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European Services Forum

MANAGING DIRECTOR

Mr. Michel Barnier
Member of the European Commission
Commissioner for Internal Market and Services

Mr. Karel De Gucht
Member of the European Commission
Commissioner for Trade

Mr. Antonio Tajani
Vice-President of the European Commission
Commissioner for Industry and Entrepreneurship
European Commission
Rue de la loi, 200
B – 1049 – Brussels

Brussels, 24 October 2011

Subject: **Impact of CRD IV on trade and export finance**

Dear Commissioner Barnier,
Dear Commissioner De Gucht,
Dear Vice-President Tajani,

We would like to express our strong concerns regarding the proposed regulation on capital requirements for banks due to the negative impact it will have on trade and export finance. We support efforts by the European Union and its partners in the framework of the G20 to reform banking regulations to improve the stability of the financial system in a manner that will facilitate trade, which has been the main driver of the global economic recovery.

However, we would like to draw your attention on some provisions of the proposals made by the Basel Committee on banking supervision that relate to trade finance and to the implementing measures proposed by the European Commission in the Draft Regulation included in the Capital Requirement Directive 4 (CRD IV). In our view, Basel III's capital requirements and the CRD IV proposals do not take sufficiently into account of the low risk profile of trade finance related assets.

If adopted and implemented as currently defined, new capital and liquidity requirements will seriously reduce the availability of short term trade and export finance and will increase significantly the cost of trade finance. Furthermore, implementing a risk-insensitive leverage ratio will have a disproportionately large impact on off balance sheet positions, particularly trade finance positions. The restriction of trade finance products for European business will also ultimately threaten the recovery of the global economy, since European banks are providing a very large share of the world's needs to finance international trade.

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Trade finance, which is essentially a means of payment and a guarantee mechanism for the movement of goods and services, has historically maintained a low risk profile in comparison with other financial instruments. A survey conducted by the ICC (International Chamber of Commerce) found that out of 5.2 million trade finance transactions, the default rate was only 0.022% and the average tenor of a transaction was 115 days. Trade finance transactions are indeed generally fixed, short-term instruments that are not automatically renewed or extended upon maturity and are self-liquidating by nature. In stress situations, countries and banks have traditionally continued to prioritise the repayment of short-term trade finance obligations as they fall due. Furthermore, banks active in trade finance are generally able to react swiftly on deteriorations in bank and country risk, as a result of the short-term, self-liquidating nature of the transaction.

On 20 July 2011, the European Commission put forward proposals to implement Basel III capital requirements in Europe, known as Capital Requirements Directive 4 (CRD IV) package. It contains a Proposal for a Regulation governing how activities of credit institutions and investment firms are carried out. The regulation will form a single rule book on capital, liquidity, leverage and counter-party risk. The trade finance provisions in the proposal are governed under the regulation. The regulation also addresses residual issues for trade finance from Basel II in relation to the maturity floor.

a. Liquidity: The Commission proposes that institutions shall at all times hold liquid assets, the sum of the values of which equals, or is greater than, the liquidity outflows less the liquidity inflows under stressed conditions so as to ensure that institutions maintain levels of liquidity buffers which are adequate to face any possible imbalance between liquidity inflows and outflows under stressed conditions over a short period of time. The European Banking Authority (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. Although this is not fully clarified in the draft legislation, we understand that during the observation period, i.e. before the 2015 EBA report, the two liquidity ratios (Liquidity Coverage Ratio - LCR and Net Stable Funding Ratio - NSFR) shall not be binding for these instruments. We welcome the progressive implementation of the liquidity ratios with a non-binding observation period adopted in the proposal. However, the calculation and reporting of the ratios is likely to cause the market to expect banks to meet the ratios. In other words, financial institutions are seeking to meet the ratios today, thereby already reducing the availability of trade finance.

b. Leverage: Under the leverage ratio, the CRD IV draft regulation proposes a credit conversion factor (CCF) for off-balance sheet instruments, including trade finance, of 100%. The proposal to increase the CCF would affect exposures primarily used in trade finance because of the low margin involved. The 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. As for the liquidity ratios, we would like to draw attention on the fact that financial institutions are already seeking to meet the ratios even before the adoption of the CRD IV by the European institutions, thereby already now having an effect to the availability of trade finance. In addition, the

leverage ratio should be anchored in pillar 2 of the reform and hence be regarded as an observation parameter also after 2018, and should not migrate to pillar 1 of CRD IV.

c. Maturity Floor: The Commission noted that maturity of the exposure is one of the determinants of the capital requirement for banks using the most advanced approach for credit risk: longer maturity requires more capital. Normally, maturity may not be less than one year. However for trade finance, the existing CRD allows national discretion to use the actual maturity for certain trade finance, and other exposures, where it is less than one year. The regulation will harmonize this treatment so that actual maturity will always be used for these exposures. We strongly support this proposal.

We also welcome the Commission's note emphasising that more beneficial capital requirements for trade finance should be considered in a future revision to the international Basel framework, notably through the dedicated Task Force on this issue. We understand that the task force will report to the G20 meeting in November 2011 in Cannes on possible measures to promote trade finance. We urge then the EU co-legislators (Parliament and the Council) to promote such revision and include possible internationally agreed changes to the Basel framework for trade finance in CRD4, before its final adoption.

In addition, we believe that the new proposed measures will also have an impact on the medium and long term finance such as export credits with potentially detrimental effects on global economic activity. At the peak of the financial crisis in 2009, the guarantees brought by the export credit agencies (ECA) contributed significantly to keep world trade flowing, with an increase of nearly 25% at a time where world trade was collapsing. By providing insurance and guarantees to protect exporters and banks against political and commercial risks connected to trade and investment, the ECAs stimulated international trade and investment particularly by SMEs. But the Basel III requirements as proposed define banks' exposure irrespective of any risk mitigating factors.

We believe that this is unjustified since export and project finance loans covered by an export credit agency (ECA) often involve backing by the home state of the ECA. No important credit losses have been reported by banks that have financed ECA-guaranteed transactions. These transactions are clearly related to real trade of goods and carry very few risks. They have never been connected to the causes of banking crisis or global financial crisis. Following the Basel III requirements, duly replicated in the European Union implementing measures (CRD IV), collateral, guarantees or other risk mitigating instruments will not reduce on-balance sheet exposure, which makes them more expensive and less attractive for banks, which will either pass the cost on the exporters or even withdraw from that market, thus restraining access to trade and export finance. Therefore, ECA guaranteed loans should be exempted from the calculation rule of the Leverage Ratio with 100% uniform credit conversion factor. Furthermore, as such assets would probably be treated unfavorably under the liquidity constraints (LCR and NSFR – see above), they should not be binding for ECA guaranteed loans before the EBA's report in 2015.

To summarise, we have clear empirical indications that banks are already anticipating the implementation of the measures related to both liquidity and leverage ratios, and indeed to the medium and long term export business and we are making an alarm signal that non-binding observation period are not sufficient as a tool to persuade banks to continue to provide the trade and export finance instruments to exporters under the same

conditions as today. Should these proposed measures not be amended soon, the unintended impact on trade and export finance will be extremely detrimental to the European and the global economy.

Furthermore, the Basel III requirements need to be implemented and applied in the same way globally to maintain a level playing field. It is unclear how major exporting economies like the US and China will implement the new rules. Differentiated implementation of Basel III rules could severely harm European exporters by putting them at an economic disadvantage with their main competitors.

We urge you to take up these concerns with the relevant EU institutions dealing with CRD IV and with global regulatory bodies and institutions, and in particular with the Basel Committee on Banking Supervision of the Bank for International Settlements, to reconsider the recommendations so as to ensure that the important role of trade finance in global economic growth is not adversely affected by the new rules.

Yours sincerely,

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