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*Basel Committee on Bankink Supervision*
*Bank for International Settlements*

BASEL COMMITTEE SECRETARIA

Dear SIr,

You will find included some comments specially directed to financing of international trade.

I hope that these consideration will help the committee in his work to implement a balance approach between protecting the global banking system without cutting poor countries from international financing.

I stay at your disposition for any precision on the subject.

C. PLAETEVOET

# BASLE COMMITTEE ON BANKING SUPERVISION
# NEW BASEL CAPITAL ACCORD

## INTRODUCTION

This letter is a personal contribution to the new set of rules proposed in order to lead bank toward a more secured approach to protect the customers and the financial systems. As I suppose that the intend is not to arm any type of financing useful to the global economy, I send there after a set of consideration relative to the financing of international trade flows

The intend is to draw attention on consequences that the new rules may generate in a specific type of financing mixing together various legal and regulatory situations..

I have been in charge for more than twenty years of the risk management of the financing on an worldwide basis of the commodities' transactions..

I read with great attention the proposals of the COMMITTEE and realised that some of the requirements would be of extremely adverse consequences for this types of financing if the guide lines set in that draft of the new accord are adopted without any modifications.

I understand well that the approach of those activities are conducted by a limited number of banking institutions and even in those banks the relative importance of these activities in the in their global portfolio is limited and not conducted by a numerous staff..Even the banks active in that business have very different ways and organisations to conduct the activity.

In consequences these activities are managed at a medium level of the hierarchy in the banks' organizations and so there is a limited level of interest and knowledge, even for the DUTCH, the FRENCH, the GERMAN or the SWISS banks which are active in that field. The AMERICAN ones have a less transactional and more corporate orientated approach.

That are the reasons why I send directly my comments to the COMMITTEE on a stand alone basis. An organized corporate approached would have, I fear generated a lot of discussions and be even considered as something not representing a subject of discussion worth a special study or approach..

## NATURE OF THE OPERATIONS INVOLVED

The types of financing involved are dedicated to three major types of approach.

1/ the discount trade receivables or the confirmation of signature dedicated to import of strategic goods

2/ the financing of trade firms on a secured basis on a contract by contract basis
3/ the financing of import and pre-financing of exports of strategic goods.

In some organisations the market operations on commodities with the scope of hedging the price risk are included.

VARIOUS EXPOSURES INVOLVED

In the majority of the cases these operations are related to countries exposed to financial difficulties with poor rating and conduct by companies with limited net worth and lead to mismatches in currency risks.

In those types of financing , the bank exposure is balanced between two, three or more counterparts, whose interests are connected. In most of cases the last payment is made either under the guarantee of a bank established in an OECD COUNTRY or by a counterpart in a safe financial situation.

For the export financing, the counterparts are in most of the cases, a producer of commodities a trader, and an end user. The producer is operating in a country with currency difficulties, the trader is located either in a safe country or conduct a function of gathering the goods in the producing country, and the end buyer is a mill in a developed country.

The main obligors are either the producer, or the trader with both limited liability in the repayment one supporting the other in the completion of the delivery of the goods.

The basic of the safety in these financing is the weight of the commercial investment necessary to sales goods abroad, logistics matters and regulatory ones are not the least important.

The other cases relate to import financing of first necessity goods, which are generally paid first even in countries with limited currency reserves. In those cases the exposure is some time under bank guarantees or relate to documentary credit confirmation.

For the import financing the exposure is a bit more risky, but orientated toward very essential products like foodstuff or energy, they are paid by priority in even very distress situations. They include in some banks the logistic or bridge financing of the governments' food support programs.

BASIC OF THE STRUCTURED PROCESS

The approach of those financing may be compared to the securitisation process of a portfolio of receivables, where the risks of loss are mitigated by over collateralisation and credit enhancement.

In essence the co-mingling of the various engagements of the obligors aims toward reaching an implicit default risk in the A- or BBB- range, but with a approach really

different from the one chosen by the COMMITTEE (ie to consider the best rating of the various obligors). That is to say to add up the respective strength of the different parties and circumventing as far as it is possible the weak aspects.

The over collateralisation is systematic and nowadays often a hedge of the price risk is included, with the object of limiting the traditional top up clause which often conduct to much more distress situations in a market price evolution drifting downward.

Finally I think that the main element of comfort may be supported by the economic and even social and humanitarian necessity of the transaction, and in the deep commitments of the obligors.

If necessary the CENTRAL BANK of the import or export country add a special support or derogatory authorizations to the exchange controls in place.

In summary the financing links together a net of obligors whose interests are strongly connected, and the duty of the RISK DEPARTMENT OF THE BANK is to ascertain these strong connexions.

In this net, the choice of who would bear the main responsibility in sorting the transaction if a difficult market situation occurs is often difficult, and I remember situations where the solution where found by the least engaged obligors.

## DEFAULT CONSIDERATIONS

The bank's role is mainly to guaranty and control a balance situation between the parties involved and to monitor the evolution of the relative strength of the counterparts' links.

The goods especially in soft commodities transactions with future delivery, are exposed to acts of God.. These events of default are always describes in the commercial contracts which link the sellers and buyers. They prevent the penalties and postpone the contractual duties.

Taking in consideration this type of events where the operators are prevented to accomplish their duties,. it is necessary, in these financing, to adopt the same type of approach and to define a default outside the scope of material adverse changes resulting from a modification of the physical situation inducing a modification in the contractual obligations.

In the same type of consideration, the due date is less precise than in purely financial obligations and must include a delay without penalty.

When expose to adverse situation, the recovery process when conduct in a country exposed to payment difficulties or with lax or traditional judicial organisation, must be always conduct in a sens of facilitating the recovery of the defaulting counterpart. It leads to unavoidable time gaps, that the bank must include in his evaluation of the default definitions.

## RESULTS OF A LONG STANDING EXPERIENCE

The twenty year of experience on assessing the level of risk of these operations lead to a medium expected loss of only 0,3% of the annual outstanding. Considering the cyclicity of the commodity prices, there are bad and good years but inside a cycle scope of five years, the medium level of losses is rather stable.

For the last five years which experienced very significative distress situation with the Asian crisis and the Russian one, the expected loss on our portfolio were respectively, 0,18%, 0,21%, 0,84%, 0,26% and 0,47%

In most of the difficult situations, the important difficulties occur when poor market situation are connected with a failure in the risk monitoring either due to over confidence of a credit officer or misunderstanding of poor trained employee conducting complex interim monitoring.

At the opposite, the benefits brought by these types of financing are very important in accelerating recovery after crisis in a country or preventing some excess of the too relax financial market approach developed in ASIA before the 1997 crisis or in CIS countries before the 1998 crisis.

For example I remember a meeting with bonds specialists operating on Emerging Countries in early 1997 asking for introduction with a client in CIS countries for bond offering ready to propose without any collateral ten fold the maximum amount I dare to propose to the counter part with strong guaranties and support of strong off taker for the good financed.

In the bleak of the Russian financial crisis, the counterpart defaulted in August 1998, I was repaid with six month delays due to the collapse of the price of the commodity, but the performance on the commercial front was perfect and was extended until ful repayment with a limited volume pledge to the loan.

In few words this type of approach conduct the banker to a good knowledge of the necessities of a physical transaction which leads to a cautious sense of the realities.

RATING DIFFICULTIES

The process of rating the counterparts involved in those operations is a rather difficult exercise. If we consider the fact that these activities are scattered in a large number of countries and submitted to much more different fiscal and legal status the thing is easily understandable. These situations imply a very large rage of approach in the valuation of the asset, especially when they are located in countries with high inflation rates.

In addition the way they register the value of their assets is really never exactly the same between LIFO, FIFO, mark to market and a great number of nuances. .The commercial assets importance toward the net worth, especially for the trader is very fluctuating in relation with the seasons, the economic cycles. and the date of registration of their transactions in their books toward the completion of the contract.

The rating base on statistics utilised the most frequently by the rating agencies lead to rater frustrating results and the most secure approach up to now is the comparison between companies dealing in a similar range of products and interpolating the ratings.

The comparison in level of rating to large corporates quoted by most known ECAI leads often to very low rating. But in fact the level of default is rather in the range of medium ratings of the various schedules.

This situation leads either to inflate heavily the rating level in consideration of the default rate or to increase the impact of the commodity collateral or of the receivables pledge in the transaction financed, improving the facility rating to investment grade levels. This last way to approximate the real risk of these financing which seems to me the most accurate need eventually a correction by the valuation of the operational risk involved. It is always a important part of the safety process based on the monitoring of the market evolutions in the various commodities involved as collateral and their impact on the performance of the transaction.

## RISKS OF THE NEW RULES

If the banks involved in this type of financing are obliged to follow the new rules cumulating the poor rating of the main counterpart, the poor rating of the country, the risk on the money, the heavy load of a BB- exposure, the limited collaterals accepted to mitigate the risk, this activity is dead by over waiting the capital base allocation.

It thus is necessary to take in consideration, some of existing rules, (ie in FRANCE or in SWITZERLAND) applying exceptions on the country risk provisioning or limited capital requirements for these types of financing.

In the case of a major bank adopting the advance approach of the new BASEL CAPITAL ACCORD, the problem may be solved by implementing a specific internal rating methodology; but for some regularly participating bank of less importance, which will adopt the standardised approach, there is no solution, and heavily at disadvantage these operations will loss liquidity.

On the country risk aspect the consequences would be much more difficulties to solve economic distress situations and transition to recovery, leaving the burden on a least reactive IMF intervention, implying increase in social and political problems.

For example if you pre finance a coffee export contract from a B- country through a trader with a B+ corporate so with a price risk exposure and a currency mismatch exposure, resold to A- coffee roaster with a pledge on the goods which is not recognised as an eligible collateral you will have at best an impact on the capital base of 3 instead of 1. The only element that mitigate the risk quotation will be that it is a one year term transaction.

In reality the probability of default on this transaction, given the fact that there is no crop uncertainty is in the range of AA-.

## CONCLUSION

In my opinion, if you are not ready to make important modifications in the propositions of the NEW ACCORD PROPOSAL, the easiest way to deal with this these activities, without heavy and uncertain investments in risk rating models, is to consider the problem on a portfolio approach. This approach linking the gross revenues generated by the activity and the concentration of the exposures by counterpart, by type of commodity, and by country would conduct to a weighted evaluation of the risks involved.

The major split being made between the payment risk involved in import of commodities, and the performance risk considered in pre-export financing and transactional financing.

Even if the final default in the first category is more frequent, the individual exposures are often more split on a larger scope of counterparts so the losses are smaller.

A ratio of 1,2 on risk weight between the first and the second seems adapted

In both cases a good organization of the follow up of the transactions is important implying the close connection (same location) between the front and the back office

Two levels of control one global on a world wide basis and market orientated; and a second locally implemented near the commercial sector, verifying the adequacy of the documentation and of the collaterals monitoring seems the most convenient organization.

The guide lines for the portfolio approach, may be a 3% concentration risk on an counterpart basis for internationally un rated counter part and a 10% ceiling for

investment grade counterpart.

The over collateralisation by commodity asset must be in the range of 10 to 25% depending of the product with a split by product similar to their part in the international trade flows (ie 45/50% for energy products, 10/15% for metals, 20/25% for cereals).

On the country risk considerations, the completion of the performance or the payment of the strategic goods imported, is not really correlated to the rating of the country as only country confronted to financial difficulties accept to apply to these collateralized transactions, the portfolio split may have various limit of concentration linked to the commodity involve in a range of 5% if it is a mono produce exporter and of 10% if it is a multi commodity exposure

As stated above the ratio of 1,2 between import financing and export financing would weight the relative exposures.

When those ratios in the portfolio are not respected an additional capital requirement would apply by adding the percentage of overweighted asset to the global portfolio to the normal requirements applied to an investment grade asset in the standardized approach.

I hope that these considerations may help in the improvement of the proposed accord, not banning from the international market a balanced approach of the country risk, leaving room to weather political or economic stresses supported by the least wealthy countries and allowing them to maintain contacts to the WORLD economy.