European Parliamentary Breakfast
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Brussels

The Impact of CRD IV on International Trade and Trade Finance

Agenda

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3. Overview of Basel III / Impact on Trade Finance
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BAFT-IFSA Overview

- BAFT-IFSA is the trade association for organizations actively engaged in international transaction banking.

- BAFT-IFSA serves as the forum for stakeholders in international trade and trade finance to provide feedback and expertise to industry participants and global regulators on market trends and best practices for the global trade finance community.

- 200 members worldwide:

Africa	Asia
Europe	Latin America
Middle East/North Africa	North America

BUSINESSEUROPE Overview

- BUSINESSEUROPE represents 40 industrial and employers federations in 34 European Countries, representing more than 20 millions European companies.

- BUSINESSEUROPE gathers the views of all industry and services sectors through its network of European sectoral organisations and Multinational companies.

- BUSINESSEUROPE mission in international trade is to ensure better conditions for our companies to import and export goods and services, to improve market access conditions in non-EU countries to expand international trade activities.

- BUSINESSEUROPE is keen to ensure that new international rules for financial services will not negatively affect access to trade finance for European companies, at a time where trade is essential for economic recovery.

Executive Summary

- Basel III and CRD IV could have unintended consequences that negatively impact the availability and cost of trade finance
- Trade Finance is an important tool to facilitate export growth, particularly for Small & Medium Enterprises (SMEs)
- Trade Finance is a short-term, self-liquidating and low risk form of financing commercial trade – an increase in cost and decrease in availability will drive activity towards higher risk and un-naturally longer term financing options
- The unintended consequences on trade finance could lead to negative impact on GDP and job growth related to exports

What is Trade Finance?

- Trade Finance facilitates and enables the management of cross border trade for bank and corporate clients. These transactions are underpinned by the movement of goods and services and evidenced by commercial contracts that document the relationship between buyer and seller.

- Trade Finance supports $14-16 trillion in annual global commerce.

- Trade Finance is a secure type of financial instrument. A survey conducted by the International Chamber of Commerce (ICC) in Paris found that of out of 5.2 million trade finance transactions, the default rate was 0.022% and the average tenor of a transaction was 115 days.

Basel III – Summary Perspective

- December 2009 – Basel Committee Publishes texts of Basel III Capital and Liquidity Framework; Final Text Agreed at November 2010 G-20 Meeting in Seoul. [1]

- During the 2008-09 financial crisis, global trade fell 23% ($3.5 trillion in value) [1]. Banks reduced the availability of trade finance to shore up capital positions, accounting for an estimated10-15% of the reduction.[2]

- In 2010, the G20 reiterated the importance of trade to the global recovery, in terms of low-income countries (LICs) in particular, and emphasized their commitment to trade programs promoting and facilitating growth. The G20 agreed to “assess the impact of regulatory regimes on trade finance”.[3]

- The Basel Committee agreed to evaluate the impact on trade finance in the context of low income countries.[4]

- Trade Finance products have significantly different risk profiles, default rates and capital uses from other corporate products. Basel III will negatively impact the availability and cost of trade financing - most commonly used by small and medium enterprises (SME), particularly in LICs.

1. Basel Committee – December 2009/December 2010
2. World Trade Organization (WTO)
2. Robert Zoellick, *Financial Times,* February 19, 2009
3. G20 Seoul Summit 2010 Communiqué
4. BIS press release Results of Basel Committee meeting on Banking Supervision – Dec. 2010

Basel III: Objectives

- The fundamental goal is to ensure resiliency in the financial sector through global standards on capital and liquidity
- At a macro level, capital requirements increased and new leverage and liquidity requirements were introduced
- Key measurements will be focused on:
  - Capital – Capital Requirements
  - Leverage – Leverage Ratio (L/R)
  - Liquidity – Liquidity Coverage Ratio (LCR)
  - Funding – Net Stable Funding Ratio (NSFR)

Multi-Year Timing But We Expect Banks Will Race to Basel III Compliance

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Capital Framework									
Minimum Common Equity (CET1)	2.0%	2.0%	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Deductions from CET1[1]	NA	NA	NA	20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**
Capital Conservation Buffer (CCB)	NA	NA	NA	NA	NA	0.625%	1.25%	1.875%	2.5%
Total Capital including CCB	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.625%**	**9.25%**	**9.875%**	**10.5%**
Counter Cyclical Buffer (if triggered)						Up to 0.625%	Up to 1.25%	Up to 1.875%	Up to 2.5%
Additional Loss Absorbency for G- SIBs[2]							Phase In		1% to 2.5%
Potential Max Total Capital with G-SIB and Countercyclical Buffer [2]						Parallel Run with Disclosures 2015+			**15.5%**
Leverage Ratio [3]								3%	3%
Liquidity Ratios									
Liquidity Coverage Ratio (LCR) [4]		Observation Period			≥ 100%	≥ 100%	≥ 100%	≥ 100%	≥ 100%
Net Stable Funding Ratio (NSFR) [4]				Observation Period				> 100%	> 100%

1. Deferred Tax Assets (DTA), Mortgage Servicing Rights (MSRs) and equity ownership of other financial institutions is capped each at 10% of CET1 and combined at 15% of CET1; phased out completely by 2018
2. Additional requirement for Global – Systemically Important Banks (G-SIBs) proposed June 25, 2011, ranges from 1-2.5% (with an additional 1% for banks in the top category who increase their systematic importance). Significant uncertainty remains in this.
3. Test run at 3% during observation period before figure set for 2018+.
4. Proposed but not final ratio

Basel III: Impact on Trade Finance

- Informal survey - Basel III may raise Trade Finance costs 18-40%, which is likely to be passed on to corporate clients
- Potential reduction of Trade Finance offered in favor of using the balance sheet for other, more profitable corporate products
- Key concerns for Trade Finance:
  - 1-year Maturity Floor – does not reflect short-term reality of Trade Finance assets – residual from Basel II (addressed in CRD IV)
  - Credit Conversion Factor (CCF) – converts off-balance sheet assets at 100% (2-5x increase for commercial, performance SBLC) – not consistent with low risk nature of Trade Finance
  - Asset Value Correlation (AVC) – lumps Trade Finance in with other, higher-risk corporate products

Assessing the Current Trade Finance Environment

December 2010 (BAFT-IFSA/IMF) Survey – Anticipation of Basel III

- **92% believe Trade Finance costs will increase due to changes in Credit Conversion Factor (CCF)**
- **32% believe availability of Trade Finance will decrease**
  - 50% of Large banks will reconsider their Trade Finance portfolio
- **Disparity in education between large and small banks as it relates to the impact of Basel III, in particular, the changes to CCF and their impact on Leverage Ratio**
  - 69% of Large bank believe Trade Finance will be more negatively impacted than other products in the bank's portfolio
  - 65% of Small and Medium banks are "Not Sure"

Basel I,II,III: Impact on Trade (Global Bank sample)

A Global Trade portfolio with a concentration of SME obligors and Emerging Market bank risk will most likely demand higher capital reserves. Banks will have margin pressures and potentially could be non-competitive in this space

			Basel 1			Basel II			Proposed Basel III	
S&P/ Moody's Rating	Type of obligor	Tenor of loan	Obligor Risk Weight	Facility Risk Weight (CCF)	Total Risk Weight	Obligor Risk Weight (LGD based)	Facility Risk Weight (CCF)	Total Risk Weight	Facility Risk Weight (CCF)	Total Risk Weight
AA+/AA1	Corporate	1 year	100%	100%	100%	6.1%	100%	6.1%	100%	6.1%
AA+/AA1	Corporate	Sight L/C	100%	20%	20%	6.1%	20%	1.2%	100%	6.1%
AA+/AA1	OECD Bank	1 year	20%	100%	20%	6.1%	100%	6.1%	100%	6.1%
AA+/AA1	OECD Bank	Sight L/C	20%	20%	**4%**	6.1%	20%	**1.2%**	100%	**6.1%**
BBB-/Baa3	Corporate	1 year	100%	100%	100%	46..5%	100%	46.5%	100%	46.5%
BBB-/Baa3	Corporate	Sight L/C	100%	20%	**20%**	46.5%	20%	**9.3%**	100%	**46.5%**
BBB-/Baa3	Bank	1 year	100%	100%	100%	46.5%	100%	46.5%	100%	46.5%
BBB-/Baa3	Bank	Sight L/C	20%	20%	4%	46.5%	20%	9.3%	100%	46.5%
BB-/BB3	EM Bank	1 year	20%	100%	20%	127.3%	100%	127.3%	100%	127.3%
BB-/BB3	EM Bank	Sight L/C	20%	20%	**4%**	127.3%	20%	**25.5%**	100%	**127.3%**
BBB+/Baa	Sovereign	1 year	0%	100%	0%	22.2%	100%	22%	100%	22%

CRD IV – What it Means for Trade Finance

- Capital Requirement Directive IV (CRDIV) implements Basel III in Europe.

- Maturity Floor: CRD IV will harmonize treatment so that always actual maturity will be used for trade finance exposures.

- Leverage Ratio: CRD IV proposes a credit conversion factor (CCF) for off-balance sheet instruments, including trade finance, of 100%. The European Banking Authority (EBA) shall report to the Commission by 31 October 2016 on the impact of the proposals on bank lending, with a particular focus on lending to small and medium enterprises and on trade financing, including lending under official export credit insurance schemes.

- Liquidity: CRD IV proposes that the EBA shall report by 31 December 2013 on the impact of the liquidity coverage requirements on trade finance exposures. By 31 December 2015, the EBA shall report to the Commission on whether and how it would be appropriate to ensure that institutions use stable sources of funding and the impact of that proposal on trade finance lending.

- Changes: CRD IV notes that more beneficial capital requirements for trade finance should be considered as a revision to the international Basel framework, currently under consideration by a Basel Committee working group on trade finance.

General Recommendations on CRD IV

Based on broad consensus on directional changes needed

1. Support CRD IV Proposal on Maturity for Trade Finance Instruments

CRD IV proposes to harmonize treatment so that actual maturity will always be used for trade finance. This recognizes the inherent nature of trade finance as a short term, self liquidating, and secure financial instrument and the proposal should be supported.

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

Increasing the CCF for trade will increase the cost of providing trade finance in some cases by a factor of five. Where the leverage ratio becomes the binding constraint on a bank, it may encourage banks to divert capital to other financial instruments, cease trade lending, or increase the cost of providing trade products to customers.

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 CRD IV.

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

Given the self-liquidating and low-risk nature of trade finance, the measurement of net outflows and categorization of high quality assets should be re-examined. We also recommend a global standard be established to ensure a consistent approach to determining run-off rates, reducing the potential for regulatory arbitrage across different jurisdictions.

Glossary of Terms

- **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.

Contact for Further Information

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