



International Chamber of Commerce

*The world business organization*



INTERNATIONAL CHAMBER OF COMMERCE

*25 March 2009*

## **ICC Banking Commission Recommendations**

### **Impact of Basel II on Trade Finance**

---

#### **ICC Banking Commission**

The ICC Banking Commission is a leading global rule-making body for the commercial banking industry as well as a worldwide forum of trade finance experts whose common aim is to facilitate international trade finance across the globe. The ICC Banking Commission has more than 500 members in 70 countries, many of them from emerging countries.

The Banking Commission is known for producing universally accepted rules and guidelines for documentary credits, documentary collections, bank-to-bank reimbursement and bank guarantees. ICC voluntary market-based approaches have often been praised for levelling the playing field in trade finance practices.



# **ICC Banking Commission Recommendations**

## **Impact of Basel II on Trade Finance**

### **1°) Introduction**

Concerns about the impact of Basel II capital adequacy requirements on the availability of trade finance were raised by industry participants at the WTO Expert Group meeting on Trade and Finance in November 2008 - which had been convened to discuss reported shortages of trade credit, particularly in developing and emerging economies. The same concerns were voiced again at the WTO Expert Group meeting of 18 March 2009.

To assist in bringing greater clarity to these discussions, ICC has undertaken a survey of major international trade finance banks over the past three months examining the impact of Basel II on the availability and pricing of trade finance. This issue was also discussed at the March 2009 meeting of the ICC Banking Commission—the global forum for the trade finance industry.

### **2°) Disproportionate capital requirements for trade financing**

The feedback we have received from ICC members shows a remarkable consistency, and it appears that most banks are facing tougher capital requirements for their trade assets. In this connection, we believe that the financial crisis has brought into sharp relief an ongoing trend whereby the implementation of the Basel II charter has eroded the incentive of banks to lend trade finance, due to pronounced capital weightings that are not fully reflective of the low risk level of the activity.

The results of our consultations indicate that these increases in capital requirements have had particularly adverse consequences on trade lending to SMEs and counterparties in developing economies. Capital requirements under Basel II will of course vary according to the nature and structure of the transaction, counterparty risk and country risk. As an example, however, we understand that the capital intensity of lending to mid-market companies under Basel II is four to five times higher than for equivalent transactions under Basel I.



- ***Rigidities in the maturity cycle applied to short-term trade lending:***  
Whilst trade finance lending is usually short-term in nature, 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 thus artificially inflated as a result. All national regulators have the discretion to waive this floor, although many have chosen not to do so.
- ***A lack of historical and performance data to assist in validating risk attributes:*** Many banks face difficulties identifying and isolating sufficient data to produce validatable estimates of risk attributes for trade lending. This tends to translate into overly conservative risk weightings for trade finance products - in particular, where banks are required to rely on “standardized” parameters provided by national regulators.

By increasing the amount of capital banks are required to hold against trade finance lending, each of the above factors significantly restricts the ability of banks to lend essential short-term credit to businesses in the current, capital-constrained environment. As such, we believe changes to the treatment of trade finance under Basel II are urgently required to ensure sufficient flows of trade credit during the current economic downturn.

### **3°) The grounds for revised treatment**

The case for revised treatment of trade finance in the allocation of banks’ capital rests on the historically low risk profile of the activity. Many banks will attest that they have experienced relatively few losses on trade lending over the past few decades. This primarily reflects the fixed, short-term maturity of trade finance products, and the fact that exposures are liquidated by cash upon maturity.

In addition, the transactional nature of trade financing allows banks to carefully manage exposures. Unlike products such as term loans or overdrafts, which may be granted on a revolving or ongoing basis, trade financing is not automatically renewed or rolled over on maturity. Moreover, each drawdown by the obligor requires submission of underlying documentation—often based upon standardized codes of practice - for the bank for review. The bank can refuse a new drawdown if it is not comfortable with the credit worthiness of the transaction, or the documentation submitted.

What is more, even in times of severe difficulty companies will generally try to avoid defaulting on trade obligations, as continual access to trade finance is a lifeline for most firms. In a similar vein, it should also be noted that trade-related instruments are generally the last forms of credit to be cut, and the first to be re-established, in debt-distressed economies.

#### 4°) Recommendations for the G-20

In the context of the above - and having regard to the key role that trade-related finance will play in stimulating a sustained economic recovery - we would urge policymakers to give consideration to how changes to international capital adequacy requirements might complement other public interventions to boost trade finance flows. Based on our consultations with major trade finance banks, we firmly believe that such changes would have a significant impact on the ability of banks to lend trade credit at the current time.

The measures we propose do not require amendments to the fabric of the Basel II framework; rather, the introduction of small, yet significant, changes to the way in which the existing rules are implemented—making use of the discretion afforded to national regulators under the charter. We suggest that the changes outlined below should be coordinated initially through the G20, in order to ameliorate the flow of trade credit on a global basis, as well as ensuring a level playing-field for banks operating internationally.

Specifically, we recommend that the G20 London Summit mandate national regulators to:

- ***Exempt trade finance products from the one-year maturity floor applied to lending facilities:*** Within the national discretion, Basel II allows for the exemption of the one-year maturity floor for “short-term self-liquidating trade transactions”. This is because the contractual maturity of Trade Finance products is reflective of the time horizon over which banks are exposed to a credit risk. Such discretion has already been exercised by a small number of national regulators. Our initial analysis suggests that removal of the maturity floor has the potential to cut capital requirements for trade finance obligations of 90 days maturity by around 20 – 30 percent. We believe that the G20 London Summit should be used to encourage all national regulators to replicate this regulatory “best practice”.
- ***Allow key risk attributes to be determined on the basis of industry benchmarking:*** As noted above, many banks face difficulties identifying and isolating sufficient data to produce validatable estimates of risk attributes for trade lending. These problems are particularly pronounced in relation to the calculation of “loss given default” (“LGD”) and “credit conversion factor” (“CCF”) inputs in modelling to determine capital requirements under Basel II.

To assist in ensuring more realistic capital weightings for Trade Finance products, we suggest that national regulators are encouraged to utilize their discretion to allow these inputs to be determined on the basis of “expert judgement”.



International Chamber of Commerce

*The world business organization*

## **5°) ICC work to support the case for supervisory changes**

In the current climate, ICC recognizes that many regulators may be unwilling to allow risk attributes to be determined on the basis of expert judgement in the absence of a comprehensive empirical evidence base. In these circumstances, we would ask that the G-20 commit to reviewing all necessary steps to ensure that trade financing is not unnecessarily constrained by capital adequacy rules. We believe that such a commitment would provide a “window of opportunity” for industry to work with national supervisors to develop a sound evidence-base to support further measures to reduce the amount of capital banks are required to hold against their trade assets.

At the recent meetings of the WTO Expert group, a request was made to ICC to collect historical and performance data for trade finance facilities. Building on our initial consultations with members, we look forward to taking this work forward in the coming months in conjunction with key partners, and with the support of the G-20 governments.