# BAFT-IFSA

September 20, 2013

Mr. Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel, Switzerland

**Re: Revised Basel III leverage ratio framework and disclosure requirements**

Dear Mr. Ingves:

BAFT-IFSA is an international financial services trade association whose membership includes a broad range of financial institutions throughout the global community. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT-IFSA member banks provide leadership to build consensus in preserving the safe and efficient conduct of the financial system worldwide.

BAFT-IFSA welcomes the opportunity to comment on the consultative document published by the Basel Committee on Banking Supervision ("Basel Committee" or "the Committee"), entitled *Revised Basel III leverage ratio framework and disclosure requirements* ("proposed framework").[1] BAFT-IFSA supports the Committee's goals of promoting a more resilient banking sector and agrees that a strong banking system is the foundation for sustainable economic growth. BAFT-IFSA believes, however, that certain aspects of the proposed framework could have an adverse effect on the availability and affordability of trade finance and could result in reduced global trade flows at a time when they are essential to support economic recovery.

**Introduction and Overview:**

As BAFT-IFSA represents the transaction banking segment of financial institutions globally, including the trade finance and cash management business lines, we are particularly concerned about the impact new regulatory initiatives could have on the provision of these crucial, real economy financing products. Regulatory proposals which adversely impact trade financing operations should be evaluated and adjusted.

To that end, BAFT-IFSA supports the Committee's efforts to impose a leverage ratio as a means to reinforce and complement the risk-based capital requirements with a simple 'backstop' measure. We emphasize, however, that the risk-based requirements should be the binding requirements for most institutions in order to effectively correlate their capital levels with the actual risks they take. The leverage ratio, on the other hand, should remain the supplemental requirement. Reversing this intended relationship would have a significant impact on the provision of important commercial financing services, including the provision of trade, export and development finance.

In addition, the current calibration of the leverage ratio could dramatically impede the flow of financing to importers and exporters - particularly in emerging markets and to small and medium-sized enterprises (SME) - by creating perverse incentives for banks to shun low-risk assets like trade finance. These consequences are evident both for a leverage ratio as the binding constraint and for a leverage ratio with a real prospect of becoming a binding constraint. Banks are increasingly making real-time balance sheet financing decisions based on current regulatory proposals. The denominator of the leverage ratio, as currently constructed, will influence those decisions well before the proposed timeline on Basel III implementation is complete. The Basel Committee should correct issues in the denominator calculation

[1] Basel Committee on Banking Supervision; *Revised Basel III leverage ratio framework and disclosure requirements*, June 2013

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that could harm economic growth and international trade in order to ensure the correct calibration of the leverage ratio at the outset. This will help avoid regulatory uncertainty during the implementation process and will prevent disincentives for banks to continue financing low-risk product and business lines that support commercial customers.

Lastly, the Basel Committee should also reaffirm the principle that national authorities should adopt capital standards, including leverage ratios, that are comparable internationally and which address unintended consequences (particularly for international trade) in a uniform and harmonized manner. National authorities should not unilaterally increase such ratios to become the binding capital requirement for firms, thereby eliminating the fundamental rationale for, and benefits of, internationally harmonized risk- based capital requirements.

**Key Recommendations:**

1. Ensure the Basel III leverage ratio remains a supplementary requirement

BAFT-IFSA believes that the proposed framework, in its current form, would greatly increase the Exposure Measure of the Basel III leverage ratio. As a result, banking organizations would be required to hold much greater levels of capital without regard to the relative riskiness of their credit exposures. This scenario would reverse the intended relationship between the two types of capital requirements for a substantial number of institutions, with the leverage ratio becoming the binding requirement and the risk-based requirements becoming the supplemental backstop. Such a reversal would very likely result in damaging consequences for the real economy.

A binding leverage ratio would encourage institutions to hold assets that are more, rather than less, risky. With a “one-size-fits-all” requirement, riskier assets will produce a higher relative return on capital than safer assets. This will ultimately have a direct impact on the provision of trade finance – a short-term, low risk financing product - to companies around the world. [2] This outcome is fundamentally at odds with the sensible risk management and pro-growth economic policies espoused by the Basel Committee and the G-20. The Basel Committee should reaffirm the principle that the leverage ratio is intended to be supplementary and a backstop and will not become the binding capital ratio that supersedes the risk-based requirement.

2. Address Exposure Measure implications for trade finance

The leverage ratio Exposure Measure in the proposed framework will specifically invoke detrimental consequences for trade finance. To help mitigate these consequences, it is important for the Basel Committee to distinguish the criticality of trade finance to global economic growth through a coordinated revision of the leverage ratio denominator at the outset. To that end, certain aspects of the calibration that were adopted in 2010 should be revisited and modified, especially in light of the greatly expanded Exposure Measure now contemplated by the Basel Committee.

a. Adjust Credit Conversion Factors (CCF) for off-balance sheet trade finance instruments

The application of a 100 percent CCF for trade finance off-balance sheet (OBS) exposures in the denominator calculation of the leverage ratio would be inappropriate and detrimental to the provision of

[2] For additional information on the risk profile of trade finance, and its particular importance to emerging markets and SMEs, please see Appendix 1

international trade.[3] Trade finance instruments, which are low-risk, short-term financing products with low drawdown rates, are critical to support global trade in goods and services. Where the leverage ratio becomes the binding constraint on a bank (or has potential to become a binding constraint due to the increased Exposure Measure contemplated) a 100 percent CCF for trade finance OBS instruments may encourage banks to divert capital to other financial instruments, cease to provide OBS trade/transaction lending or increase the cost of providing these products to customers (importers and exporters).[4]

While we recognize the Basel Committee intentionally designed a global leverage ratio to be simple, the use of a 100 percent CCF for trade finance is excessive given the objective the leverage ratio intends to achieve. The leverage ratio aims 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.

Trade finance is also not a source of the kind of leverage that the Basel Committee was concerned about when creating the CCF framework. As stated in the Committee's formative paper on the ideas behind the CCF framework, the prime motivation for some off-balance sheet innovations has been the avoidance of capital requirements. [5] The goal of the 100 percent CCF is to recapture those transactions that contribute significantly to a bank's leverage but are made opaque by the off-balance sheet treatment. Trade finance, in contrast, does not have the capital arbitrage motivation discussed in that report but instead is part of the "traditional" off-balance sheet commitments financing the real economy.

In other areas of regulatory supervision recommended by the Basel Committee, trade finance has received recognition as an important, real-economy financing product. We note the statement in paragraph 66 of the March 2013 consultative document, *Supervisory Framework for Measuring and Controlling Large Exposures*, which reads:

> *"…..the Committee considers it inappropriate to apply the flat 100 percent CCF to specific types of exposure if there is a risk that this could have material unintended consequences. This is the case for exposures linked to trade finance activities, where application of a flat 100 percent CCF is likely to have a material adverse impact on an essential form of financing in some countries, particularly in emerging markets."*[6]

As the Basel Committee is aware of the likely impact a flat 100 percent CCF could have on trade finance, the Committee should extend consideration of this impact to the final calibration of the Basel III leverage

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[3] Basel Committee on Banking Supervision; *Revised Basel III leverage ratio framework and disclosure requirements*, June 2013: Para 40-41

[4] *Should the leverage ratio become the binding constraint for a bank, the direct consequence on the capital allocation and pricing of trade finance products to the end user would become acute. For example, analysis by BAFT-IFSA has found that in an emerging market trade finance transaction example (whereby a hypothetical Brazilian company obtains a letter of credit to import capital goods from Europe) the company involved could experience as much as a 60 basis point increase in fees charged under a binding 100% credit conversion factor in order for a bank to achieve a comparable cost of capital allocation as compared to a transaction with a 20% CCF. As such, a bank would need to make the rational decision to discontinue conducting such trade deals or continue with a substantial increase in the cost of providing those trade financing products to customers. Such an impact would severely undermine the ability of companies to grow through trade and would hamper economic recovery.*

[5] Basel Committee on Banking Supervision; *The Management of Banks' Off-Balance Sheet Exposures*, March 1986, p. 1

[6] Basel Committee on Banking Supervision; *Supervisory Framework for Measuring and Controlling Large Exposures*, March 2013, p. 12, Para 66

ratio.[7] As such, we recommend use of the Basel II Standardized Approach credit conversion factors of 20 percent for trade related contingencies and 50 percent for transaction related guarantees rather than a flat 100 percent CCF.[8] These values reflect both the low-risk nature of trade finance and the fact that not all OBS trade exposures will necessarily convert to on-balance sheet exposures.[9]

Standardized Approach CCFs are not risk-weights but are instead tools to estimate actual exposure amounts. They are also reasonable proxies for Exposure Measures because they estimate the drawn amount of a commitment and they are much better measures of actual exposure than the blunt 100 percent CCF set forth in the proposed framework. It is noted that the Basel Committee already agreed that OBS unconditionally cancelable commitments should receive a 10 percent CCF for the purposes of the leverage ratio, thus recognizing the intrinsic nature of those instruments in a way that will not harm the effectiveness of the ratio's overall purpose or its simplicity as a backstop measure. [10]

We also note that through Capital Requirement Directive IV (CRDIV/CRR), the European Union (EU) recognized the importance of the appropriate regulatory treatment of trade finance in their calibration of the leverage ratio. [11] The EU applied credit conversion factors of 20 percent for medium/low risk trade finance products and 50 percent for medium risk trade finance products rather than a flat 100 percent CCF. These sensible, pro-growth and pro-trade changes to the leverage ratio should be harmonized across all jurisdictions of the Basel Committee. [12] In addition, and in line with CRDIV/CRR, the Committee should recognize and mitigate the potential consequences for lending under officially supported export

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[7] Additionally, in other parts of the Basel III framework, trade finance has been recognized for its unique nature. This includes the application of drawdown rates applied in the Liquidity Coverage Ratio (LCR). Trade finance instruments receive "a relatively low run-off rate (*e.g.*, 5% or less)," which appropriately reflects the low drawdown rates underpinned by the movement of goods or provision of services. These runoff rates conservatively assume a stressed environment in which "all facilities that are assumed to be drawn . . . will remain outstanding at the amounts assigned throughout the duration of the test, regardless of maturity." These conservative assumptions also should be appropriate as applied to off-balance sheet items in the leverage ratio context. (Basel Committee on Banking Supervision; *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools,* January 2013: p.33, Para 138)

[8] Basel Committee on Banking Supervision; *International Convergence of Capital Measure and Capital Standards: A Revised, Comprehensive Version,* June 9, 2006; Para 82-86

[9] For discussion regarding the low rate of on-balance sheet conversion of trade finance products, please see: International Chamber of Commerce, *Global Risks Trade Finance Report* 2013;
http://www.icctraderegister.com/docs/public/ICC%20Global%20Risks%202013%20Report%20Final%20Version.pdf: p. 22

[10] Basel Committee on Banking Supervision*; Revised Basel III leverage ratio framework and disclosure requirements*, June 2013: Para 42

[11]Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (CRDIV/CRR): Article 429, Para 10 (b) and (c) and Annex 1

[12] If the Committee were to propose use of the Standardized Approach CCF for trade finance for the purposes of calculating the leverage ratio, BAFT-IFSA believes the Committee should consider adjusting the CCF for non-financial guarantees and standby guarantees from 50% to 20%. Non-financial guarantees and standby guarantees are essential products supporting international trade. Their historical performance data substantiates a 20% CCF calculation. The International Chamber of Commerce (ICC) analyzed the default rate for performance guarantees, alongside performance standby L/Cs. Their low default rates and low rates of conversion on-balance sheet enumerate the fact that these types of trade finance products are low-risk, particularly when compared with corporate loans (See: International Chamber of Commerce, *Global Risks Trade Finance Report* 2013, p.15 and p.22). Through CRDIV/CRR, the EU adjusted the CCF for non-financial guarantees and standby guarantees to 20% for the purposes of the Basel III leverage ratio calculation. By taking this step, the EU recognized the intrinsic nature of these products and their low default profile. This treatment should be harmonized across all jurisdictions of the Basel Committee.

credit regimes, whereby off-balance sheet exposures related to these regimes would be converted to the Exposure Measure at full face value, thereby impeding global export flows.

Lastly, it is important to ensure global consistency in the implementation of Basel III. At this stage it is not clear whether the leverage ratio will apply at the consolidated group level of a financial institution or at the subsidiary and branch level as well. If applied at the branch/subsidiary level, there is greater likelihood that some global banks active in supporting international trade will find themselves constrained. Local capital and liquidity requirements are increasingly becoming the binding local requirement for the subsidiaries and branches of global banks active in various jurisdictions. This could cause disparate treatment for banks with a group head office in a developed economy and subsidiaries or branches in an emerging market economy. This could, in turn, inhibit the provision of trade finance to customers in the latter market. As some jurisdictions have begun to recognize the possible consequences of 100 percent CCF on trade finance, the Basel Committee should look to harmonize a lower CCF for trade finance across all jurisdictions of the Committee and clarify the application level of the leverage ratio for large, globally active banks to ensure cross border trade flows are not harmed.

b. Exclude cash and other high quality liquid assets (HQLA) from the Exposure Measure

BAFT-IFSA believes that cash and other high quality liquid assets (specifically Level 1 HQLA) should either be excluded from the Exposure Measure or discounted according to their relative levels of liquidity.[13]

The inclusion of cash in the Exposure Measure impacts a bank's trade finance business, as trade finance exposures are often cash collateralized. The cash placed as collateral with a bank will first be on the liability side of the balance sheet and in itself not be counted into the calculation of the leverage ratio. However, to have a squared balance sheet this liability will be used to create an asset, most likely by passing the cash on to a Central Bank. As a result, the collateral on the one hand achieves a near risk-free trade finance exposure for the bank but on the other hand increases the Exposure Measure of the leverage ratio. This treatment penalizes banks for using cash collateral in their trade finance operations and has the potential to limit the ability of a bank to undertake certain trade financing transactions.

The leverage ratio Exposure Measure requirements also have implications for a banks' adherence to the Liquidity Coverage Ratio (LCR) requirements. The LCR requires banks to hold HQLA in case of a liquidity stress scenario. These assets (mostly held at Central Banks) are counted into the leverage ratio exposure although they cannot actually be used for anything other than HQLA and are not a source of leverage. Additionally, when a bank takes cash deposits from its clients, the cash is either matched off against a loan (*i.e.* used as funding) or it is placed with a Central Bank. If it is placed with a Central Bank, an asset is created on the bank's balance sheet which adversely impacts the leverage ratio Exposure Measure. By providing deposit taking services to its clients and passing the cash through to a Central Bank, banks are penalized for providing "basic" banking services due to the negative impact on the leverage ratio exposure. This creates a disincentive for providing client-based services like deposit taking.

By excluding cash and other Level 1 HQLA from the leverage ratio Exposure Measure, the framework will be better aligned to capture truly significant risk exposures and will eliminate or greatly reduce the perverse incentives to avoid cash and other high quality liquid assets.

[13] Level 1 HQLA as defined by the Basel Committee on Banking Supervision; *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools,* January 2013; p. 12, Para 50

3. Ensure harmonization in implementation of leverage ratio requirements and align mitigation of unintended consequences

Harmonization of international financial regulation is critical to mitigate regulatory uncertainty and to avoid potential regulatory arbitrage. As such, BAFT-IFSA is particularly concerned about the impact that disparate financial regulations propagated regionally could have on the provision of transaction banking services, including trade finance. We also remain concerned about unaddressed unintended consequences emanating from multilateral regulatory initiatives.

To assist in mitigating disparate and contradictory implementation of the Basel III leverage ratio, the Basel Committee should reaffirm the principle that national authorities should adopt capital standards, including leverage ratios that are comparable internationally, in a uniform and harmonized manner. National authorities should not unilaterally increase such ratios to become the binding capital requirement for firms, thereby eliminating the purpose and benefits of internationally harmonized capital requirements.

The Basel Committee should also engage in a proactive examination of regulatory proposals to eliminate unintended consequences for the real economy in a uniform and consistent manner. As noted, the Basel III leverage ratio has the potential to impact international trade for both developed and emerging markets. In particular, an appropriately transparent and internationally consistent lower CCF calculation, along with the appropriate treatment of cash and other Level 1 HQLA under the leverage ratio, would not diminish the simplicity or overall purpose of the leverage ratio as a backstop. These adjustments would more effectively manage the global applicability of the leverage ratio by mitigating unintended consequences for the end-user of financial services. This will help ensure that growth and stability in global markets, and particularly in emerging markets, is consistently available.

**Conclusion:**

BAFT-IFSA believes that the appropriate regulatory treatment for the financing of international trade will ultimately have a positive effect on global markets and will spur job creation and growth in the real economy. We very much appreciate the opportunity to comment on the consultative document and look forward to further dialogue with the Committee on these issues going forward.

Very truly yours,

Tod R. Burwell

Tod R. Burwell
President and Chief Executive Officer

## Appendix 1

### Trade Finance Profile and Emerging Market/SME Issues

**Trade Finance Profile:**

Global trade relies upon accessible financing for trade transactions. Trade financing assists customers with their import and export requirements by providing import/export financing as well as country and counterparty risk mitigation. Trade finance, as a transaction banking product, is a core banking business serving the real economy.[14]

Trade finance has historically maintained a low-risk profile in comparison with other financial instruments. Trade finance transactions are generally fixed, short-term instruments that are not automatically renewed or extended upon maturity and are self-liquidating by nature (*i.e*., exposures are liquidated by payment at maturity). In stress situations, countries and banks have traditionally continued to prioritize 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.

According to an ongoing registry project conducted by the International Chamber of Commerce (ICC), banks have experienced relatively minimal losses on trade lending. The ICC has created this Trade Finance Register to track default and loss rates for trade finance, creating a living database of the trade finance market which has helped to demonstrate the resilience of this important business. The pooled data within the Register supports the view that trade finance is a low-risk asset class, particularly when compared with corporate loans. According to that data, accumulated over 8,133,031 transactions, only 1,746 defaults were recorded, which accounts for a default rate of 0.021 percent.[15] Trade finance instruments also have a low conversion rate on-balance sheet, with rejections for certain off-balance sheet products averaging 92 percent due to dependence on an event happening (*i.e.,* fulfillment of the terms of the agreement) before the bank needs to make a payment to the beneficiary of the product. [16]

**Trade Finance Implications for Emerging Markets and SMEs:**

Trade financing is an important tool for economic development around the world, particularly in emerging markets. There are significant challenges, however, facing global trade generally and emerging markets specifically. Developing economies are experiencing the effects of volatile capital flows, tighter financial conditions, commodity price volatility and domestic structural challenges. These issues add to growing concerns around the availability of trade finance to support growth in these countries.

Though global trade fell to 2.0 percent in 2012 (down from 5.2 percent in 2011) emerging market export and import volumes still grew by 3.3 percent and 4.6 percent respectively, far outpacing developed economy statistics. This emphasizes the increasing role these countries play in the global economy, particularly since between 1980 and 2011, developing economies raised their share in world exports from 34 percent to 47 per cent and their share in world imports from 29 per cent to 42 percent.[17]

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[14] BAFT-IFSA has defined the specific products that the industry considers traditional trade finance: *BAFT-IFSA Traditional Trade Finance Definitions*; February 2012: http://www.baft-ifsa.com/eweb/docs/BAFTIFSATFDefinitions.pdf

[15] International Chamber of Commerce, *Global Risks Trade Finance Report 2013*, p. 15: http://www.icctraderegister.com/docs/public/ICC%20Global%20Risks%202013%20Report%20Final%20Version.pdf

[16] IBID, p. 22

[17] World Trade Organization; *World Trade Report 2013*

However, according to a 2013 Asian Development Bank (ADB) survey, banks reported that they rejected about 35 percent of requests to finance imports and exports. This meant that roughly $1.6 trillion of the $4.6 trillion of demand for global trade finance was unmet, causing potential harm to growth in trade in developed and developing economies. [18]

Banks surveyed by the ADB cited the more stringent Basel III regulatory requirements as one of the significant factors inhibiting banks' financial support for trade. The banks indicated that they would reduce support to trade finance by about 13 percent once Basel III is fully implemented.[19] More broadly, 65 percent of respondents to the ICC 2013 Trade Finance survey found that the implementation of Basel III is currently affecting the cost of funds and liquidity for trade finance.[20]

Such developments in Asia and elsewhere could have serious implications for the real economies of both emerging markets and developed countries. The ADB also found that respondent companies (*i.e*. the users of trade financing) indicated that a 5 percent increase in trade financing availability would mean a 2 percent growth in their business and a requirement to hire 2 percent more staff, while a 10 percent increase in trade financing availability would result in 5 percent increase in both production and jobs.

Trade finance support for small and medium sized enterprises (SME) is also critical. SMEs make up 80-90 percent of businesses in most regions and trade lending to SMEs is limited by their lack of collateral, credit history, and technical expertise in trade finance. As a result, in many regions the trade finance gap is very large for SMEs. According to the ICC, the shortage of trade finance for international trade remains a major challenge for economic recovery and development. To finance exports and imports, traders (especially SME's in emerging markets) continue to rely on loans in local currencies and overdrafts. This restricts their ability to trade at optimum levels and this non-availability of trade finance for SMEs will ultimately impact economic growth and job creation.

Additionally, outside of the G-8, most local banks borrow in US dollars (USD) to finance the trade flows of their customers. If the calibration of the Basel III leverage ratio isn't adjusted and uniformly applied, USD funding may be inhibited, which will lead to increased costs borne directly by SME clients of financial institutions. These SMEs will in turn face less supply and higher hurdles to finance international trade.

**Conclusion:**

Leaders of the G-20 have emphasized the need to "…*work collectively to strengthen global demand and restore confidence with a view to support growth and foster financial stability in order to create high quality jobs and opportunities for all….citizens*"[21]. Furthermore, the G-20 most recently committed to achieving further progress in removing barriers to global trade and investment.[22] Ensuring the appropriate regulatory treatment for trade finance under implementation of the Basel Framework will support the accomplishment of these goals.

[18] *Asian Development Bank Trade Finance Survey: Major Findings*, ADB Briefs No. 11, March 2013

[19] IBID; pp. 2 and 5

[20] International Chamber of Commerce; *Global Survey on Trade Finance 2013*: http://www.iccwbo.org/Products-and-Services/Trade-facilitation/ICC-Global-Survey-on-Trade-Finance/

[21] G-20 Los Cabos Summit Communiqué; June 19, 2012

[22] G-20 St. Petersburg Summit Communiqué; September 6, 2013

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Building on the G-20 mandate, trade finance is increasingly being recognized as an important driver of growth in developed and developing economies. For example, in July 2013, the Financial Stability Board (FSB) issued guidance on recovery and resolution planning for systemically important financial institutions and recognized trade finance as a "special issue" in critical function determinations for resolution planning.[23] The World Trade Organization (WTO), in their 2013 World Trade Report, also emphasized the important link between increased global trade and the availability of trade finance and highlighted the need to ensure that trade finance is recognized as 'a development-friendly and low-risk form of finance' when creating new prudential regulatory standards. [24]

It is widely recognized that trade finance has historically been an engine of growth in world commerce and an important source of growth in emerging economies. By some estimates, 80 percent to 90 percent of world trade relies on some form of trade finance. BAFT-IFSA believes that regulatory proposals should support international trade finance and should not exacerbate problems already being experienced in certain markets. Initiatives which could further impact trade finance affordability and availability, including the current calibration of the Basel III leverage ratio, should be reevaluated and adjusted.

[23]"…..because industrial corporates often rely on trade finance for cross-border business, the unavailability of trade finance may disrupt the international flow of goods. Trade finance products are regularly part of a more encompassing banking relationship and may be difficult to acquire on standalone basis. In addition, in some countries relatively few banks may be able to expand their provision of trade finance products." Financial Stability Board; *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Identification of Critical Functions and Critical Shared Services; July 2013*: p. 18

[24] World Trade Organization; *World Trade Report 2013; pp. 251-256*