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EBF response (complementary) to the Basel Committee consultations “Strengthening the resilience of the banking sector” and “International framework for liquidity risk measurement, standards and monitoring”: Impact on financing of international trade.

The measures proposed by the Basel Committee, seen strictly from the angle of international trade, can be damaging for its financing. The resulting higher cost of funding will feed through to the real economy and world trade. European banks ask that the elements below be taken into account by both the Basel Committee and regulators. Otherwise, banks’ capacity to support and facilitate international trade and growth (without increasing risk in the banking system) will be affected.

Pursuant to the G20 recommendations, the Basel Committee initiated a complete revision of the prudential framework applicable to banks. This revision process, which started last summer, continued in December with the publication of two consultative documents “*Strengthening the resilience of the banking sector*” and “*International framework for liquidity risk measurement, standards and monitoring*”.

These two documents notably detailed the following proposals:

- To raise the quality, consistency and transparency of the capital base i.e. strengthen capital requirements
- To introduce a leverage ratio
- To introduce two liquidity ratios

The purpose of this EBF paper is to highlight how the proposed measures can constitute a potential threat to the financing of international trade.

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1. Capital requirement.

The Basel Committee suggests raising the quality of the capital base by adopting a more restrictive definition of Tier one capital and by adjusting the risk weighting structure. Amongst the proposals, Art. 135 of “*Strengthening the resilience of the banking sector*” provides that a multiplier of 1.25 should be applied to the asset value correlation of financial firms. This would mean that operations made with financial counterparties would suffer from a heavier risk weighting. Trade finance business, which generally involves financial counterparties, will obviously be penalized.

Yet trade finance is global, and much of the traditional trade finance undertaken by banks is cross-border between developed and developing markets, and across regions. The correlation of default between these markets is much lower, as has been proved by recent economic events and the lesser impact on markets such as Brazil and India.

In addition, impairment levels in trade finance transactions (in the absence of manifest fraud/negligence) are/have been much lower than in other classes of transaction. Furthermore, in many classes of trade transaction (for example performance bonds) the risk undertaken by the bank is not solely financial in nature, but is also performance driven. Here the risk of default or damage to the banking system is driven not by the leverage activity of the banks or market liquidity, but by the ability of the parties to the underlying real transaction to perform their contractual arrangements. Again impairment rates support the view that “willing buyer/willing seller” in this context mitigates risk.

The proposed change could have significant consequences for the wider economy and companies of all sizes as the higher cost of funding feeds through and negatively affects the real economy.

2. The leverage ratio.

This would be defined as Tier one capital (defined according to the new capital requirements measures proposed) on total exposure, irrespective of any risk mitigation factors i.e. without taking into account either collateral, guarantees, or insurance, etc. (cf. Art. 202 of “*Strengthening the resilience of the banking sector*”).

Yet these risk mitigation factors play a key role in the financing of exports.

a/ **Officially supported export credit facilities** are in fact insured or guaranteed, up to a large percentage -from 90% up to 100%- by national Export Credit Agencies (ECAs) which are state-owned or acting on behalf of said State. Their role is to facilitate the provision of finance to foreign buyers of goods and services from national suppliers. Under Basel 2, it was widely admitted that the ECA-covered portion of an export credit should be assimilated to an exposure on the corresponding ECA sovereign risk. Denying the quality of the cover received in the calculation of the leverage ratio will thus place traditional export products (that have long been used) and toxic assets at the same level of risk. In addition, the failure to consider the cover received will increase very significantly the level of exposure for export credits, both at the in-balance sheet (for the drawn portion) and off-balance sheet level (for the undrawn portion).

Admittedly, the effect of such a ratio if kept as an indicator under Pillar 2 will be limited. However, should it ultimately migrate to Pillar 1 and become a regulatory constraint, its effect will be detrimental as banks' capacity to provide an export finance solution will be significantly impaired.

b/ As for the **Trade Finance business**, the Basel Committee suggests that the credit conversion factor (CCF) for off-balance sheet trade operations be raised to 100% (from the current 20% -50%). Such a rise, for the purposes of calculating the leverage ratio, would obviously penalize trade finance-focused banks and/or even encourage them to divert capital to higher risk/higher return products¹. Trade finance products cannot be likened to a source of leverage since they are supported by an underlying transaction that involves either movement of goods or provision of services. By securing both financial and real flows, banking intermediation plays a major role in promoting international trade which is essential to foster a global recovery.

In April 2010, a survey conducted by BAFT-IFSA in association with the IMF already showed that, comparing 4th quarter 2009 with that of 2008, among banks reporting an increase in capital requirements, 33% said that the implementation of Basel II has had a negative impact on their ability to provide trade finance. Among these banks, 43% reported that pricing of trade finance had increased as a result of increased capital requirements. The new proposals from the Basel Committee would once again penalise trade finance activities, which already suffer from low margins and high operational costs. These measures could eventually lead to higher costs being passed on to customers, who would probably turn to alternative sources of financing, and/or have a chilling effect on the banks' capacity to provide trade finance solutions.

Finally, it is worth noting that traditionally, trade finance has received preferred treatment on the part of regulators in restructuring/debt rescheduling procedures, because of the systemic importance of trade, as in sovereign or private defaults a priority is to "treat" expeditiously trade lines of credit to allow for such credit to be restored and trade to flow again.

The low risk nature of trade finance and its preferential treatment from a regulatory perspective in many instances enables banks to extend a greater amount of credit than they otherwise would. Reduction in such additional financing opportunities would reduce the amount of credit available to companies to support their business activities. The impact of any disincentive for banks to undertake trade finance, combined with inevitable price increases, could only have a detrimental impact upon global trade. The scale of this effect could not at this stage be predicted.

¹ *If the CCF were in line with other products, there is potential for trade finance to be seen as product substitution. With the higher operational cost of trade due to its document-based nature, it could become more attractive for banks to provide other forms of financing which deliver higher revenue for lower cost (such as loans) as an alternative. This would increase the risk undertaken by the bank and reduce the control over, and visibility of, the underlying transaction. That would in turn remove an important means for companies to mitigate the risk - such as payment risk - inherent in their business activity. Thus, as more people are encouraged to trade on an open account basis, the risk of non-payment increases, which in turn increases the risk to companies and the risk of default on obligations owed to the bank. As companies may be forced to take payment risk, etc themselves, they may be dissuaded from dealing with emerging markets, which would have a direct impact on both the company and the impacted countries in the developing world.*

3. Liquidity coverage and Net Stable Funding ratios.

Lastly, the Basel Committee suggests the introduction of two ratios:

- **A Liquidity Coverage Ratio**, which would compare the stock of high quality liquid assets to the net cash outflows over a 30-day time period. In that respect, banks warn against a too narrow definition of eligible assets and ask that ECA-backed export credits can be qualified as high quality liquid assets and be used for the purpose of calculation (cf. Art. 34 of “*International framework for liquidity risk measurement*”).

In addition, it is worth remembering that the definition of assets eligible for refinancing at Central Banks is not harmonized amongst jurisdictions. US Exim-backed export credit for instance, can be refinanced at the Fed while European ECA-backed export credits cannot be refinanced at the ECB. This will probably entail that US Exim-backed export credits will be considered as High Quality Liquid Assets while European ECA-backed export credit will not. Banks thus call for a level playing field in this respect.

- **A Net Stable Funding Ratio**, which would compare the available amount of stable funding to the required amount of stable funding. This metric would compel banks to refinance short term credit (up to one year) by long-term borrowings, hence impairing banks’ transformation role. As a consequence, either they would be obliged to raise a significant volume of funds on the market, with the risk that the market would dry up and interest rates increase; or else credit distribution would be curbed, to the detriment of the real economy. This ratio would not only be detrimental to short term trade transactions (L/Cs, forfaiting, factoring) but also to the export business as a whole.

As a conclusion, the measures proposed by the Basel Committee, seen strictly from the angle of international trade, can be damaging for its financing. The resulting higher cost of funding will feed through to the real economy and world trade. Banks ask that the above elements be taken into account by both the Basel Committee and regulators. Otherwise, banks’ capacity to support and facilitate international trade and growth (without increasing risk in the banking system) will be affected.