Balancing Basel

Rosali Pretorius and Juan José Manchado consider the unique features of trade finance and whether the new capital rules in Europe will damage trade

Recently, several commentators have expressed misgivings about the potentially restrictive impact of the new capital requirements, forged in the wake of the 2008 global financial crisis, on trade.

In this article, we start by outlining the capital requirements in the Basel framework and how they have been reflected in the EU legislation.

We then look at how regulators have addressed concerns over the impact of capital requirements on trade finance. After considering the capital framework, we consider developments in the new liquidity framework, which are still a work in progress. We focus mainly on short-term and off-balance sheet trade finance products, as they are the most distinct from non-trade finance alternatives and it is on them that industry persuasion efforts and successes have concentrated.

Trade finance – a unique asset class?

Trade finance supports the import and export of goods across the global market by funding production or helping mitigate credit and liquidity risks. It takes many forms, ranging from pre-export finance to standby letters of credit (LCs).

Some trade finance products are on-balance sheet and others remain off-balance sheet. But they all create exposures, actual or potential, for the banks involved in extending, issuing or confirming the different products. Capital rules require banks to match those exposures with minimum levels of funding, in the form of loss-absorbing capital, and liquid assets. The size of those prudential cushions should depend on the potential impact of losses caused by trade finance on the resilience of banks.

The International Chamber of Commerce (ICC) stresses in its 2013 *Global Risks Trade Finance Report*[1] that trade finance is "relatively low risk" and not to be "feared" nor "overregulated". The ICC's *Trade Register* data shows that the default rate across global trade finance activity stands at 0.02%. Other industry associations have pointed to the contradiction between more restrictive prudential requirements and governments' efforts to stimulate global trade and the financing of SMEs.

The Capital Requirements Regulation 648/2012 (CRR)[2] implements the Basel III global framework in Europe. Some of its provisions have been in force since January this year. The CRR acknowledges that trade finance products are different to other bank assets. The recitals describe trade finance exposures as "small in value and short in duration and having an identifiable source of repayment... Inflows and outflows are usually matched and liquidity risk is therefore limited". The recitals also acknowledge that trade finance is "underpinned by movements of goods and services that support the real economy and in most cases help small companies in their day-to-day needs, thereby creating economic growth and job opportunities".

Regulatory capital requirements

Methods for calculating regulatory capital requirements were laid down in the first two iterations of the Basel accords. Basel III has not changed the fundamental requirement that banks must have qualifying capital equal to 8% of risk weighted assets. But it amends inputs on both sides of this fundamental equation, and supplements it with several other ratios.

Under Basel III, banks must improve quality and quantity of their regulatory capital. So, for example, by 2015, banks will need a capital buffer composed, at least, of common equity tier 1 (CET 1) instruments amounting to 4.5% of that bank's assets, topped up with 1.5% in additional tier 1 instruments and a further 2% in tier 2 instruments. These capital requirements can be increased further by supervisors requiring banks to build up a countercyclical buffer during periods of excessive credit growth. Basel III also includes measures to stop distributions and bonuses when capital falls below a certain level (capital conservation buffer). This will effectively mean that banks are incentivised to hold an extra 2.5% in capital.

To capture differences in the non-repayment risk posed by different counterparties, the Basel framework has always allowed banks to risk weight assets before applying the capital ratio calculations. Basel III has not changed the approach to weighting introduced in the Basel II accords. Risk-weighted assets (RWAs) can be calculated using the standardised approach or one of the internal ratings based approaches. We consider these approaches, and the concerns they generated for trade, below.

Basel III now also requires the application of a 1.25 multiplier for large exposures to large financial sector entities and to any unregulated financial sector entity. This is meant to address the systemic risk that the interconnectedness between financial institutions creates. It will increase the cost of export-confirmed letters of credit, where an accepting bank becomes exposed to the credit risk of the issuing bank.

Finally, as a backstop to risk-weighted capital requirements, Basel III introduces the leverage ratio, which we discuss in more detail.

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The standardised approach to calculating RWAs

Using the standardised approach, RWAs are arrived at by multiplying the exposure of a bank to a transaction by a prescribed risk weight. Risk weights are based, broadly speaking, on the class of counterparty and its external credit rating. External credit ratings are provided by external credit assessment institutions (ECAIs). The counterparty's credit rating is then mapped into a credit quality step. Adopting this approach for trade finance, where exposures are often not posed by rated institutions, is problematic. The Basel framework made it possible to apply a 50% risk weight for exposures to unrated banks, or 20% where the original maturity of the exposure was three months or less.

These concessions were subject to the overarching requirement that no claim on an unrated bank can receive a risk weight lower than that applied to claims on its sovereign of incorporation. This became known as the sovereign floor, and is based on the assumption that unrated banks cannot be less risky than the sovereign country in which they are incorporated. As risk weights for unrated sovereigns are set at 100%, this meant that exposures to the unrated banks of unrated sovereigns could never be subject to a risk weight below 100%. This increased the capital required for confirming letters of credit (LCs) issued in respect of importers in lower income countries. The sovereign floor has been the subject of much criticism – mainly because it did not reflect empirical evidence that trade debt in emerging markets is often more likely to be repaid than other indebtedness.

When calculating capital requirements under the standardised approach, the potential exposure created by an undrawn off-balance sheet commitment must also be multiplied by a credit conversion factor (CCF) reflecting the likelihood that it will be drawn. The Basel framework sets CCFs by reference to the classification of off-balance sheet assets. This is now reflected in CRR Annex I. Medium risk assets attract a 50% CCF and medium/low risk assets a 20% CCF.

Documentary credits are categorised as medium risk. They will be medium/low risk where the "underlying shipment acts as collateral". "Other self-liquidating transactions" are in the same category. It is not clear what "self-liquidating" means in this context. Normally, "self-liquidation" means that a facility will be repaid with the proceeds from the sale of the goods the facility has served to produce or acquire, rather than from the resources of the borrower. But by using the word "other" after "documentary credits in which underlying shipments acts as collateral", CRR seems to suggest that only those documentary credits where there is such collateral are "self-liquidating." This goes against the normal understanding in the market that documentary credits linked to a shipment of goods are all self-liquidating. Furthermore, CRR's requirement that the underlying shipment must act as collateral for the documentary credit for that credit to be in the low/medium bucket is strange and needs clarification. With documentary credits, banks do not usually take security over the goods themselves. Sometimes they take a pledge over the bill of lading, but that document does not normally give legal title to the goods.

Shipping guarantees, customs, and

tax bonds are medium risk. Trade finance warranties, guarantees and standby LCs that are not credit suitable are deemed medium/low risk. Agreements to provide guarantees or acceptance facilities, or undrawn credit facilities for tender and performance guarantees, which are unconditionally cancellable or are cancelled automatically on occurrence of credit events, benefit from a 0% CCF and therefore do not pose an exposure.

Internal ratings-based approach to calculating RWAs

Banks with experience at using internal models and access to historical data may be allowed to calculate their capital requirements applying the foundation or the advance IRB approaches (FIRB and AIRB). Banks on the AIRB can themselves decide all the parameters assumed in the risk weights and CCFs under the standardised approach. The four parameters are probability of default, loss-given default, maturity and exposure at default, the latter fulfilling the same role as CCFs.

Banks on FIRB may only use their own models to determine probability of default. The other parameters are prescribed for them. Probability of default reflects the exact estimated default risk of a particular counterparty. Under AIRB this parameter can even incorporate evidence that counterparties under technical default may still meet their trade finance obligations, compelled by the need to maintain access to funding for their daily operations. Loss-given default calculations under the AIRB approach recognise, for credit risk mitigation purposes, goods underlying the transaction and that the bank takes as collateral, although this is subject to proof of actual recovery levels.

Basel II applied a one-year floor to the maturity parameter under AIRB. It gave national regulators the discretion to apply an exemption from the one-year floor to certain exposures with an original maturity of less than one year and that were not part of a bank's ongoing financing of a counterparty. FSA, in the BIPRU sourcebook of its Handbook, made use of this discretion. In other countries, where the parameter for maturity did not correspond with the actual effective maturity of transactions, short-term trade finance was affected negatively. This floor did not recognise the lower risks linked to the lower maturity of some trade finance and contrasted with the favourable treatment the standardised approach grants to exposures with less than three months' residual maturity. As with the sovereign floor, this has now been addressed.

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Leverage ratio

The leverage ratio is a new requirement. It is meant to be simple, and measures capital against assets on a non-risk-weighted basis. It will be binding from 2018. Set by the Basel Committee at 3% (the EU has not proposed a figure yet) of total exposures, it is volume-based, meaning that exposures have to be accounted for at their full value, rather than adjusted according to their risk. It can therefore be understood as a cap on leverage against funding, or as a cap on the reduction in capital requirements which could otherwise be obtained via lower risk weights.

The leverage ratio will affect financing structures which are relatively lower risk, such as those involved in trade finance, as banks will have an incentive to use their leverage to enter into riskier but more profitable exposures. Furthermore, it is not possible to use netting of loans against deposits of the same counterparty to reduce the exposure measure for the purpose of leverage ratio calculations. This will hinder the use of cash-backed or pre-funded structures. The original Basel III accord also demanded that a uniform 100% CCF should be applied to off-balance sheet exposures, given that they were a source of potentially significant leverage. This lack of recognition of the low conversion rates of trade finance would have made the its provision an unviable banking activity.

Changes to the capital framework and review of the leverage ratio

In response to the G20 commitment to evaluate the impact of bank prudential regulation on low income countries, the Basel Committee made in October 2011 two changes to the capital treatment of trade finance. They waived, for certain trade finance products:

- the sovereign floor in the standardised approach in respect of exposures to unrated issuing banks; and
- the one-year maturity floor under the AIRB.

These two changes have been incorporated in CRR articles 121.4 and 162.3. They establish, respectively, that:

- exposures to an unrated bank, which may be incorporated in an unrated country, in respect of self-liquidating short-term trade finance transactions with a residual maturity of up to one year, attract a 50% risk weight, or 20% where the residual maturity of those exposures is three months or less; and
- a bank using AIRB can recognise the residual maturity, subject to a one-day floor, of exposures in respect of self-liquidating short-term trade finance transactions with a residual maturity of up to one year, on the condition that those exposures are not part of the banks' ongoing financing of the counterparty.

Note that unlike in the context of the CCF, there is no reference to the shipment as collateral for "self-liquidating short term finance transactions".

In that same review, the Basel Committee decided not to reduce the 20% CCF applying to short-term self-liquidating LCs. It also declined to introduce the CCF scale for measuring exposures for the leverage ratio, as this would have run counter to the financial stability objectives of the capital framework. This decision was reversed in the review of the leverage ratio international standard, which the Basel Committee published in January 2014. Nonetheless, industry efforts at EU level had already achieved the application, in CRR article 429.10, of the same CCF scale as that available under the standardised approach to capital requirements. So for the purposes of the leverage ratio, banks will be able to apply either a 20% or 50% CCF depending on whether a trade finance product is in the medium or the medium/low category.

> **"The use of credit ratings and internal models put trade finance at a disadvantage in comparison with other banking activities"**

Liquidity

Basel III introduces a liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR). The LCR will start applying in 2015 at 60% and will be "stepped up" at 10% per annum until its full application in 2019. The target introduction date for the NSFR is 2018, although CRR in the EU already requires banks to meet long-term obligations with adequate and diverse stable funding.

The LCR requires firms to hold enough high-quality liquid resources to survive an acute stress scenario lasting 30 days, assuming, among other outflows, increased drawdowns of off-balance sheet commitments. Basel III allows national discretion in determining the run-off ratio of contingent trade finance during a stress scenario. CRR follows the Basel III LCR standard (revised in January 2013) in distinguishing outflows from committed credit and liquidity facilities from those related to off-balance sheet trade finance items. Article 420 CRR requires that banks assess the potential outflows resulting from trade finance off-balance sheet items, taking account of the reputational damage that could result from not honouring those commitments in a stressed scenario. Where those potential outflows are material, banks must report them to their regulator, which may apply a run-off rate of up to 5%.

The Basel Committee is currently consulting on the new NSFR,[3] which should ensure a sustainable maturity structure of assets and liabilities over a one-year horizon. Under the NSFR proposals, published in January 2014, national regulators are given the discretion to determine, based on national circumstances, the amount of stable funding that will have to match trade finance-related obligations (including guarantees and LCs). The treatment of irrevocable and conditionally revocable credit and liquidity facilities, which form the other category of off-balance sheet exposures, can serve as guide to where required stable funding could lie for off-balance sheet trade finance. They are assigned a 5% required stable funding factor.

Moving forward

Market participants had already expressed concerns over the measures introduced in Basel II to enhance the risk sensitivity of the prudential framework. The use of credit ratings and internal models put trade finance at a disadvantage in comparison with other banking activities. This is because trade finance products are prevalently used by mid-cap companies, of relatively worse credit standing, often in the context of trade with lower income countries. Often, more data is needed to model the risk parameters needed for the more flexible AIRB approach accurately. ICC has already made great strides towards putting together the required data with its trade register (see note 1).

Basel III increases the cost of funding required to back trade finance products. However, now, the favourable risk weights for those which are shorter-termed and self-liquidating, and the more realistic CCFs and outflow rates for off-balance sheet ones are likely to mean that the biggest impact will be felt by banks on the standardised approach with longer-term on-balance sheet trade finance structures. Export credit providers will nonetheless still be able to benefit from the unfunded credit protection offered by export credit agencies. TFR

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