INTERNATIONAL TRADE FINANCING: THE U.S. VERSUS THE WORLD

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ABSTRACT

Much of the history of banking can be traced to banks providing international trade financing. And in today's global economy, a nation's economic strength is closely tied to its ability to compete in the global marketplace. As much of modern commerce relies on the efficient functioning of financial markets, the role of banks providing the financial services necessary for businesses to conduct international business activities can not be overstated. This paper examines recent and historical developments of banks providing international financing services, primarily letters of credit (L/C) and related forms of trade financing, in the United States economy. The role of both domestic (U.S.-based) and foreign banking institutions is examined in light of the size and attractiveness of the U.S. market.

INTRODUCTION

Much of the long history of banking can be traced to banks providing international trade financing (see, i.e., Green, 1989). And in today's global economy, a nation's economic strength is closely tied to its ability to compete in the global marketplace. As much of modern commerce relies on the efficient functioning of financial markets, the role of banks providing the financial services necessary for businesses to conduct international business activities can not be overstated.

More specifically, banks play a very important role in facilitating international trade. Banks not only provide letters of credit (L/Cs), a significant component of the financing that is often necessary in many international trade transactions, but they also act as the primary conduit through which the payments for such transactions flow. Whether providing L/Cs, confirming (guaranteeing) another institution's L/C on behalf of a customer, or simply handling the flow of documents associated with international trade transactions, banks have always been at the focal point of international trade and commerce.

The role of banks is likely critical to the success of smaller companies engaged in international business, the companies that make up the bulk of trade-oriented companies in the U.S. For example, the Department of Commerce reports that large exporting companies (those employing 500 or more workers) are responsible for seventy-one percent of the *value* of U.S. exports but only represent three percent of the *number* of exporters (U.S. Department of Commerce, 2007). This

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means that the vast majority of exporters, and by association importers as well, are small– and medium-sized companies.

It is probably safe to assume that many smaller companies engaged in international trade rely heavily on their banks for assistance. Furthermore, because of their small size, many of them likely rely on *smaller* banking enterprises, often referred to as community banks. In fact, due to the strong relationships and personalized services provided by community banks, they remain critical to the success of smaller companies with nearly forty percent of smaller companies using community banks, rather than their much larger money center brethren in New York and elsewhere, for the majority of their financing needs (Bernanke, 2006).

However, in examining U.S. banking statistics, one finds some disturbing trends of apparent disinterest in providing trade financing services on the part of those very same community banks. For example, in 1984 nearly thirty percent of the 7,200 *large* community banks in the U.S. (i.e., those assumed to have the size and clientele necessary to have international services requested of them) provided letter of credit financing, while by the end of 2006 that figure had fallen to less than seventeen percent of the 4,000 large community banks remaining after two decades of consolidation within the banking industry. In fact, much of the slack in providing trade credit appears to be being taken up by foreign banks eager to develop and expand their markets in the U.S. (Ramchander, Reichert & Jayanti, 1999). These foreign banks have been vocal in demonstrating their importance to the economic well-being on the U.S. (Institute of International Bankers, 1997). Even former Federal Reserve Board Chairman Alan Greenspan noted how foreign banks have become important providers of liquidity and depth to the U.S. banking system and how they have become significant sources of credit for all types of businesses throughout the country (Greenspan, 1991)

This paper examines various trends in trade financing activities within the U.S. banking sector, particularly the apparent abandonment of the international banking sector by U.S. banks, or at least the middle-tier thereof. It also looks at the move by foreign financial institutions to fill the gap that this phenomenon has created. Foreign banks have made major inroads to the U.S. banking sector for decades, and are increasingly becoming a factor in the commercial activities, domestic and international, of many U.S. and foreign companies. Their increasing role, along with the decreasing role of the U.S. domestic banking sector, is evaluated.

OVERVIEW OF TRADE FINANCING AND PAYMENT METHODS

Success in international trade can, at a minimum, be measured in terms of an exporter being paid in a timely manner and an importer receiving the goods or services ordered with the correct specifications. To accomplish this, there is a wide spectrum of possible payment schemes that determine the amount of risk taken on by each party. Among the most common terms of payment are payments in advance, letters of credit, documentary collections (drafts), and open accounts.

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Due to the inordinate amount of risk taken on by the purchaser, advance payments are relatively uncommon except under special circumstances. A similar argument could be made for the other extreme of exporters providing unsecured financing (open account) following the shipment and/or delivery of goods. Nonetheless, given the competitiveness of the global markets, the majority of international trade transactions are said to be settled via the open account method. However, the risk borne on the sellers under such arrangements may be difficult for many small- and medium-sized businesses to accept. They often rely on a middle road, i.e., letters of credit or documentary collections.

Letters of credit and documentary collections both involve the use of financial intermediation, most commonly the services of commercial banks whose actions provide the conduits through which the rights, obligations, and risks of all participants in the trade agreement are assured. Legal guidelines for conducting such transactions are dictated by the International Chamber of Commerce and published in its *Uniform Customs and Practice for Documentary Collections* (the newest revision of which, UCP 600, was published in late 2006).

Both letters of credit and documentary collections involve the use of a draft, drawn by the seller, requiring that the face amount, either on sight (sight draft) or on a specified date in the future (time draft), be paid, in accordance with its terms, which among other items specify the documents needed before title to the goods passes to the buyer.

The primary difference between the two methods is the party responsible for making payment. For documentary collections, this is usually the importer or purchaser of the goods; under a letter of credit, it is usually the commercial bank providing the letter of credit. Thus, the letter of credit generally provides a higher level of assurance of payment because it is the obligation of a commercial bank rather than a private party. Documentary collections will usually be less expensive but involve the acceptance of additional risk because there is no guarantee of payment as provided under a letters of credit.

Due to the nature of international dealings, including factors such as distance, differing laws in each country and difficulty in knowing each party personally, the use of L/Cs has historically been an important aspect of international trade. It is estimated that approximately fourteen percent of all world trade, nearly $1 trillion in total, is settled through the use of L/Cs (Clark, 2007).

L/Cs are important for exporters and importers alike. For exporters they help ensure the receipt of payment for goods sold in foreign markets. For importers they provide a mechanism by which the acquisition of foreign goods, goods often vitally important to the success of the importer's business activities, can be better facilitated. Therefore, the ability to use L/Cs can be viewed as a significant component of a firm's ability to compete in the global marketplace. This may be especially true for smaller companies that may not have the resources to devote to some of the more arcane aspects of international trade transactions that larger, more sophisticated, firms have at their disposal. They will likely need to rely more on their banks for their international trade and financing needs.

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SOURCES OF TRADE FINANCING IN THE U.S.

Globalization has allowed all types of companies, regardless of size, to become participants in the international market. And trade financing is an integral component of this process. To secure help in trade financing, companies have a variety of avenues to pursue. On one hand, there are several government agencies that offer assistance and various resources to companies, particularly smaller and mid-sized ones. This assistance comes primarily from the big three – the Export-Import Bank, the SBA, and the Agriculture Department. Each has its own set of programs but they all focus on providing various credit guarantees and other help to U.S. companies engaged in international trade, making it easier for them to get financial backing from the banking sector. In addition, the Commerce Department, through its nationwide network of Export Assistance Centers, is available to help smaller and mid-size firms deal with the challenges of international trade and commerce.

Whether or not assistance is received from a government agency, companies will still need to receive the bulk of their financing from the banking sector. They will normally first turn to their own bank, since banks are in the business of accommodating their customers when they can. But if the bank does not handle trade financing or if the transaction is too large or complex for the bank to handle, companies are forced to look elsewhere. To meet this need, there are a small but growing number of lenders who have entered the field, specializing in providing trade financing for their own customers as well as to non-customers on a case-by-case basis. Besides the three largest U.S. banks (Citibank, JP Morgan Chase, and Bank of America), this group includes several U.S. regional banks that have found trade financing as a profitable niche business as well as foreign-based banking institutions who often come with long histories of trade financing expertise and are more than willing to "fill the gap."

Within the U.S. market, Citibank, JP Morgan Chase, and Bank of America collectively account for nearly half of the U.S. letter of credit market. Globally, the concentration among banks is even more pronounced, with ten institutions accounting for seventy-five percent of the global L/C market (Barovick, 2005). Other notable players in the U.S. market include national banks such Wells Fargo, Wachovia, The Bank of New York, and U.S. Bank, and major regional players such as National City Bank (Cleveland), Union Bank of California, and Amegy Bank (Houston). Similarly, many foreign banks such as Societe Generale (Paris), Barclays (London), BNP Paribas (Paris), HSBC (London), ABN AMRO Bank (Amsterdam), and Standard Chartered Bank (London) provide letter of credit financing in the U.S. banking markets. In fact, in terms of L/C financing, fifteen of the top twenty-five banks in providing letters of credit in the U.S. are foreign banks. See Table 1 for a listing of the major providers of L/Cs in the U.S.

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FOREIGN BANKS IN THE UNITED STATES

Foreign banks operate in the U.S. through a myriad of different organizational forms. Many do nothing more than open representative offices. These offices cannot accept deposits nor make loans (but they can forward payments or loan papers to the home office). A second alternative are agencies, which are allowed to make business loans (such as letters of credit) but can not make consumer loans nor are they permitted to accept domestic deposits. They are usually financed by the parent bank or by borrowings in the Federal Funds or interbank markets. A third choice, albeit a limited one, are investment companies, which are similar to agencies as they cannot accept deposits but tend to focus more on securities dealing than lending activities.

Table 1: Leading Providers of Letters of Credit in U.S.
(amounts in millions)
As of December 31, 2006

1. Citibank	$7,694
2. JPMorgan Chase	$6,415
3. Bank of America	$4,702
4. Wachovia	$1,765
5. Societe Generale	**$1,374**
6. Bank of New York	$1,220
7. BNP Paribas	**$1,209**
8. Barclays	**$1,170**
9. Svenska Handelsbank	**$986**
10. HSBC	**$852**
11. SanPaolo Imi	**$656**
12. Mega International New York	**$508**
13. ABN-AMRO	**$422**
14. U.S. Bank	$417
15. Mega International Los Angeles	**$351**
16. Bank of Tokyo-Mitsubishi New York	**$332**
17. Wells Fargo	$331
18. Standard Chartered	**$325**
19. Wells Fargo HSBC Trade Bank	$309

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Table 1: Leading Providers of Letters of Credit in U.S. (amounts in millions) As of December 31, 2006	
20. KBC Bank	**$294**
21. Deutsche Bank	**$292**
22. National City Bank	$287
23. Doha Bank	**$255**
24. Natixis Bank	**$253**
25. Comerica	$249
Note: **Bold** denotes a foreign bank	

Foreign banks are also allowed to establish Edge Act Corporations. These corporations are chartered by the Federal Reserve Board and specialize in international banking activities with a permitted scope of activities similar to those of agencies. Agreement Corporations, a fifth alternative for foreign banks, are state-chartered alternatives to Edge Act Corporations, but are of limited importance or scope.

The most popular form of organization for foreign banking organizations are branches. Like agencies, branches are considered to be an integral part of the parent bank, but unlike agencies they can offer a full range of banking services. Branches of foreign banks can accept domestic deposits and make all types of loans and have become major forces in the U.S. corporate banking markets. A final option for foreign banks is the creation of partially- or wholly-owned subsidiaries. Foreign banks can gain control of a subsidiary either through acquisition of an existing U.S. bank or by establishing a new bank. Subsidiaries have identical banking powers as domestic banks and are therefore regulated as domestic banks.

DATA

The primary data sources used are the Bank Call Reports delivered to the Federal Deposit Insurance Corporation (FDIC) and available for download from the Federal Reserve Bank of Chicago (www.chicagofed.org). Because L/C financing tends to be short-term rather than long-term, quarterly rather than annual reports were used to capture any short-term deviations in the data.

Although the general population of U.S. banks is examined when appropriate, of greater importance are the data on large community banks and on foreign banks. Large community banks are generally defined as institutions having total assets between $100 million and $1 billion (Gilbert & Sierra, 2003; DeYoung, Hunter & Udell, 2004). However, to capture a subset of institutions not often examined, we also include “mid-sized banks” with total assets up to $10 billion (Ennis, 2004)

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in our grouping of large community banks. Smaller banks, those below $100 million in total assets, are excluded because they are likely to be too small or too localized to have customers in need of L/C services or lack sufficient resources to devote to such activities. Larger banks, those with total assets of more than $10 billion, are excluded because they tend to have significant international exposures and likely concentrate on serving their large corporate customers rather than the many small- and medium-sized exporters that make up the bulk of internationally-active companies within the U.S.

To allow for better comparability of results given the steady growth in the size of banks over time, we have chosen to arbitrarily exclude the largest (in terms of asset size) one percent and smallest forty-nine percent of banks for each period studied. This is assumed to eliminate the large money center banks on one end and the small community banks on the other. This is based on a review of the data from 2002 through 2006 in which an *average* of 49.0 percent of banks had asset sizes less than $100 million and an *average* of 1.1 percent had asset sizes greater than $10 billion. Thus, fifty percent of the entire population of banking institutions could be defined as large community banks. This fifty percent rate was maintained for all periods covered in this study by eliminating the largest one percent and smallest forty-nine percent of the total amount of banks for each period.

The definition of foreign banks used in this study is the one used by the Federal Reserve Board itself. In providing statistics on foreign banks in the U.S., the Fed includes the following types of institutions: U.S. branches and agencies of foreign banks, including those that are state-chartered, and any U.S. commercial bank with a minimum foreign ownership of 25 percent.

ANALYSIS

Turning attention to the actual situation within the U.S. banking markets, we find that the percentage of community banks providing trade financing in the form of letters of credit has steadily declined over the past decade and a half. Despite the considerable amount of consolidation that has taken place in the banking sector over this time period (when the total number of institutions fell by forty percent from 13,580 to 8,128), the percentage of banks providing letters of credit fell from thirty-five percent to less than seventeen percent.

And it is not only the number of institutions offering letters of credit that is dropping but also the relative amount of financing. Current figures (as of the fourth quarter 2006) show that while nearly half of trade financing comes from the big three (Citibank, JPMorgan Chase, and Bank of America), the 308 foreign banks operating in the U.S. provide an additional 31.6 percent of the total, yet the 3,864 large community banks provide only 6.5 percent! Thus, the explosive growth in international commerce that has taken place in recent history, at least the U.S. component of it, is being finance in large part due to the prowess of foreign banks operating in the U.S.

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This apparent abandonment of international finance by community banks comes despite the repeated exhortations from professional bankers for community banks to get more involved due to the profitability of trade financing (Emens, 2006; Streeter, 2006). Yet, except for a handful of globally-active money center banks, and a handful of niche players such as National City and Amegy, the U.S. banking community has allowed foreign banks to grab a significant amount of the financing opportunities that exist in international trade financing. Whether it is the ease with which outsourcing trade financing products to specialist institutions can be made or an unwillingness to venture in to the brave "old" world of international finance, it appears that the vast majority of the middle-market of U.S. banks, the larger community banks, is willing to allow these opportunities to go to others.

CONCLUSIONS

International trade is a significant component of the global business environment. Much of a country's economic strength rests on the shoulders of its ability to compete in the global markets. And while it may be the competitiveness of the products that drives international commerce, there are many aspects of international transactions that must be mastered to be successful. One of these is the efficiency and effectiveness of the payment process, a process that is very closely associated with the magical world of trade finance.

The market for trade financing products, specifically letters of credit, within the U.S. is splitting off in to several directions. In one direction we find the big money center banks, who are devoting significant resources to maintain and embellish their already dominant presence in the market. In another direction, there are a handful of regional and larger community banks that are heeding the call and carving a niche for themselves by moving in to trade financing with a great deal of apparent success. Filling the remaining void left by the disinterest of community banks in providing international services to their valuable business customers are the foreign banks.

Although obviously also interested in servicing their own customers doing business in the U.S., foreign banks have gone after and maintain a significant portion of the overall market for trade financing in the U.S. The activities of foreign banks in the U.S. have helped finance much of the growth of the U.S. economy over the past few decades. Whether the continued reliance on these institutions is advantageous to the U.S. financial and economic system as a whole is yet to be evaluated. Further analysis on the reasons for the shift away from providing international services by the regional and community banks will be useful in formulating a position on how best to meet the future financing needs of the small- to medium-sized companies upon which much of the growth of the U.S. and global economies rests.

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