

BAFT-IFSA

26 July 2012

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Ladies and Gentlemen:

We write to you in the context of the current economic situation, where countries across the world are working to stimulate economic recovery and job creation. For centuries, Trade Finance has been considered the engine for international trade and global commerce. We remain concerned, however, about the unintended consequences of the regulatory treatment of Trade Finance under Basel II and Basel III, and the impact this will have on growth and development. Elements of the Basel Framework do not reflect the risk profile of Trade Finance, nor do they take into account the adverse effects of the recommended changes on international trade and real economy financing.

International trade relies on accessible financing for trade transactions. Trade Finance instruments are low risk, short-term assets that assist customers with their import and export requirements. A disproportionate regulatory burden for Trade Finance will increase the cost and/or reduce the availability of such financing and adversely affect economic growth.

We have detailed several issues in past correspondence to the Basel Committee related to our concerns and we would like to specifically highlight one area here for your consideration. We believe one of the unintended consequences of the Basel Framework is a lack of a separate risk curve / Asset Value Correlation (AVC) for Trade Finance. We respectfully encourage the Basel Committee to examine the possibility of creating a separate AVC for Trade Finance exposures, the rationale and background for which is outlined in the attached position paper. This will aid in the goal of creating a stronger banking sector, without damaging Trade Finance lending to the real economy. Currently, the AVC applicable to Trade Finance is at a counterparty level and not at a product level. However, under consumer lending, the applicable AVC appropriately varies by product, with a separate AVC for "residential mortgages" and "qualifying revolving retail exposures", thus providing a more accurate reflection of the risk and subsequent capital requirements attributed to each of these products. The nature of Trade Finance as a real economy financing tool warrants similar treatment.

At its most recent meeting in Los Cabos, the G-20 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. Ensuring the appropriate regulatory treatment for Trade Finance under the Basel Framework will support the accomplishment of these goals.

We very much appreciate the opportunity to share our comments, concerns and recommendations and we look forward to further dialogue with the Basel Committee on these issues going forward.

Very truly yours,



Robert R. Davis
Chief Executive Officer (Acting)

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Trade Finance – Basel Framework Risk Curve Application

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. Under the Basel framework, the application of the Asset Value Correlation (AVC) is of particular concern. As short-term, self-liquidating instruments, Trade Finance products warrant a separate AVC from other types of corporate banking products. 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.

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. This 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, particularly Small and Medium Sized Enterprises (SME), to engage in international trade. Industry estimates indicate that pricing for Trade Finance products could increase by 18-40% under the Basel III proposals. Disproportionate treatment for Trade Finance under the risk curve application adds to this burden for these real economy financing instruments.

Key Recommendation - Create a Separate Asset Value Correlation for Trade Finance:

1. Background. Capital on Trade Finance exposures is determined by using the generic AVC, known as the corporate risk curve. This is despite Trade Finance having low product default rates, Trade assets having low correlation, and Trade assets being small in value and diversified (multi-geography and multi-industry). This results in banks maintaining much higher capital than what corresponds to the true risk for Trade Finance exposures. This ultimately reduces the availability of Trade Finance and increases the cost of providing Trade Finance for businesses globally.

Under the current Basel guidelines, Risk Weighted Assets (RWA) is a function of, *inter alia*, the 1 year Probability of Default (PD), Maturity (M), Loss Given Default (LGD), Exposure at Default (EAD), and AVC (counterparty).

- $RWA = f(PD\ 1yr, M, LGD, EAD\ 1yr, AVC\ counterparty...)$
- In the above formula, whilst Maturity, LGD and EAD can reflect Trade Finance specific values, the PD is always based on counterparty default (not trade default) and 1 year PD.
- While the PD being used is always a 1 year PD, the adjustment for tenor of the exposure is carried by making the maturity of the transaction a determinant of RWA, *i.e.* RWA is a function of Maturity as well. However, this only takes care of the impact of PD migration and it does not lower PD due to short term maturity.
- The other option could be to use a maturity adjusted PD so that the lower PD, due to shorter maturity, is also taken into consideration: $PD_m = 1 - (1 - PD_{1yr})^m$.¹

Currently, for wholesale banking, the only differentiation on the AVC is on counterparty. As such, there are two separate AVCs – one for exposures to Corporates and small Financial Institutions (FI) and another one for exposures to large FIs. Under Basel II, only one AVC (12% to 24%) is applicable for all products and all counterparties for the wholesale banking book. During the last financial crisis, it was

¹ Please refer to Appendix Chart 2 for an illustration of differences in RWA exposures between Maturity Adjusted PD (PD_m) compared with 1 yr PD for a typical 90 day maturity profile.

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observed that exposures to large FIs were more correlated to the macro environment than the Basel II AVC (12% to 24%). As such, under Basel III, the Basel Committee on Banking Supervision (BCBS) proposed a separate AVC of 15% to 30% for exposure to large FIs, defined as institutions with assets on-balance sheet greater than 100 Billion USD.

For consumer lending, the AVC also varies by product. For example, there is a separate AVC for “residential mortgages” and “qualifying revolving retail exposures”. As such, for consumer lending, there is effectively AVC differentiation based on products. The industry believes there needs to be a similar approach for Trade Finance through the creation of a Trade Finance specific AVC with implementation in a harmonized way across BCBS jurisdictions.

The accumulated industry data on loss rates and tenor of Trade Finance products, when compared with corporate loans, clearly shows that the defaults and losses on Trade Finance are very low compared to corporate loans (please see section 2). However, since there is no differentiation in PD for Trade Finance vis-à-vis corporate loans (as they both will use a counterparty PD), we believe it is necessary to make an adjustment to the AVC to take into account the low correlation of trade exposures.

As such, a Trade RWA should be a function of, *inter alia*, Maturity Adjusted PD, Maturity, LGD, EAD, “AVC for Trade”:

- $RWA_{trade} = f(PD_m, M, LGD, EAD_{1yr}, AVC_{trade} \dots)$ where $M = 1$;
and where Maturity Adjusted PD or $PD_m = 1 - (1 - PD_{1yr})^m$
and $m =$ actual maturity expressed as a fraction of months (e.g. 6 months maturity = 6/12)

2. Trade Finance Data Comparison: The International Chamber of Commerce (ICC) has created an ongoing Trade Finance Register on default and loss rates for Trade Finance². The ICC’s Trade Finance Register created a living database of the Trade Finance market and has helped to demonstrate the resilience of the Trade Finance business. The Register is the most comprehensive dataset now available and demonstrates the true nature of Trade Finance. Historically, Trade Finance had been considered to be an extremely low-risk, routine operation. The ICC Register data reveals that a minimum of 60-65 percent of traditional global Trade Finance activity is based on assets (or about USD2.2-2.5 trillion) and the pooled data within the Register supports the view that Trade Finance is a low-risk asset class, particularly when compared with corporate loans for the purposes the current AVC calculation.

Parameter	Trade Finance ³	Corporate Loans ⁴
Default rate:	0.013% to 0.290%	1.01% ⁵
Loss rate:	0.0007% to 0.07%	0.20% ⁶
Tenor:	Average ~147 days	1-3 years
Diversification:	Diversified- \$454k average transaction size	Less diversified than Trade given large corporate focus

3. Benefits of a Separate Trade Finance AVC: The current calculation of the AVC increases the cost for the industry in providing Trade Finance to the end user and its application is disproportionate to the nature of the instrument, as demonstrated by the ICC register data on Trade Finance. A separate AVC for Trade Finance will accord the correct capital treatment for Trade Finance, recognizing the self-liquidating, short-term, diversified nature of these products. It will result in greater availability and modified pricing for Trade Finance and also enable more banks to become active in providing this important, real economy financing. This will in turn increase trade financing for SMEs, increase export/import business and propel economic activity that results in job creation and growth. Additionally, as there is currently no requirement for data to be reported by a “Trade Finance” asset class, creating a separate AVC for Trade Finance will

² International Chamber of Commerce: http://www.iccwbo.org/uploadedFiles/ICC-Register_Report_26_October_2011.pdf

³ Data from ICC Trade Register—Rated & Unrated Counterparties; Data for 2008-2010

⁴ Data from Moody’s report—Global Corporate Finance- Feb 2011- Rated Counterparties

⁵ Data analyzed: 1982-2010

⁶ Data analyzed: 1987-2010- 80.3% recovery rate

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provide this default and loss data to regulators and assist in ongoing discussion around liquidity requirements for Trade Finance off-balance sheet exposures.

Conclusion: Based on the current data available, the industry recommends an estimation of a separate AVC for Trade Finance and implementation across BCBS jurisdictions. As such, a Trade Finance AVC could be positioned between the corporate AVC and that of the “qualifying revolving retail exposures”. RWA will then be a function of the following:

- $RWA = f(PD_{1yr}, M, LGD, EAD_{1yr}, AVC_{trade} \dots)$ where Maturity (M), LGD and EAD can reflect Trade Finance specific values whilst holding PD constant at 1yr.⁷

In the longer term, work would need to be undertaken to compile further industry data through the ICC registry to further refine (if necessary) the AVC for Trade Finance. In addition, to more accurately account for the effects of a lower PD due to shorter term maturity profiles of trade, the introduction of Maturity Adjusted PD or PD_m should be implemented. RWA will in effect be a function of the following:

- $RWA_{trade} = f(PD_m, M, LGD, EAD_{1yr}, AVC_{trade} \dots)$ where $M = 1$; and where Maturity Adjusted PD or $PD_m = 1 - (1 - PD_{1yr})^m$ and $m = \text{actual maturity expressed as a fraction of months}$ (e.g. 6mths maturity = 6/12)

BAFT-IFSA respectfully requests further dialogue with the Basel Committee in this regard. For Further information, please contact Tod Burwell (+1-202-663-5252; tburwell@baft-ifs.com) or Matthew L. Ekberg (+1-202-663-5537; mekberg@baft-ifs.com).

⁷ Appendix Chart 1

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Appendix Chart 1

$$RWA = f(PD_{1yr}, LGD, EAD_{1yr}, M, AVC \dots)$$

$$RWA = f(\text{Counterparty PD, LGD, } EAD_{1yr}, M, \text{Counterparty AVC})$$



Moving away from Client AVC and towards Product AVC



- All products assumed equal
- Adjusted by type of counterparty under Basel III

- Product AVC**
- Loans**
- More correlated
 - Lumpy
 - Mono-geography
- Trade**
- Smaller value
 - Low correlation
 - Multi-geography
- To be modelled

Current ICC data available

Trade risk (data from ICC Trade Register) *

Default rate:	Between 0.013% to 0.290%
Loss rate:	Between 0.0007% to 0.07%
Tenor:	Average ~147 days
Diversified:	\$454k average transaction size

* Rated & unrated counterparties
Data for 2008-2010

Corporate loans – Moody's report *

Default rate**:	1.01%
Loss rate***:	0.20%
Tenor:	1-3 years

Less diversified than Trade given lumpy large corporate focus

• Global Corporate Finance – Feb 2011 – Rated counterparties
 ** Data analysed: 1982-2010
 *** Data analyses: 1987-2010 – 80.3% recovery rate

NOTE: Long Term – ICC Data needed to further refine (if necessary) Trade Finance AVC

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Appendix Chart 2

Difference in RWA – Maturity Adjusted PD (PD_m) vs. 1 yr PD

With $m = 90$ days

