



International Chamber of Commerce

The world business organization



Strengthening financial regulation and ensuring the availability of trade finance

Issue

New global financial regulations should be complemented by effective international supervisory mechanisms and consistent implementation across jurisdictions.

Great care should be taken to avoid that new regulations have a detrimental effect on the availability of trade finance, especially in developing countries.

Analysis

Strengthening financial oversight

Since the outset of the financial crisis, the focus of near-term policy action has been on strengthening the regulatory framework. But regulation is only part of the solution, and it is through supervision that the authorities enforce compliance with the rules.¹

In order to prevent the recurrence of financial crises in the future, the G-20 nations declared supervision a key pillar of the financial reform agenda and gave an explicit mandate to develop it. Thus:

- Every country should have a supervisory system that is up to the task of ensuring that the regulations, including the new regulations coming out of Basel III, are backed up by effective risk assessment and enforcement, especially as they relate to systemically important financial institutions (SIFIs). Supervisors are expected to detect problems proactively, and intervene early to reduce the impact of potential stresses on financial institutions and therefore on the financial system as a whole.²
- Each supervisory agency must have a clear mandate and timetable to supervise financial institutions and markets, with priority given to the maintenance of financial stability and the safety and soundness of the financial system.
- National oversight boards are unable to monitor effectively financial conglomerates active on a global scale. Only a unified global system would be able to detect and sanction off-balance sheet activities and regulatory arbitrage that overlap national borders and sectors. In terms of regulatory oversight, the prevention of coordination failures requires a trans-national mandate. This can only be achieved through the creation of a global financial market oversight system.³

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¹ Shaping the New Financial System (2010). Vināls, José ; Fiechter, Jonathan ; Pazarbasioglu, Ceyla ; Kodres, Laura E. ; Narain, Aditya ; Moretti, Marina

² Reducing the moral hazard posed by systemically important financial institutions (2010). The Financial Stability Board (FSB)

³ Agenda for a New Financial Market Architecture (2009). German Institute for Economic Research
ICC-G20 Advisory Group

Balancing financial stability and the role of finance as a growth driver

Since the global financial crisis, policy makers have been focusing on building a new regulatory bulwark to minimize the likelihood of another financial tsunami. The resulting atmosphere of caution, however, has led to the creation of various regulations that impose considerable costs on businesses and consumers and diminish the economic benefits of a competitive and dynamic financial services sector. A well-developed financial system is not only the product of economic growth but also a key driver of such growth. Therefore, regulatory authorities should always be mindful that striking an optimal balance between stability and innovation will remain a key challenge in their quest for more sustainable economic growth.

Improving rules on financial market integrity and transparency

The implementation phase of Basel III will require the transposition of the global framework into national rules. While the Basel Committee on Bank Supervision (“BCBS”) and the G20 have pledged to adhere to the global framework, there are signs that implementation in individual jurisdictions might diverge in a number of important respects. Some jurisdictions are likely to “top-up” Basel III minima and/or accelerate implementation timetables. Others might opt for implementing only portions of the new rules or local adaptations of the new rules. An undesired consequence could be that it might unbalance the playing-field and create market disruption.

ICC is of the view that Basel III should be understood and implemented in a consistent manner across jurisdictions, building on the guidance published over the years by the BCBS, but perhaps with additional guidance focused on the very different conditions created by Basel III.

Ensuring the availability of trade finance

The global financial crisis of 2007 was unique in many ways. Among its effects were unprecedented limits on the access to trade finance, an impediment that continued for more than two years (2007–09) and significantly curbed import and export trade, one of the principal drivers of economic growth worldwide.

The G20 London Summit in April 2009 came up with a substantial package of measures to support trade finance – specifically, USD250 billion of funding to be made available through multilateral banks and export credit agencies, as well as a mandate for regulators to “make use of available flexibility in capital requirements for trade finance”.

At its December 2009 meeting, the BCBS approved for consultation a package of proposals to strengthen global capital and liquidity regulations with the goal of promoting a “more resilient” banking sector. At the November 2010 G20 Summit in Seoul, a number of proposals were accepted and a timetable put in place for regulators to implement the new regulatory regime.

Defining new bank capital and liquidity standards

The recent crisis signaled the need to review the global financial regulatory framework to reinforce the banking sector's ability to absorb economic shocks and to build a stronger,

safer international financial system. The private sector has consistently voiced strong public support for these objectives

However, in attempting to create a more robust regulatory framework and curb speculative and highly leveraged instruments, Basel III could significantly curtail banks' ability to provide affordable financing to businesses.

ICC respondents to the ICC Global Survey on Trade & Finance 2011⁴ were concerned about the unintended consequences arising from the new regulatory regime, which would indiscriminately put trade finance into the same risk class as high-risk financial instruments. According to many respondents, the new regulatory regime was obviously not taking into account the adverse effects of the proposed changes on global trade and growth. Specifically, the augmentation of the leverage ratio under the new regime will significantly curtail banks' ability to provide affordable trade financing to businesses in developing and low-income countries and to SMEs in developed countries. Banks would now be required to set aside 100% of capital for any off-balance-sheet trade finance instruments such as commercial letters of credit (compared to 20% under Basel II), which are commonly used in developing and low-income countries to secure trade transactions.

The concerns expressed by banks in the ICC Survey 2011 can be summarized as follows:

- **Banks moving away from trade finance:** There is a risk for small to medium-sized banks to move away from the trade finance market, thereby significantly reducing market liquidity. Regulatory capital under Basel III requires multiple times higher pricing than economic capital. This would first impact small and medium-sized enterprises that are the engine of economic growth in poor countries for which trade finance is critical to the sustenance of these emerging markets. The vast majority of trade financed from low-income countries is through traditional trade products such as Letters of Credit (LCs) and Guarantees. For larger banks, with lower internal rates of return, trade finance may also be less attractive compared to riskier products so banks will allocate more of their balance sheets to speculative leveraged instruments.
- **Unintended consequences on the timing of the implementation of the regulatory regime in different regions:** There is still quite a lot of uncertainty about the impact of Basel III, because of the role of national regulators in deciding the local form of the rules. This uncertainty over local implementation was already a problem with Basel II rules, which have been implemented by many European banks, but were implemented much later or not at all in many countries. The non-implementation of the regulatory regime in a consistent fashion would create competitive arbitrage opportunity for some financial institutions and may impact on the domiciling of banks.

⁴ <http://rebusparis.com/icc/ICC2011GlobalSurvey210311S144.pdf>

- **Unintended consequences on cost of trade:** Those who remain in trade finance could naturally raise their costs as a result of the more stringent regulatory requirements. We have already seen what can happen when liquidity is reduced: during the crisis, markets such as South Korea and India faced a hike in letter of credit pricing from 0.2% to 6.5% per annum.
- **Unintended consequences on SMEs and banks in emerging markets:** Again, as a result of a reduction in the supply of trade financing and an increase in pricing, the most severe effects would be felt by small to medium-sized enterprises in the developing world, where trade financing is needed most to create jobs and alleviate poverty.
- **Unintended consequences on non-regulated sectors:** Banks may be encouraged to move high-quality trade assets and contingents into non-bank sectors such as hedge funds. For instance, banks may likely decide to securitise their trade assets – pushing them into higher-risk, unregulated markets. This clearly would defeat the very purpose of Basel III which was implemented to prevent another financial crisis and use of such practices.

Evidence has shown that trade finance is generally low-risk, self-liquidating, and short term in nature, which is markedly different from most corporate or financial institution lending exposures, which tend to be larger in size and longer term. The difference is demonstrated in the ICC-ADB Trade Register. Created in November 2009, the Register pools performance data for trade finance products from nine international banks, covering a total of 5.2 million transactions between 2005 and 2009 with a total value of over \$2.5 trillion. Analysis of the data largely supports the view that trade finance is a relatively low-risk asset class:

- Trade-finance transactions have an average tenor of just 115 days;
- Trade-finance transactions typically have a low incidence of default, with less than 1,200 defaults reported for all 5.2 million transactions. Off-balance sheet trade transactions have an even lower default rate, with only 110 defaults reported for 2.4 million transactions;
- Even during the global economic downturn, trade-finance transactions experienced relatively low levels of default, with fewer than 500 defaults among 2.8 million transactions;
- For written-off products, recovery rates average 60% for all product types, albeit with significant variance year to year and by product type.

The collected data supports the view that trade finance should be given treatment that reflects business realities under Basel III, in terms of the capital, leverage and liquidity requirements. Indeed, grouping trade finance with other corporate asset classes suggests that default and recovery rates are similar, but this is clearly not the case. Restricting trade finance would be unwise under any circumstances, and now we can see from the data that it would also be unwarranted.

Recommendations

Based on the above, business would like to make the following recommendations to G20 leaders:

- a. **Retain current CCF values:** Increasing the Credit Conversion Factor (CCF) to 100% for trade-related contingencies for the purposes of calculating a leverage ratio could significantly disadvantage trade finance-focused banks. As such, ICC recommended that if a leverage ratio is to be adopted, off-balance sheet trade products should be allowed to retain the CCF values used by banks under the current “risk weighted assets” calculation (Basel II). This would point in the same direction as foreseen in the “additional option for impact assessment” in the consultative document, which would allow financial institutions to “Apply a lower (positive) CCF for unconditionally cancellable commitments or Basel II standardized CCFs”. ICC proposed to allow key risk attributes to be determined on the basis of industry benchmarking. As noted above, many banks have historically faced difficulties identifying and isolating sufficient data to produce validated estimates of risk attributes for trade lending. Today, the ICC Register can provide evidenced-based information for this purpose. It is our view that such an approach would be consistent with the G20 agenda to promote trade finance, without compromising the overall objective of the Basel Committee on Bank Supervision proposals.
- b. **Reconsider maturity floor:** Business has asserted that there should be reconsideration of the Basel rules in respect of the maturity floor applied to trade assets under the advanced model. Whilst trade financing is usually short-term in nature, based on between 0 to 180 days maturity, the Basel II framework applies a one-year maturity floor for all lending facilities. Since capital requirements (naturally) increase with maturity length, the capital costs of trade financing are artificially inflated as a result. All regulators have the (national) discretion to waive this floor (so far only 3 regulatory agencies in the world have been inclined to waive - Germany, UK and Hong Kong). The ICC Register clearly confirmed that the average LC has a maturity close to 90 days (a standard of payment in short term international trade), so obliging financial institutions to back self-liquidating asset for a full year is a considerable waste of capital resources at a time when these are scarce.
- c. **Improve liquidity:** ICC proposed to include trade instruments below 30 days and correspondent banking deposits as a stable source of funding. Practical considerations suggest that correspondent banking deposits have similar characteristics as operational deposits and are typically operationally complex and logistically difficult to move within 30 days.

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