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Trade Finance - Key Concerns and Recommendations for the Basel Framework

BAFT-IFSA, along with others in the manufacturing, banking and services industries, is concerned about the effect that Basel II and Basel III could have on the availability of trade finance. Basel III does not address industry issues with Basel II regarding trade finance. Indeed, Basel III presents additional concerns.

Background: The Importance of Trade Finance

Global trade relies upon accessible financing for trade transactions. Trade financing assists customers with their import and export requirements, by providing import/export financing and trade risk mitigation. Trade finance, as a transaction banking product, is a core banking business serving the real economy.

Trade finance exposures are diverse in nature, smaller in value, shorter in tenor, self-liquidating and exhibit different behavior and payment patterns from other corporate banking products. Basel III, building on Basel II, could result in higher costs for these transactions, which could impact banks active in trade finance and ultimately result in higher costs or reduced product offerings for corporate importers and exporters, negatively impacting the ability of companies to engage in international trade. Industry estimates indicate that pricing for trade finance products could increase by 18-40% under the Basel III proposals.

While we are encouraged by the October 2011 changes the Basel Committee introduced to the regulatory treatment of trade finance¹, we believe the beneficial impact of these changes will be extremely limited.

Key Recommendations: Support Trade Finance as a Driver of Economic Growth

1. Apply the One-Year Maturity Floor Waiver to all Trade Finance Instruments

The one-year maturity floor applied under Basel II is excessive for trade finance transactions because they are short-term in nature (*i.e.*, a tenor of 180 days or less) and self-liquidating. We note that the one-year maturity floor is removed in the new Basel framework but it only applies to Letters of Credit (LCs). A waiver for other trade instruments continues to remain under the discretion of national regulators. However, under the current capital rules, many jurisdictions have waived the one-year maturity floor for all trade finance instruments and loans. The effect of restricting the waiver to LCs could potentially increase capital requirements and thus lead to higher financing costs or reduction in financing capacity in those jurisdictions where the waiver is inclusive of all types of trade finance instruments.

2. Adjust Credit Conversion Factor for Trade Finance Instruments under the Basel III Leverage Ratio

Under the leverage ratio proposal, the Basel Committee proposes a credit conversion factor (CCF) for off-balance sheet instruments, including trade finance, of 100%, increasing the cost of providing trade finance in some cases by a factor of five. Increasing the CCF to 100% could disadvantage trade finance-focused banks. While we recognize that the Committee intentionally designed the leverage ratio to be simple and not based on any differential risk weighting, we are of the view that a 100% CCF for trade finance is excessive given the objective the leverage ratio intends to achieve, *i.e.* to constrain the build-up of leverage in the banking sector to avoid destabilizing deleveraging processes which can damage the broader financial system and the economy. Trade finance instruments are underpinned by the movement of goods and services; hence they do not lead to the kind of leveraging that may endanger real economic activity.

¹ Basel Committee on Banking Supervision, *Treatment of trade finance under the Basel capital framework*, Oct 25, 2011; <http://www.bis.org/publ/bcbs205.pdf>

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3. Create Separate Asset Value Correlation for Trade Finance

The Asset Value Correlation (AVC) is the asset value applied by analyzing historical loss data for financial instruments. As short-term, self liquidating instruments, trade finance products may warrant a separate AVC from other types of corporate banking products and this should be considered under the Basel framework. There are various AVCs for consumer banking, but only one for all corporate products—this imposes a treatment for trade finance that does not reflect its low risk nature and could hinder the provision of trade financing globally.

4. Account for Low Risk Behavior of Trade Finance under Liquidity Coverage Ratio

Off-balance sheet trade finance products have matched inflows and outflows. The liquidity risk that these products pose is therefore quite small, and should be reflected in the Liquidity Coverage Ratio (LCR) calculations. On-balance sheet trade finance items also carry low liquidity risk, so the assets should be similarly considered in the context of LCR calculations. There should be a global standard recommended to national supervisors to ensure a consistent approach to determining run-off rates, reducing the potential for regulatory arbitrage that might result from the use of national discretions.

Glossary

Asset Value Correlation: Value derived by analyzing historical loss data for the respective Basel II asset classes.

Basel I: Capital adequacy ratio prescribed under the 1988 Basel Capital Accord.

Basel II: Capital adequacy guidelines that consist of three main pillars: capital requirements based on the internal risk weighting of individual banks, active supervision processes, and information disclosure requirements to enhance market discipline. Issued initially by the Basel Committee on Banking Supervision in 2004, the framework has not yet been fully implemented in all jurisdictions.

Basel III: Recommendations on capital and liquidity contained in two consultative documents, published by the Basel Committee on Banking Supervision in December 2009 entitled *Strengthening the resilience of the banking sector* and *International framework for liquidity risk measurement, standards and monitoring* along with three annex documents published in July 2010 and September 2010; the subject of current debate.

Credit Conversion Factor: Percentages designed to convert off-balance sheet items to credit equivalent assets.

Required Stable Funding: Amount of stable funding required by supervisors that is measured using supervisory assumptions on the broad characteristics of the liquidity risk profiles of an institution's assets, off-balance sheet exposures and other selected activities.

Risk Weighted Assets: Assets used in the calculation of risk based capital ratios. These are the total assets calculated by applying predetermined risk weights, as devised by regulation, to the nominal outstanding amount of each on-balance sheet asset and the notional principal amount of each off-balance sheet item.

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