general overview of the programme's operations but do not clearly communicate the programme's transition impacts.

TFP reports are unable to measure progress in operational and transition impact, because there are no measurable objectives for:

- intra-regional trade;
- SME exporters and importers;
- Issuing and Confirming Banks network;
- Issuing Bank improvements to trade finance expertise and banking relationships;
- institution development impacts on Issuing Banks;
- the TFP's contribution to sector and country strategies.

Recommendation: The EBRD's Management has requested that a three-year business plan be developed for the TFP. This plan should set out operational and transition impact objectives and benchmarks, with specific and measurable performance milestones.

For example, the TFP's present network creates over 12,000 pairs of banks that can twin on LC deals. Less than 200 of these twins have used a TFP guarantee: intensity of twinning is about 2 per cent.

Recommendation: The Bank should set targets for the TFP to activate dormant banks and trading partnerships, thereby increasing the intensity of twinning.

Recommendation: Russian exports to smaller CIS countries can promote documentary credit in Russia. The Bank should help firms, like the company refer to in Box 2, import goods under LC from Russia (see Box 2).

Recommendation: The three-year TFP plan should target and measure the number of:
- Issuing and Confirming Banks and compare these with the target number of banks for a comprehensive network;
- transactions that achieved new market and financial linkages;
- transactions that demonstrated new trade finance techniques or instruments;
- banks that executed risk sharing transactions;
- LCs issued or confirmed by each TFP bank.

Box 14

The transaction eligibility criteria do nothing, for example, to reinforce the TFP's stated goals of promoting intra-regional trade and assisting small and medium-sized companies of the region.

Recommendation: The Bank should report the number of bilateral cash advances separately from the number of guarantees.

Recommendation: The Bank should resume tracking deals formally proposed by the market which were rejected by the TFP and the reasons for this.

Deal criteria should be set to fulfil the Bank's TFP objectives. The TFP's transaction selection process does not apply criteria designed to achieve operational or transition impact objectives. Any trade-related transaction in the region is eligible for the TFP, subject to a short exclusion list. TFP business is handled on a "first come, first served" basis; this simple process permits quick treatment of all requests for assistance.

Recommendation: The transaction approval criteria should be reviewed and expanded to support the objectives set in the TFP's three-year plan. Areas which need particular review include intra-regional trade and limits on deals with state-owned firms.

7.2.3 **Best practice for collateral should be promoted.** Issuing Banks told PED that the TFP provided liquidity by releasing cash tied up in collateral. The TFP has allowed these banks to have their LCs confirmed without needing cash collateral. Most banks in the region deposit hard currency with foreign banks and most Confirming Banks require "cash cover" from CIS Issuing Banks before confirming LCs. Financial statements of Issuing Banks should disclose how much of these deposits have been pledged to cover LC confirmations (see Box 15).

Box 15: "A bank should disclose the effect of credit risk mitigation techniques, including collateral, guarantees, credit insurance and legally enforceable netting agreements. *Banks are encouraged to provide information about assets that they themselves have pledged for their own liabilities or commitments."*

***Best Practices for Credit Risk Disclosure**, Basle Committee on Banking Supervision, September 2000*

Failure to disclose pledges would overstate the liquid assets ratio. The Bank's standard liquid assets covenant excludes pledged assets from the ratio. The TFP guarantees replaces collateral, easing compliance with a covenant that constrains many Issuing Banks.

Recommendation: The EBRD's credit agreements should require Issuing Banks to conform with *Basle best practices for credit risk disclosure*, particularly in the areas of off-balance sheet and LC liabilities, and pledging of liquid assets to foreign banks.

Recommendation: The EBRD's partner banks should set corporate policies about pledging cash and other liquid assets to foreign banks.

7.2.4 Focus should be placed on documentary credit and activating the network. Revolving credit facilities crowd out higher transition impact guarantees. Cash advances to Kazakh Issuing Banks, for example, used limits that could have guaranteed LCs. Cash advances do not use the documentary credit network (See Table 12).

Table 12: TFP guarantees out-perform TFP loans for transition impact

Sources of impact	TFP guarantee	Pre-export loan
Promotes documentary credit	Yes	No
Connects Issuing and Confirming Banks	Yes	No
Promotes global trade standards	Yes	No
Tied to specific trade transaction	In most cases	No
Provides crisis response safety net	Yes	Possibly

TFP loans crowd out TFP guarantees. Banks and firms find it easier to borrow money, loosely linked to a trade deal, than to sign a commercial contract and deliver the finished goods under a documentary LC. Given a choice, these banks will always take money, using up limits needed for LC guarantees.

Recommendation: The Bank should re-establish sub-limits for loans at the programme and Issuing Bank level. Every Issuing Bank should have a limit for TFP guarantees that is not available for loans, to ensure continuous access by the Confirming Banks to the TFP network for guarantees.
Documentary Credits can provide the same liquidity as a loan. Discounting drafts under LCs can finance trade, but against a specific contract under documentary trade terms. In 1998, the Bank began promoting the use of acceptance financing, but has not followed this through.

Recommendation: One bank in Kazakhstan has demonstrated success in discounting drafts under LCs. The EBRD should replicate this success with other banks.

7.2.5 Technical cooperation (TC) should be used to promote documentary credit via the TFP. The IMF's call for technical assistance to collect trade finance data, echoes the same call by the Doha Declaration. Doha makes the case for "further expediting the movement, release and clearance of goods, including goods in transit, and the need for enhanced technical assistance and capacity building in this area."[12] The EBRD can invest more TC in the TFP, thereby furthering the Bank's own form of trade facilitation through documentary credit.

The EBRD's SME programmes supply financing to banks, as well as sustained expert consulting to train and coach bankers on how to make sub-loans. The consultants attend client meetings with the bankers, identify and structure deals, and help assess risks. In contrast, the TFP supplies banks with guarantees, but does not supply similar expert consulting. While the TFP's training programme is an excellent start, it could go further.

Recommendation: The Bank should use technical cooperation, modelled on the EBRD's SME programmes, to promote documentary credit via the TFP. The Bank should retain trade credit advisers to assist TFP Issuing Banks find and execute LC deals, assess the credit risks and build sustainable trade services businesses for confirmation as well as LC issuance.

[12] WTO/Doha Declaration explained. Www.wto.org/english/tratop_e/dda_e/doahexplained_e.htm

Recommendation: The TFP could pay flat performance fees, as the EIB does under the EU/EBRD SME Finance Facility, to Issuing Banks for confirming their first LC's, and to Confirming Banks for activating a new twinning pair of TFP banks.

7.2.6 Back office support should be supplied for the rapid organic growth of the TFP[13]. Usage of the TFP should grow given the appropriate support. At the present time, the installed network is large and growing, with its current size creating over 12,000 unique banking pairs for LCs. However, less than 200 of these have been activated. Hence, although the number of banking pairs grows each time a new bank joins the programme, some important factors need to be considered:

- *The TFP is unknown beyond its present users.* Many exporters to the region practice pre-payments believing that LCs are not available. Many do not trade with the region because of the payment risks, risks that LCs can eliminate.

- *The TFP has been under-communicated.* News about pilot transactions has not always reached the right audiences.

- *LCs are largely unknown in the CIS*, and not widely used in eastern Europe.

However, the benefits of the TFP are great:

- *The TFP multiplies banking relationships*. Issuing Banks in the CIS have less than 10 correspondent bank partners. The TFP lets another 170 banks confirm a LC for each Issuing Bank, without having to set up a correspondent relationship.

- *The seller chooses the Confirming Bank.* The TFP serves many exporters by being their Confirming Bank's sole link to the Issuing Banks.

- *The TFP increases competition among banks.* A few global banks fill the gaps in the international correspondent networks. The TFP lets regional banks confirm LCs without having to rely on a global bank.

- *The TFP permits spontaneous trade among more players.* SME exporters rarely have access to global banks. If their regional bank can confirm a LC, then they can enter cross-border trade at low risk.

Recommendation: The EBRD's three-year plan should estimate the resources needed to manage and accelerate the growth momentum built into the TFP, such as:
- periodic audits (the TFP as a business unit has never been audited);
- IT platforms (e.g. Summit prioritisation) to support operations that now require heavy manual processing by various teams;
- co-financing (mobilisation, risk sharing) using the A/B structure and other instruments;
- marketing to global banks;
- communications;
- external call centre to service network users;
- external sales force to activate the network.

The growth in the number of transactions will encounter operational constraints that resume resources and simplified procedures.

[13] Limited back-office support poses the risk that the TFP team may be forced to act as both front office and back office.

7.2.7 **Potential conflict with other Bank projects should be managed.** TFP transactions, which can be greater than USD$ 10 million, do not undergo the normal project approval process required by other EBRD projects. Hence, there is the possibility that these projects may conflict with other Bank projects.

> **Recommendation:** The Bank should favour multiplicity of smaller transactions over size. Larger deals, which are valuable for demonstration effect, should be kept near to their present small number.

> **Box 16: Managing the future expansion of the TFP**
>
> The TFP is still in its infancy as a programme. There is every reason to expect its growth will continue and even accelerate. This will occur as the benefits of the network of Issuing and Confirming Banks become known. To date, the programme has been demand-driven and the TFP has gradually increased its limits in response to demand. It is now appropriate, however, to project TFP's growth several years forward and set programme limits accordingly.

7.2.8 **A programme limit to meet the three-year plan should be proposed.** The TFP has returned to the Board several times to request limit increases. The limit on the size of the programme, which should be more generous, should serve mainly to guide the Bank about the scale of support required for the TFP (see Box 16).

> **Recommendation:** Using more of the TFP's twinning capacity should drive planning of the portfolio limit. The three-year plan, to be developed for the TFP, could consider the size of programme needed to activate many more of the 12,000+ trading partnerships between the banks. For example, raising twinning intensity from 2 per cent to 10 per cent would require about 1,000 single transactions, and would likely give rise to 2,000 transactions or more.

A measure, such as 1 per cent or regional trade flows, would point to an upper limit on the programme of US$ 2-2.5 billion. It also points to the TFP's large potential for growth.

7.2.9 **A portfolio diversification strategy should be applied to the TFP.**[14] The TFP does not have a portfolio management strategy; rather, its credit exposures are managed within the overall credit portfolio strategy of the Bank.

A portfolio strategy for the TFP would help it fend off eventual criticism of any portfolio concentrations that might be viewed, in hindsight, as excessive. Also, a portfolio strategy would help set crisis response limits, described earlier.

> **Box 17: Portfolio diversification in the TFP**
>
> The TFP argues that it has achieved reasonable portfolio diversification. However, Russia and Kazakhstan account for about 60 per cent of total cumulative exposures. In addition, much of the TFP business is exposed to commodity-based transactions, such as grain, oil, sugar, seeds and cotton.

> **Recommendation:** The Bank should consider setting a portfolio strategy for the TFP to limit exposure to countries, individual banks, and sectors or products.

[14] "The Bank shall seek to maintain reasonable diversification in all its investments": Agreement Establishing the Bank, Article 12

7.2.10 Business with Issuing Banks should be increased. The Bank has made good progress setting up an active network of Issuing Banks. It has selected the better local banks in each country as Issuing Banks. The strong selection process has helped the Bank avoid guarantee claims or losses.

Tight credit limits and the role of foreign-owned Issuing Banks keeps the TFP network from reaching all firms that needs its support. The case is acute in Russia. Also, foreign-owned Issuing Banks prefer to deal with the largest firms in a country, rather than to pursue many clients across the economy.

The short tenor and contingent nature of payment risk make TFP guarantees less risky than loans. The EBRD often limits the programme’s total exposure, to a bank, to 50 per cent of capital. This spreads the risk over various kinds of facilities. The TFP’s lower risk justifies a greater programme limit and greater allocation of Issuing Bank facilities. The Bank can allocate more TFP limits to Issuing Banks without taking excessive risk. This would likely occur if the bank's portfolio limits were aligned with the Bank’s Risk Capital Model. Also, an eventual Return on Risk Capital model could show that one-year TFP risk gives strong risk-adjusted return on capital compared with similarly rated five-year loans.

Guarantees are less risky because they are contingent and short-term. The guarantee is a contingent liability: the firm must default on its trade payment, and the Issuing Bank must default on its LC payment, before the Confirming Bank can call the EBRD guarantee. Loans, on the other hand, expose the Bank to unconditional risk on the Issuing Bank.

TFP guarantees are short-term, delivering transition impact with tenors that average one year. The underpinnings of the Bank’s provisioning guidelines illustrate the degree of risk involved. For example, if the provisioning policy took tenor into account, a one-year exposure could require about one-fifth the provisions of a five-year loan (see Table 13).[15]

Table 13: TFP guarantees require less economic capital (RR-6w)

TFP guarantees	Loan	Equity
1 year	5 years	No maturity
2.8%	13.9%	34.7%

Recommendation: The Bank should allocate facilities according to their relative risk. Greater facilities for the TFP should be allocated to each Issuing Bank for short-term guarantees on documentary credit. Likewise, the Bank should set the TFP programme limit in light of the TFP’s low usage of risk capital, and measure programme size in terms of risk capital, not nominal programme amount.

Recommendation: The Bank should consider adding more locally owned and controlled regional banks as Issuing Banks.

Recommendation: The Bank should encourage the largest Issuing Banks, such as Sberbank, to act as “money centre” Confirming Banks for domestic banks that do not have Issuing Bank status with the TFP.

7.2.11 The number of Confirming Banks should be increased. The Bank has made good progress setting up a network of Confirming Banks, while recognising that there is room to add more banks. The three-year TFP plan could list all Issuing Banks and Confirming Banks

[15] The Bank does not vary provisions by tenor, but may do so in future.

that would comprise an optimal TFP network. It could define the resources needed to enrol the banks.

Only 16 of the 63 Confirming Banks in the region are located in the early transition countries, the main market for intra-regional TFP business. About 30 of these Confirming Banks are locally owned and controlled (see Box 18).

Recommendation: The Bank should identify candidate Confirming Banks in each major trading nation on each continent. These banks should be built into the network expansion plan.

Recommendation: The Bank should promote intra-regional trade by adding locally owned and controlled Confirming Banks. This may require TC and twinning with international banks for training in documentary credit. Once a bank is a Confirming Bank, it may grow into an Issuing Bank.

Recommendation: The Bank should consider engaging an independent, contractual sales force to recruit Confirming Banks on each continent, and to originate TFP transactions with those banks.

Box 18: Locally owned and controlled Confirming Banks

The coverage of Confirming Banks in the early/intermediate countries is inadequate and needs to be expanded to reinforce intra-regional trade linkages. A striking aspect of the network of Confirming Banks is the dominance of foreign ownership and the relatively small number of locally owned and controlled Issuing and Confirming Banks in the early/intermediate transition countries. The number of locally owned and controlled Confirming Banks is quite small, compromising the objective of supporting intra-regional trade.

7.2.12 More steps should be taken to mobilise and share TFP risk. [16] Most of the TFP's guarantees covered 100 per cent of the LCs, consistent with the need to activate the network at low risk. Less than a quarter of the TFP's guarantees involved risk sharing by Confirming Banks or others (mainly donor funds). Only 12 Issuing Banks did a risk-sharing transaction with the TFP. Also, heavy use by any Issuing Bank should lead to graduation through risk sharing. There is space for more co-financing, a challenging task that the Bank seems committed to.

The low mobilisation rate limits the business that the TFP can support. Some Issuing Banks that have reached their TFP limits can do more TFP business only as old deals mature, or if they increase their capital to support greater TFP bank limits. Instead, the EBRD could actively pool and sell down the exposures to permit more transactions (see Box 19).

Box 19: Increasing risk sharing

The TFP has reached the stage where it needs to increase its risk-sharing efforts. The TFP faces bank limit problems in Georgia, Kyrgyz Republic, Russia and Ukraine. Some banks in Kazakhstan, Kyrgyz Republic, FYR Macedonia and Russia told PED that they had more trade business than their TFP bank limits would allow. The problem will only get worse as the network is used more intensely.

[16] "The Bank shall seek to revolve its funds by selling its investments to private investors whenever it can appropriately do so on satisfactory terms": Agreement Establishing the Bank, Article 12

Recommendation: The Bank should actively manage its TFP bank and programme limit exposures using market-standard techniques to transfer risk on pools of TFP exposure. These include re-insurance, structured credit derivatives and credit-linked notes issued by the EBRD. Structured credit linked notes could be purchased by the Issuing Banks, among other investors.

Box 20: TFP Pricing

TFP pricing appears to be somewhat above market-based pricing to encourage use of credit facilities from the private sector and other sources. The TFP offers modest price breaks to promote risk-sharing or intra-regional trade. There is clear pricing differentiation between various country and bank risks involved. *There is no differentiation, however, in pricing between transactions having greater or less transition impact.*

As the risk appetite of ECAs and international banks grows, the need for the TFP tends to be toward longer tenors and riskier countries. *Nevertheless, Issuing and Confirming Banks will not always graduate themselves from the TFP.* They may become comfortable using the TFP because they can easily pass along the costs, or prefer to use the TFP for provisioning benefits and yield reasons even though risk capacity exists.

7.2.13 **Prices for mobilisation, graduation and transition impact should be set.** The TFP sets a pricing benchmark for short-term LCs in the region. The Bank posts its guarantee prices to the Confirming Banks, setting a good standard of transparency (See Box 20).

Recommendation: The Bank should define a TFP pricing policy that would set prices based on market-tests through active trading of TFP risk.

Recommendation: Pricing policy should promote transition objectives, such as activating dormant links in the TFP network and encouraging banks to graduate to risk sharing. It should take into account the high risk-adjusted returns that global banks receive from the TFP.

7.2.14 **Greater support from global banks should be sought**. A handful of global banks, mainly German, have performed acceptably for the TFP as both Confirming and Issuing Banks. As this section will show, the TFP provides benefits for global banks. Hence, they should provide support in return. The TFP needs a "TFP champion" inside each global bank to drive TFP deals per account plan.

The TFP benefits global banks by:

- supporting their trade finance business in the region;
- providing high risk-adjusted returns on deals guaranteed by the Bank;
- cutting the regulatory (Basle) capital demands of longer term LCs.

Global banks make high economic returns on TFP LCs. They charge 25 to 75 basis points to confirm LCs backed by EBRD guarantees, which have an expected loss of less than 0.1 per cent. This rate is about 50 basis points over the yield on a short-term investment in EBRD Euro commercial paper. Also, the EBRD's guarantee is safer than the cash collateral often taken by Confirming Banks. Pledges of cash collateral are hard to achieve and enforce in the region.

Recommendation: The TFP should imitate the success of the Bank's treasury in getting global banks to deliver exceptional support. The Bank should ask global banks to establish TFP goals in their account plans for the EBRD. A "TFP champion" should also be assigned to internally promote the TFP and deliver deals across the global networks. The EBRD's Business Development Unit should be able assist with this.

Recommendation: The Bank's senior management should meet its peers at the global banks to set high expectations for TFP performance. Indeed, the TFP should figure as an agenda item for most senior meetings between the Bank's clients and sponsors.

7.2.15 **Staffing needs should be reviewed.** The three-year plan, to be developed for the TFP, should assess the staff needed to support an enhanced and expanded TFP effort (see Box 21).

Box 21: Staff requirements

Further growth of the TFP will be constrained by a lack of staff required to:
- answer growing numbers of inquiries;
- execute more guarantees and loans;
- promote global communications, marketing and business development;
- mobilise TFP risk;
- develop new products; and
- properly administer and monitor the growing portfolio.

Recommendation: The Bank's three-year TFP plan should consider if more staff members are needed to achieve the set objectives.

7.2.16 The TFP warrants better IT support. The Bank's IT systems cannot track Issuing Bank sub-limits by tenor, weakening independent controls and causing costly manual processing.

Recommendation: The Bank should analyse and provide for the TFP's future IT systems.

8. BEYOND THE TFP: REPLICATING THE TRANSITION LESSONS

8.1 Transaction banking is a powerful way to deliver transition impact at the grass root level.

Documentary credit is a core transaction-banking service, futhering transition by:

- connecting isolated EBRD countries to global networks and
    - applying formality and standards to thousands of transactions across those networks.

Other transaction banking services, such as payment cards and settlement of foreign exchange and international securities, can further transition in similar ways.

Linking banks to global networks that are governed by sound standards fosters transition. The TFP fosters transition by connecting banks and firms to formal, standardised systems of the international economy. The Bank can deepen these linkages, and help connect the operating country banks to other networks, some allied to payment and settlement systems, others to securities clearing systems.

Recommendation: The Bank should replicate the TFP in other transaction-banking programmes which apply international standards set by industry networks.

New EBRD financial institution programmes could launch projects:

- in retail payments, such as financing investment in payment card businesses and ATM networks;
- foreign exchange, such as helping banks invest to connect themselves to CLS Bank or its agents; and
- securities settlement, such as helping banks invest to connect themselves to Euroclear and Clearstream, or set up domestic securities depository companies.

8.2 Payment cards

Payment cards make it safer for entrepreneurs to travel and do business abroad. A payment credit card works like a portable LC for an SME, while bringing its payments into formal banking channels (see Box 22).

Box 22: Innovative payment cards efforts in Vladivostok

Over 250,000 used Japanese cars ply the streets of a city in western Russia. A bank issues two payment cards to traders who import cars from Japan to the city. The trader delivers the second card to his business partner in Japan and deposits money for the car into the account in Vladivostok. The partner in Japan uses the card to buy the car, then puts the car on the boat to the Russian city. The payment card moves the money safely to Japan.

The bank also issues payment cards to takers of "Express Loans" under the Russia Small Business Fund. Borrowers can use the cards to make purchases at many merchants in Vladivostok.

Recommendation: The Bank should encourage foreign direct investment in payment card systems, jointly with local banks, to bring transparency and global standards to retail and SME payments.

For example, the TFP has backed guarantees to Europay International[17]: two Issuing Banks used the TFP to obtain access to the Europay network, so they may issue Master and Maestro cards to their clients (see Box 23). The Bank can use these small projects to promote the use of card payment technology in private regional banks, filling the "card gap" in early transition countries.

Box 23: Europay (now Mastercard) – A standard setting network for payment cards

Europay International is a network of 8,000 member banks in Europe (including CEE and CIS) founded in 1992. It allows banks to offer Eurocheque, Maestro, Cirrus and Eurocard-MasterCard services to cardholders and merchants. Europay transfers technology and supervises the network.

Europay claims a 71 per cent market share in debit cards and 59 per cent in combined debit/credit cards, with 270 million cards issued. Over 2.5 million terminals in 42 countries accept Maestro debits from 183 million cards. Eurocard-MasterCard acceptance sites grew to almost 4.8 million in Europe and 19 million worldwide. Over 270,000 ATMs are open to Eurocard-MasterCard and Maestro/Cirrus cardholders.

[17] Europay, a Mastercard franchisee, has been acquired by Mastercard International.

Several EBRD countries have no debit cards in the Europay network: Turkmenistan, Serbia and Montenegro, Tajikistan, Albania, Armenia and Kyrgyz Republic. Payment cards provide a core business of most banks, but have developed too slowly in the early transition countries. The average accession country boasts 200 Europay debit cards per 1,000 people, on a par with Greece or Turkey. The CIS countries support only 3 per 1,000. Even Russia, the biggest Europay issuer in the region outside the accession countries, shows less than 14 cards per 1,000 people (see Table 14).

Table 14

Europay debit Cards per 1,000 people	
Accession country	200
Russia	14
CIS	3

Poor quality of banks, regulation and governance has blocked the transfer of payment card technology to the CIS. EBRD projects could support investment in systems and training, and even build a private, regional settlement system for Central Asia. Such projects involve investment in technology and training by Issuing Banks, and guaranteeing payments to the governing bodies and suppliers of network standards and services.

8.3 Foreign exchange services

Most trade deals create a need to purchase and deliver foreign exchange (FX), both spot and forwards for essential hedging by importers. Trading and settling FX, a core banking business, is a natural cross-sell for participating banks. Global banks dominate the FX business, although new electronic trading platforms and the advent of CLS Bank will alter the competitive landscape. The Bank can foster competition, transparency and standards in FX business in the region by linking the Issuing Banks to global FX networks, including CLS Bank (see Box 24).

Box 24: CLS Bank – A global network of banks for FX settlement

Over 60 large banks are forming Continuously Linked Settlement (CLS) Bank to reduce settlement risk (also called Herstatt risk) as required by G-10 central banks. CLS Bank will reduce the risk of paying one currency and failing to receive the other currency.

Basle Committee guidance reinforces the stance of the G-10 governors, stating that "FX settlement risk must be addressed by the private sector. Banking supervisors need to ensure that individual banks are taking all appropriate steps to measure, manage and control this risk. In particular, the guidance makes it clear that banks have an obligation to thoroughly explore and take advantage of the benefits offered by industry-sponsored risk-reduction initiatives", such as CLS Bank.

CLS Bank is based in the United States and regulated by the Federal Reserve as an Edge Act Corporation. It simultaneously settles trades in seven major currencies irrespective of time zones. CLS Bank holds multi-currency accounts for each settlement member and an account with the seven central banks.

Celent, a consultancy, expects CLS Bank to settle 50per cent of all FX transactions by 2005.

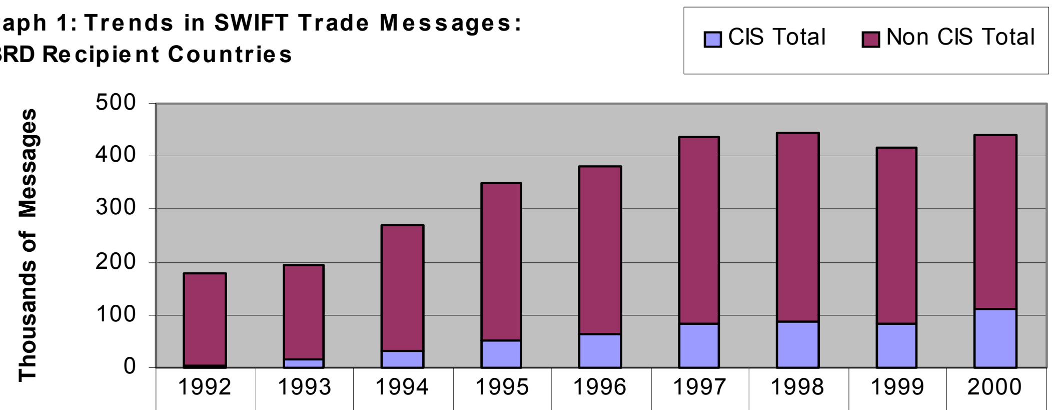
Recommendation: For transition impact, the Bank should devise a project to ensure that at least two local Issuing Banks in each country of operation have access to CLS Bank.

9. PREPARING A THREE-YEAR PLAN FOR THE TFP

Management's request for a three-year plan for the TFP is an acknowledgement of the size and importance of the programme. The programme has grown quickly and outgrown some of its operational and control infrastructure. On the other hand, realising the TFP's excellent transition impact potential requires many more transactions over several years. Appendix 3 gathers together all the recommendations of this Special Study. The three-year plan could usefully consider how to implement these recommendations, along with other recommendations that management and support units will undoubtedly suggest.

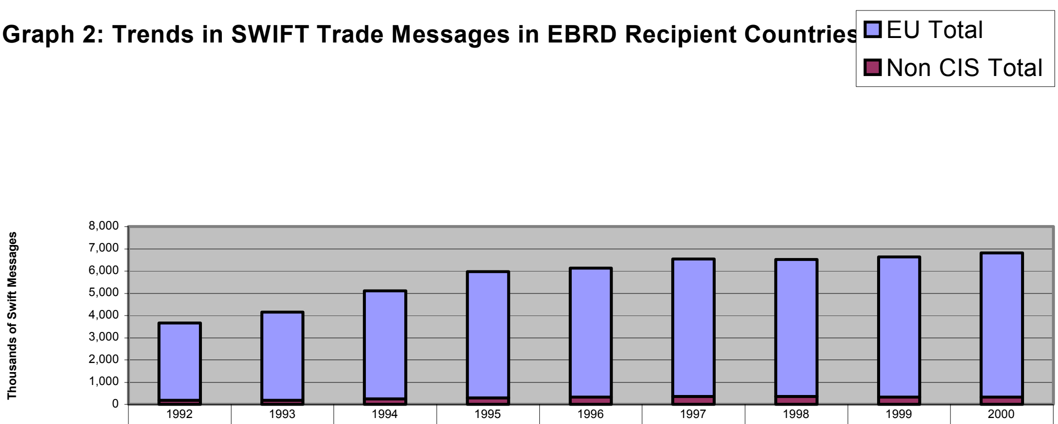
PATTERNS AND TRENDS IN SWIFT TRADE SERVICES MESSAGING

Graph 1: Trends in SWIFT Trade Messages: EBRD Recipient Countries



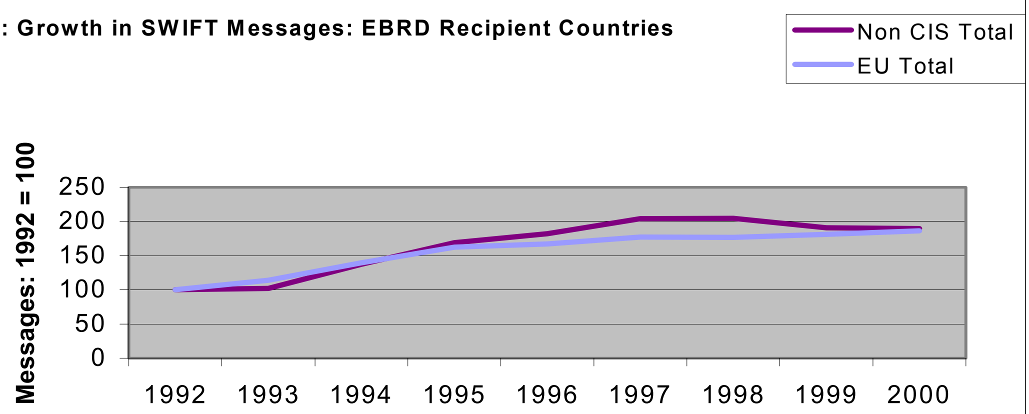
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Non CIS Total	174	178	240	295	318	356	357	333	331
CIS Total	3	16	30	52	63	82	88	83	110

Graph 2: Trends in SWIFT Trade Messages in EBRD Recipient Countries



	1992	1993	1994	1995	1996	1997	1998	1999	2000
EU Total	3,485	3,971	4,861	5,666	5,820	6,175	6,165	6,303	6,486
Non CIS Total	174	178	240	295	318	356	357	333	331

Graph 3: Growth in SWIFT Messages: EBRD Recipient Countries

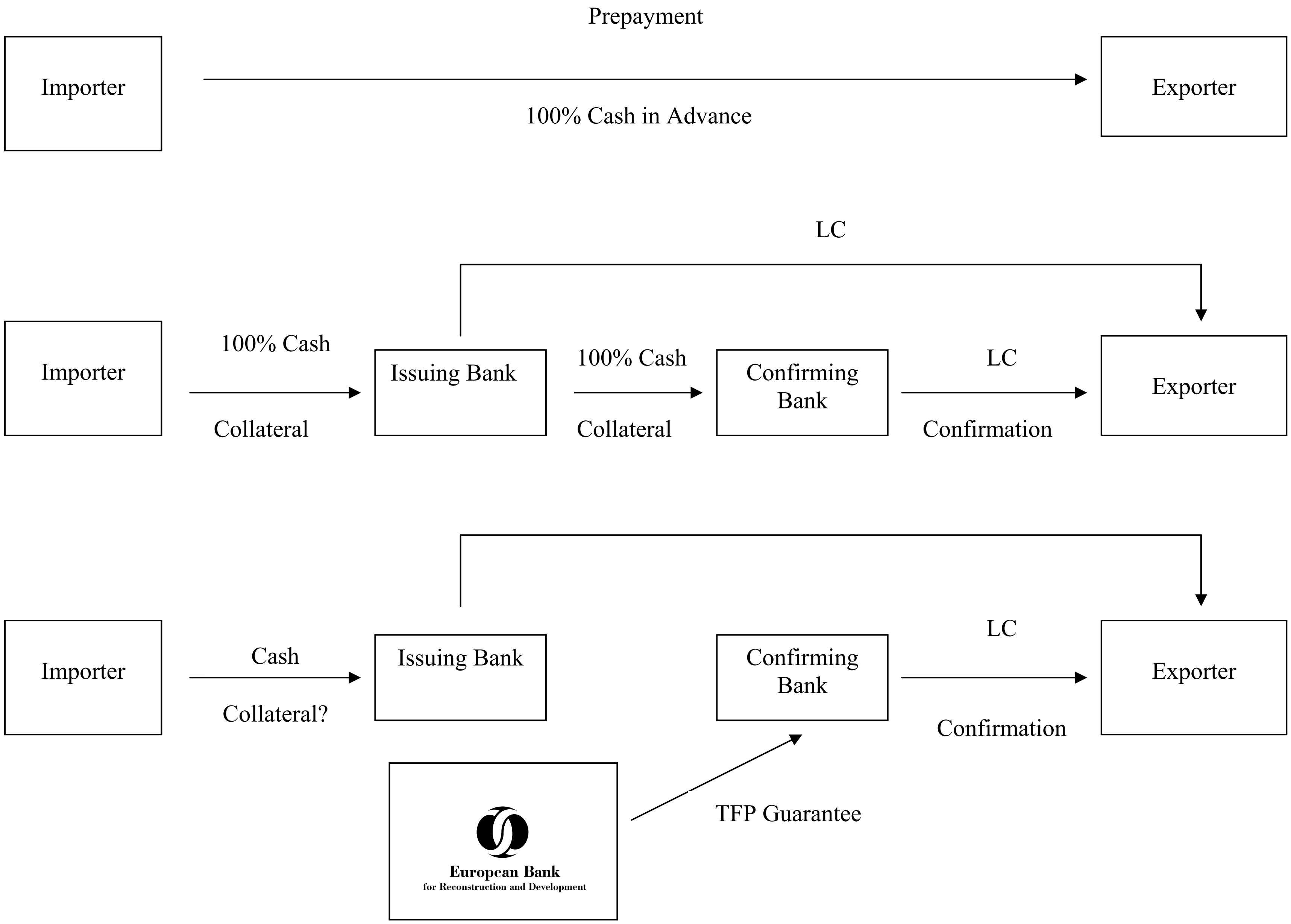


EBRD TFP Guarantee may not Free-Up Importer's Cash Collateral

A. CIS exporters often demand 100 % pre-payment

B. The importer may reduce settlement risk using a LC

C. EBRD guarantee: Importer may still have to pledge 100% cash collateral



RECOMMENDATIONS

ADDITIONALITY	
1.	To better justify additionality, the Bank's three-year plan for the TFP should contain a report on available Export Credit Agency and international bank credit lines and terms to countries and banks in the region.
2.	Issuing Banks should regularly report their lines of credit by tenor, amount and collateral from ECAs and commercial banks. This will permit the Bank to better assess and defend the additionality of the TFP.
TRANSITION IMPACT	
3.	The Bank should bring the TFP's crisis response success to the attention of: - the IMF, which should value its crisis response features; - the IBRD, which should value its contribution to sustainable development; and - the regional development banks for replication in their region of operations. The international financial institutions should seek to replicate the TFP world-wide to build a global safety net for documentary credit. Regional development banks could replicate the TFP and connect the networks to build a global TFP network. Lack of a crisis response plan puts the TFP's transition impact at risk. The main risk to the TFP's transition impact is that the Bank itself may suspend the TFP during a financial crisis, a time when it is most needed. Planning ahead would reduce that risk (see Box 10).
4.	The Bank should prepare a crisis response plan for the TFP, based on the estimated trade credit needs of the countries during crisis. The plan should define crisis response credit lines for each Issuing Bank.
5.	Due diligence and monitoring should report patterns in the SWIFT messaging practices of banks.
6.	The Bank should encourage the use of Category 7 and other specific SWIFT messages to deepen the impact of SWIFT standards on the banks in the region.
7.	The Bank should deepen the TFP's links to ICC and SWIFT. For example, TC could help the TFP's Issuing Banks attend the training programmes on trade offered by ICC and SWIFT. These training programmes may be more cost-effective than those that the Bank can organise.
8.	The Bank should encourage Issuing Banks to test new systems, such as ICC's Paction, to deepen links to ICC global standards and cut errors and delays in LC processing (see Box 11). (Paction is the ICC's model international contract on the Web. Its software lets buyers and sellers prepare, negotiate and sign contracts for international trade, online. ICC designed Paction for the smaller trader, perhaps new to international trade. www.modelcontracts.com)
TFP PERFORMANCE	
9.	The EBRD should place higher importance and reward new twinning partnerships and greater quantities of TFP deals than the value of TFP deals booked at year end.
10	The EBRD should ensure that its representatives on the boards of investee banks promote the growth of documentary credit businesses at the banks and good performance under the TFP programme.
11	The Bank should modify the loan eligibility rules of its SME finance facilities to include issuance of LCs as part of the programme's performance measurements. Opening a LC involves the same

	types of credit risk, and develops the same types of credit skills, as making a loan. In addition, SMEs often require a loan to finance payments under the LC.
12	The Bank should find establish why the successful Confirming Banks in the region have taken up the challenge of confirming intra-regional LCs and whether they view this as a sustainable business.
IMPROVING TRANSITION IMPACT	
13	The Bank should adopt promotion of documentary credit practice as part of its transition strategy for the region.
14	The Bank should encourage best practice in documentary credit in all of its activities and by all of its clients.
15	The Bank should draft a communications plan for the TFP. Among other things, the Bank should publicise descriptions of each week's deals through the appropriate media channels.
16	The Bank should team with an industry media group, such as *Trade Finance Magazine,* to create a TFP league table. A broad range of awards should be given to push competition and maximise transition impact. Possible awards could be: best TFP Issuing Bank in each country as measured by the number and size of deals; the most innovative bank in each country; and the best deal in each country. Other awards could recognise the Issuing Bank that does the most deals with the greatest number of Confirming Banks. Similar awards could apply in all categories to the Confirming Banks.
17	The Bank should use SWIFT's annual SIBOS trade fair to better promote the TFP to correspondent bankers. SIBOS is the leading annual trade convention for correspondent bankers who manage most relationships between banks.
18	The EBRD's Operations Committee has requested a three-year business plan be developed for the TFP. This plan should set out operational and transition impact objectives and benchmarks, with specific and measurable performance milestones. For example: The TFP's present network creates over 12,000 pairs of banks that can twin on LC deals. Less than 200 of these twins have used a TFP guarantee: intensity of twinning is about 2 per cent.
19	The Bank should set targets for the TFP to activate dormant banks and trading partnerships, thereby increasing the intensity of twinning.
20	Russian exports to smaller CIS countries can promote documentary credit in Russia. The Bank should help firms, like Beta Stores (see Box 3), import goods under LC from Russia.
21	The three-year plan should target and measure the number of: - Issuing and Confirming Banks and compare these with the ideal number of banks for a comprehensive network; - transactions that achieved new market and financial linkages; - transactions that demonstrated new trade finance techniques or instruments; - banks that executed risk sharing transactions; - The number of LCs issued or confirmed by each TFP bank.
	The Bank should report the number of bilateral cash advances separately from the number of guarantees.
22	The Bank should resume tracking deals formally proposed by the market which were rejected by the TFP and the reasons for this.
23	The transaction approval criteria should be reviewed and expanded to support the objectives set in the TFP's three-year plan. Areas which need particular review include intra-regional trade and limits on deals with state-owned firms

24.	The EBRD's credit agreements should require conformity with *Basle best practices for credit risk disclosure*, particularly in the areas of off-balance sheet and LC liabilities, and pledging of liquid assets to foreign banks.
25.	The EBRD's partner banks should set corporate policies about pledging cash and other liquid assets to foreign banks.
26.	The Bank should re-establish sub-limits for loans at the programme and Issuing Bank level. Every Issuing Bank should have a limit for TFP guarantees, that is not available for loans, to ensure continuous access by the Confirming Banks to the TFP network for guarantees.
27.	One bank in Kazakhstan has demonstrated success in discounting drafts under LCs. The EBRD should replicate this success with other banks.
28.	The Bank should use technical cooperation, modelled on the EBRD's SME programmes, to promote documentary credit via the TFP. The Bank should retain trade credit advisers to assist TFP Issuing Banks find and execute LC deals, assess credit risks and build sustainable trade services businesses for confirmation as well as LC issuance.
29.	The TFP could pay flat performance fees, as the EIB does under the EU/EBRD SME Finance Facility, to Issuing Banks for confirming their first LC's, and to Confirming Banks for activating a new *twinning pair* of TFP banks.
30.	The EBRD's three-year plan should estimate the resources needed to manage and accelerate the growth momentum built into the TFP, such as: - periodic audits (the TFP as a business unit has never been audited); - IT platforms (e.g. Summit prioritisation) to support operations that now require heavy manual processing by various teams; - co-financing (mobilisation, risk sharing) using the A/B structure and other instruments; - marketing to global banks; - communications; - external call centre to service network users; - external sales force to activate the network.
31.	The Bank should favour multiplicity of smaller transactions over size. Larger deals, which are valuable for demonstration effect, should be kept near to their present small number.
32.	Using more of the TFP's twinning capacity should drive planning of the portfolio limit. The three-year plan could consider the size of programme needed to activate many more of the 12,000+ trading partnerships between the banks. For example, raising twinning intensity from 2 per cent to 10 per cent would require about 1,000 single transactions, and would likely give rise to 2,000 transactions or more.
33.	The Bank should consider setting a portfolio strategy for the TFP to limit exposure to countries, banks, and sectors or products.
34.	The Bank should allocate facilities according to their relative risk. Greater facilities for the TFP should be allocated to each Issuing Bank for short-term guarantees on documentary credit. Likewise, the Bank should set the TFP programme limit in light of the TFP's low usage of risk capital, and measure programme size in terms of risk capital, not nominal programme amount.
35.	The Bank should consider adding more locally owned and controlled regional banks as Issuing Banks.
36.	The Bank should identify candidate Confirming Banks in each major trading nation on each continent. These banks should be built into the network expansion plan.
37.	The Bank should promote intra-regional trade by adding locally owned and controlled Confirming Banks. This may require TC and twinning with international banks for training in documentary credit. Once a bank is a Confirming Bank, it may grow into an Issuing Bank.
38.	The Bank should consider engaging an independent, contractual sales force to recruit Confirming Banks on each continent, and to originate TFP transactions with those banks.

39.	The TFP should imitate the success of the Bank's treasury in getting global banks to deliver exceptional support. The Bank should ask global banks to establish TFP goals in their account plans for the EBRD and assign a "TFP champion" to internally promote the TFP and deliver deals across the global networks. The EBRD's Business Development Unit should be able to assist this.
40.	The Bank's senior management should meet its peers at the global banks to set high expectations for TFP performance. Indeed, the TFP should figure as an agenda item for most senior meetings between the Bank's clients and sponsors.
41.	The Bank's three-year plan for the TFP should consider if more staff members are needed to achieve the set objectives.
42.	The Bank should analyse and provide for the TFP's future IT systems.
REPLICATING THE TRANSITION LESSONS	
43.	The Bank should replicate the TFP in other transaction-banking programmes which apply international standards set by industry networks.
44.	The Bank should encourage foreign direct investment in payment card systems, jointly with local banks, to bring transparency and global standards to retail and SME payments
45.	For transition impact, the Bank should devise a project to ensure that at least two local Issuing Banks in each country of operation have with access to CLS Bank.