BAFT-IFSA

June 21, 2013

Mr. Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Centralbahnplatz 2
Basel, Switzerland

Re: Recognizing the cost of credit protection purchased

Dear Mr. Ingves:

BAFT-IFSA is an international financial services trade association whose membership includes a broad range of financial institutions throughout the global financial community. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT-IFSA member banks provide leadership to build consensus in preserving the safe and efficient conduct of the financial system worldwide.

BAFT-IFSA agrees with the Basel Committee's objectives of promoting a stronger global financial system, and we thank the Committee for the opportunity to provide comments on their proposal, *Recognizing the cost of credit protection purchased.*[1] As BAFT-IFSA represents the transaction banking segment of financial institutions globally, including the trade finance and cash management business lines, we are particularly concerned about the impact new regulatory initiatives could have on the provision of these crucial, real economy financing products. To that end, BAFT-IFSA's comments on the proposal are limited to the Committee's first question as it relates to trade finance transactions and guarantees.[2]

Introduction:

BAFT-IFSA supports the goal of the Basel Committee to ensure that credit risk mitigation techniques serve as effective risk management tools. We understand the Committee's concerns regarding the potential for regulatory arbitrage in the credit risk mitigation framework and we support efforts to address those concerns. In doing so, we respectfully request the Committee make every effort to ensure that legitimate credit risk protection, and the purposes that protection serves for downstream clients of financial institutions, is not inhibited by the promulgation of the new rules. Additionally, the Committee should be cognizant in forming new rules that could hamper the mitigation of risk through effective securitizations and thus limit use of a bank's balance sheet for corporate exposures.

We recognize there are existing concerns that a guarantee of a financial product could be misused in a synthetic financial transaction. We emphasize, however, that trade finance transactions, guaranteed or otherwise, are not synthetic in nature due to their direct link to the provision of goods and services, and thus do not pose the risk the Committee wishes to obviate through implementation of the proposal. Since the proposed rule is not meant to capture transactions that are clearly meant to mitigate risk in support of

[1] Basel Committee on Banking Supervision; *Recognizing the cost of credit protection purchased*, March 2013

[2] IBID; p. 2, Question 1: *In addition to the 150% risk-weight threshold, should additional exemptions for certain types of transactions be considered? In particular, the Committee welcomes feedback on (1) exposures guaranteed by governmental entities (including sovereigns and public sector entities) and (2) trade finance transactions with guarantees.*

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real economy financing, guarantees extended to trade finance transactions should be exempt altogether from the materiality threshold in the context of this proposal. Having a blanket application of the proposed rule would penalize a large number of legitimate risk mitigation transactions and harm the businesses supported by those transactions. Additionally, the Committee should consider providing a clear exemption for all trade finance transactions, along with funded and unfunded risk participation transactions for trade finance, to ensure these important products are not inadvertently penalized by the regulatory proposal.

Key Recommendations:

1. Clarify and exempt guaranteed trade finance transactions from the consultative proposal

BAFT-IFSA believes that guaranteed trade finance transactions used to allay risk and facilitate the financing of international trade should be exempt from the proposal. Exempting these types of transactions will not harm the overall intention of the proposal and will instead afford regulatory clarity and support for the financing of global trade in goods and services.

Generally, guaranteed trade finance exposures involve several different types of transactions. Trade finance and export finance transactions are often guaranteed by export credit agencies (ECA) or multilateral development banks (MDB) around the world. This financing can take the form of credits, credit insurance, financial guarantees or a combination thereof. MDBs and ECAs offer partial or full guarantees covering payment risk for trade related transactions. These guarantees are often transaction-specific and may be evidenced by a variety of underlying trade instruments and financing structures such as letters of credit, trade-related promissory notes, accepted drafts, bills of exchange, guarantees, bid and performance bonds and advance payment guarantees.

Guarantees supported by ECAs and MDBs offer a variety of benefits to the end-user. These include risk mitigation for a transaction with a particular buyer, financing for international buyers of capital goods and related services, flexible lender financing options for buyers of capital goods and related services in medium/long-term projects, and flexible repayment terms.

Guarantees by ECAs and MDBs also assist in the secure entry to emerging markets by companies wishing to expand their trading capabilities. ECA and MDB guarantees form a public/private sector partnership between governments and financial institutions ensuring effective mitigation of risk and allowing for the provision of increasingly necessary support for trade in developing markets.[3]

ECA and MDB guaranteed trade finance and export finance is also less risky than other types of transactions. [4] This type of financing is usually backed by the full faith and credit of the government or

[3] Guarantees offered by the International Finance Corporation (IFC), for example, have supported the supply of antiretroviral medication for HIV patients in the Democratic Republic of the Congo; energy-efficient machinery for Armenia's first and only steel production facility; turbines and other equipment for a hydroelectric dam in Honduras; and the relocation of an entire power plant to Pakistan from Germany.

[4] The International Chamber of Commerce (ICC) 2013 Trade Finance Register analyzed for the first time medium and long-term trade finance products, often supported by ECA and MDB guarantees. In a data set from 2006-2011, the ICC found an average annual transaction default rate of 1.11% for medium and long-term trade finance products; International Chamber of Commerce;

multilateral development bank supplying the guarantee. Additionally, whereas credit derivatives are generally used to hedge a portfolio of single name risks, guarantees for trade transactions are generally protected/risk mitigated on a transaction by transaction basis and the cost of protection is closely aligned with a percentage of the revenue earned on the transaction.

Similarly, trade credit risk insurance falls into the category of a guarantee that should be exempt from the consultative proposal. Trade credit insurance is a risk management product offered by private insurance companies, as well as governmental ECAs, to business entities and banks in order to mitigate potential credit or country risk defaults. Though trade insurance requires a payment to the protection provider, the cost of the protection is less than, and often a percentage of, the spread income recognized. It is an important facilitator of international trade and is a risk mitigant that, along with other types of guarantees, supports an underlying trade transaction.

For the reasons noted, ECA/MDB guaranteed trade finance, along with insured trade finance, provide important risk mitigation in the provision of trade finance. Both serve a reasonable and essential purpose for the clients of financial institutions importing and exporting goods and services around the world. Providing a clear exemption under the framework, and providing clear guidance on the types of guarantees exempted, will not diminish the objectives of the consultative proposal but will instead provide regulatory clarity and ensure the continued availability and affordability of trade finance products to end-users globally.

2. Clarify and exempt trade finance exposures, along with funded and unfunded risk participation transactions for trade finance, from the consultative proposal

In addition to formally exempting guaranteed trade finance transactions, clarification should be provided that short-term, self-liquidating trade finance transactions (and any applicable related guarantees), along with funded and unfunded risk participation transactions for trade finance, are also exempt from the scope of the proposed rules.[5] BAFT-IFSA has defined what it considers traditional trade financing products which support international trade.[6] These products are essential to the functioning of prosperous markets and economic growth and thus should be explicitly excluded from any final rulemaking.

Global Risks Trade Finance Report 2013, p. 26:
http://www.icctraderegister.com/docs/public/ICC%20Global%20Risks%202013%20Report%20Final%20Version.pdf

[5] Trade finance generally means financing connected to the exchange of goods and services through financial products of fixed short-term maturity (generally less than 1 year) without automatic rollover. Such finance is generally uncommitted and requires satisfactory supporting transactional documentation for each drawdown request, enabling refusal of the finance in the event of any doubt about credit-worthiness or the supporting transactional documentation. Repayment of trade finance exposures is usually independent of the borrower, with the funds instead coming from cash received from importers or resulting from proceeds of the sales of the underlying goods. Short-term trade finance is also traditionally a low risk financial product. The 2013 ICC register found an average default rate across products of 0.021% for a data set of over eight million transactions between 2008 and 2011; International Chamber of Commerce; Global Risks Trade Finance Report 2013, p. 15: http://www.icctraderegister.com/docs/public/ICC%20Global%20Risks%202013%20Report%20Final%20Version.pdf

[6] BAFT-IFSA Traditional Trade Finance Definitions; February 2012:
http://www.baft-ifsa.com/eweb/docs/BAFTIFSATFDefinitions.pdf

We also request clarification that funded and unfunded risk participation transactions for trade finance are exempt from the scope of this consultative document. These types of participation transactions provide a service to real economy financing. For example, if an exporter - the beneficiary of a Letter of Credit (LC) – requests a bank to add its confirmation to an LC opened by the LC issuing bank as a means of protection against future non-payment by the LC issuing bank, the LC confirming bank, in turn, may have internal limit constraints (*i.e.* maximum exposure limits on the issuing bank) which prevent them from confirming the transaction or a portion thereof. This will then lead them to bring in third-party banks to participate in the transaction. Though these transactions are unfunded risk participations they should not in any way be characterised as swaps or derivatives. These transactions only take place when there is an actual underlying transaction financing the import and export of goods or services requiring additional support and, importantly, the aggregate total participation amount will not exceed 100% of the financing value.

Conclusion:

Covered risk mitigation transactions for trade finance are an important tool to support international trade. They should not be unnecessarily penalized by the new rules. BAFT-IFSA respectfully requests that should the Basel Committee move forward with revised rules for the credit risk mitigation framework, a clear exemption should be provided for legitimate risk mitigation products, including guaranteed trade finance transactions, short-term trade finance transactions, and funded/unfunded risk participations in various types of trade finance transactions. BAFT-IFSA believes that the appropriate regulatory treatment of trade finance will ultimately have a positive effect on global markets and will spur job creation and growth in the real economy.

We very much appreciate the opportunity to comment on the consultative document and look forward to further dialogue with the Committee on these issues going forward.

Very truly yours,

Tod R. Burwell

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President and Chief Executive Officer

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