BAFT-IFSA

June 28, 2013

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

Re: Supervisory framework for measuring and controlling large exposures

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 welcomes the opportunity to comment on the consultative document published by the Basel Committee on Banking Supervision, entitled *Supervisory framework for measuring and controlling large exposures*.[1] BAFT-IFSA supports the Committee's goals of promoting a more resilient banking sector and agrees that a strong banking system is the foundation for sustainable economic growth. 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 question concerning the application of a 100% credit conversion factor (CCF) for "traditional" off-balance sheet commitments.[2]

Introduction:

BAFT-IFSA supports the objectives of the consultative proposal to form an international standard for the effective means of measuring, aggregating and controlling exposures to single counterparties across the books and operations of financial institutions. We note, however, that the framework must be properly designed and calibrated to avoid any potential damage to the global financial system and the broader economy.

In the Committee's efforts to structure a large exposures framework, BAFT-IFSA is pleased the Committee has highlighted the potential consequences from the broad application of a 100% CCF for traditional off-balance sheet commitments, and we thank the Committee for their recognition of this important distinction. We fully agree with the Committee's statement that applying a 100% CCF to certain types of exposures is inappropriate if there is a risk that it could have material unintended consequences.[3] This is particularly true of exposures linked to trade finance activities, where a 100%

[1] Basel Committee on Banking Supervision; *Supervisory framework for measuring and controlling large exposures*, March 2013

[2] IBID, p. 12, Question 7: *The Committee welcomes views on the proposal to generally apply a 100% CCF for "traditional" off-balance sheet commitments.*

[3] IBID, p. 11-12, para 63-66

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CCF would have an adverse impact on this essential form of financing in both emerging markets and developed economies.[4]

As such, BAFT-IFSA respectfully requests the Committee recommend use of internal credit conversion factors for banks on the advanced approaches Basel model when calculating the CCF for trade finance instruments in the context of the large exposures framework. Where banks are not able to internally model the CCF for trade finance, the application of the standardized approach credit conversion factors for off-balance sheet trade finance transactions is recommended. Should the Committee recommend use of the standardized approach calculation, the Committee should also recommend lowering the CCF for non-financial guarantees and standby guarantees from 50% to 20% in recognition of their consistently low default rates and their direct support of real economy import/export transactions.

Additionally, as the Basel Committee is aware of the likely impact a flat 100% CCF could have on trade finance, we respectfully request the Committee extend consideration of this impact to the final calibration of the Basel III leverage ratio. We recommend application of the standardized approach CCF for trade finance for the purposes of the denominator calculation in that regulatory standard. Any regulatory approach to trade finance that could reduce trade flows essential to economic recovery should be evaluated and adjusted. The appropriate application of credit conversion factors for trade finance will help contribute to sustained economic growth through trade in goods and services.

Key Recommendations:

1. Support an appropriate CCF calculation for off-balance sheet trade finance instruments in the large exposures framework

Certain off-balance sheet (OBS) exposures are used in trade flows. These include trade related contingencies[5] and transaction related contingencies[6]. Maintaining a CCF of less than 100% when calculating a large exposure will help avoid a possible reduction in the volume of trade flows and an increase in the cost of trade in goods and services. A CCF of less than 100% is also consistent with the

[4] Please see Appendix 1 for background on the importance of trade finance to international trade

[5] Trade Related Contingencies (TRC) are contingent liabilities that arise from trade-related obligations underpinned by the movement of goods or services and evidenced by commercial contracts that document the arrangements between buyer and seller. These include documentary letters of credit, confirmations of letters of credit, and shipping guarantees. From historical experience, it has been observed that companies prefer to prioritize payment for their trade obligations over other obligations, as they have a tendency to avoid defaults on trade obligations as far as practically possible to ensure their businesses remain an ongoing concern. Moreover, TRCs do not necessarily materialize into an exposure, even if the obligor is in financial difficulty. Historical evidence has shown that the default of the obligor does not necessarily induce drawing of the guarantee by the beneficiary, as the underlying trade contract might still be fulfilled as contracted between the two parties. On the rare occasions that the bank is obliged to make payment following default of the obligor, there will often be constructive possession of the underlying goods validating a prior pledge, allowing the bank to make a recovery from that channel.

[6] Transaction Related Contingencies (TRRC) are performance standby letters of credit or performance guarantees. Examples of these types of exposures include performance bonds, bid bonds, tender bonds, and advance payment guarantees. These guarantees support certain performance obligations of a borrower, with the drawing on these guarantees being contingent on the specific performance of the borrower rather than the financial soundness of the borrower. Prior to providing a TRRC, the bank will ensure that there is an underlying transaction and that any drawing on the TRRC is triggered by a performance event and not the customer failing to pay. As such, even in the event of default, a contingent standby letter of credit or bank guarantee will not necessarily result in an on-balance sheet exposure and internal bank data suggests that it is more likely that these types of exposures never become a liability for banks.

nature of the OBS exposures used in trade. These exposures are traditionally short-term, self-liquidating and less risky in nature than other types of financial products.[7]

BAFT-IFSA recommends the use of internal credit conversion factors for banks on the advanced approaches Basel framework in calculating the CCF for trade finance instruments. BAFT-IFSA believes that where a bank's own internal historical data (in conjunction with the loss data present in the International Chamber of Commerce Trade Finance Register[8]) allows for use of the advanced approaches standard, its application would not diminish the objectives of the consultative proposal and would support the effective risk management tools propagated by the credit conversion factor. This would be done without triggering the unintended consequences for trade finance availability that are noted as cause for concern by the Committee.

BAFT-IFSA is aware that in some cases there is a lack of required historical and performance data for banks to meet the minimum data requirements of the Basel II advanced approaches rule. Where banks are not able to internally model the CCF for trade finance, BAFT-IFSA agrees with the Committee's proposal that the CCF used for the standardized approach to credit risk is appropriate, and indeed critical, for large exposure purposes. In those cases, the most frequently used standardized approach values of 20% for trade related contingencies and 50% for transaction related guarantees would be the appropriate calibration for trade finance in the large exposure context[9]. These values reflect both the low-risk nature of trade finance and the fact that not all OBS trade exposures will necessarily convert to on-balance sheet exposures.

Were the Committee to recommend a flat 100% trade finance CCF for the calculation of large exposures, it may encourage banks to divert capital to other financial instruments. Banks may also cease to provide OBS trade/transaction lending or increase the cost of providing these products to customers. These scenarios will most likely result in a reduction of trade activity by diminishing the availability of trade finance to the end user exporter/importer, both in terms of pricing and general obtainability, as banks could potentially exit the marketplace in favor of focusing capital on other types of products.

2. Support a 20% standardized approach CCF for non-financial guarantees and standby guarantees

If the Committee were to propose use of the standardized approach CCF for trade finance for the purposes of calculating a large exposure, BAFT-IFSA believes the Committee should consider adjusting the CCF for non-financial guarantees[10] and standby guarantees[11] from 50% to 20%.

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[7]Please see Appendix 1 for background on the nature and risk profile of trade finance instruments

[8] 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

[9] The Standardized Approach CCF is also applicable to banks on the Internal Ratings Based Approach (IRB) model.

[10] Non-financial guarantees, or guarantees that do not have the character of a credit substitute, provide a means of securing performance or other obligations under the terms of a contract. In these transactions, the bank acts as a guarantor and will pay the beneficiary a specific sum, usually on presentation of a written demand. In return, the bank will require a counter-indemnity from its client for the full amount and any costs. These contingent instruments used by banks to cover trade finance are products that will only materialize as actual drawings contingent upon a set of conditions being fulfilled. These conditions can involve either performance or non-performance, but in either case will not necessarily involve the contingent risk becoming an on-balance sheet

Non-financial guarantees and standby guarantees are essential products supporting international trade. Their historical loss data substantiates a 20% CCF calculation. The International Chamber of Commerce analyzed the default rate for performance guarantees, alongside performance standby L/Cs. Only 208 of 609,920 transactions resulted in a default. Losses in dollar terms were 0.034%. The pooled data within the Register enumerates the fact that these types of trade finance products are low-risk, particularly when compared with corporate loans.

Through Capital Requirements Directive IV (CRDIV/CRR), the European Union (EU) adjusted the CCF for non-financial guarantees and standby guarantees to 20% for the purposes of the Basel III leverage ratio calculation.[12] By taking this step, the EU recognized the intrinsic nature of these products and their low default profile. A lower, more appropriate CCF for these types of products will assist financial institutions in the financing of global trade. BAFT-IFSA believes the Committee should harmonize a 20% CCF for these products, both through the large exposures rules and through the wider application of the standardized approach, across all jurisdictions of the Basel Committee.

3. Apply principles of an appropriate trade finance CCF calculation to the Basel III Leverage Ratio

BAFT-IFSA believes it is also important to assess the large exposures consultation in view of the wider implementation of Basel III. Industry estimates show the potential for an 18-40% pricing increase for trade finance instruments if Basel III is fully implemented. This increase will lessen available support to companies reliant on trade finance across global markets. Recently, the Asian Development Bank (ADB) issued a study of its participant banks and companies and found that on average, surveyed banks would reduce support to trade finance by 13% due to the demands of Basel III.[13]

If adjustments are not made to Basel III trade finance rules, and the Committee were to recommend a flat 100% CCF for trade finance in the large exposures rules, trade finance availability would be impacted in a substantial way highly detrimental to the global economy. As the Basel Committee is aware of the likely impact a flat 100% CCF could have on trade finance, we respectfully request the Committee extend consideration of this impact to the final calibration of the Basel III leverage ratio.

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item as a result of a credit default event. In the case of guarantees, the occurrence is always dependent on non-performance by the bank's client.

[11] Standby guarantees, or standby letters of credit not having the character of a credit substitute, are written undertakings given by a bank, at the request of a client to provide assurance to a beneficiary regarding the client's (or a third party's) performance, that promises to pay the beneficiary against presentation of a documentary demand conforming with the terms and conditions specified in the letter of credit. Unlike a commercial letter of credit, which is expected to be the means of payment in the underlying transaction, a standby guarantee is typically not drawn unless there is some manner of default in the underlying transaction. They include an expiry date and will normally call for a statement of default from the exporter and also evidence of default.

[12] For further information, please see BAFT-IFSA Letter to G-20 on CRDIV/CRR Trade Finance Harmonization; April 17, 2013: http://www.baft-ifsa.com/eweb/docs/BAFT-IFSAG20LetteronEUImplementation2013.04.17Final.pdf

[13] Asian Development Bank Trade Finance Survey; March 2013: http://www.adb.org/sites/default/files/pub/2013/trade-finance-survey-major-findings.pdf

While we recognize that the Basel Committee intentionally designed a global leverage ratio to be simple and not based on any differential risk weighting, we are of the view that use of a 100% CCF for trade finance is excessive given the objective the leverage ratio intends to achieve. The leverage ratio aims to constrain the build-up of leverage in the banking sector to avoid destabilizing deleveraging processes which can damage the broader financial system and the economy. Trade finance instruments are underpinned by the movement of goods and services; hence they do not lead to the kind of leveraging that may endanger real economic activity. They also do no contribute to downward pressure of asset pricing, as they are short-term in nature and liquidated by fulfillment of the underlying transaction and payment at maturity. Trade finance products could apply the standardized approach CCF to the leverage ratio calculation without any harm to the objective of the Committee's recommendations.

Conclusion:

The application of a flat 100% CCF would be highly detrimental to trade finance availability. BAFT-IFSA is grateful the Committee, through the large exposures consultation, also recognizes that a flat calculation of the CCF could have a materially adverse impact on the provision of trade finance. We recommend use of a more risk sensitive measure for the calculation of trade finance. BAFT-IFSA believes that the appropriate regulatory treatment for trade finance will ultimately have a positive effect on trade finance 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

Tod R. Burwell
President and Chief Executive Officer

Appendix 1

The Importance of Trade Finance

Global trade relies upon accessible financing for trade transactions. Trade financing assists customers with their import and export requirements by providing import/export financing as well as country and counterparty risk mitigation. Trade finance, as a transaction banking product, is a core banking business serving the real economy.[14] In order to set our comments on the consultative proposal in context, a review of the secure and unique nature of trade finance as a financial instrument, and its significance to the global economy, is important.

Trade finance has historically maintained a low-risk profile in comparison with other financial instruments. Trade finance transactions are generally fixed, short-term instruments that are not automatically renewed or extended upon maturity and are self-liquidating by nature (*i.e.*, exposures are liquidated by payment at maturity). In stress situations, countries and banks have traditionally continued to prioritize the repayment of short-term trade finance obligations as they fall due. Furthermore, banks active in trade finance are generally able to react swiftly on deteriorations in bank and country risk as a result of the short-term, self-liquidating nature of the transaction.

According to an ongoing registry project conducted by the International Chamber of Commerce (ICC), banks have experienced relatively minimal losses on trade lending[15]. The ICC has created this Trade Finance Register to track default and loss rates for trade finance, creating a living database of the trade finance market which has helped to demonstrate the resilience of this important business. The pooled data within the Register supports the view that trade finance is a low-risk asset class, particularly when compared with corporate loans. According to that data accumulated over 8,133,031 transactions, only 1,746 defaults were recorded, which accounts for a default rate of 0.021 percent.

These low-risk, short-term trade financing instruments are pivotal in supporting international commerce and contributing to the growth of the world economy. At the G-20 meeting in April 2009, during the height of the financial crisis, it was recognized widely by world leaders that trade finance is the lifeblood of $19 trillion USD in annual global commerce and one of the fundamental engines of growth and development, especially in emerging markets. Restricting the flow of credit to this area, by increasing the risk weight of trade finance instruments disproportionate with their nature, means essential goods cannot be traded, posing a threat to international trade, with smaller banks and small- and medium-sized enterprises (SME) disproportionately affected.

Trade finance is particularly important to emerging market economies. A survey of companies conducted by the Asian Development Bank (ADB) found that a 5% increase in trade finance support would mean a 2% growth in their business and a requirement to hire 2% more staff. The same companies said that a

[14] BAFT-IFSA has defined the specific products that the industry considers traditional trade finance: BAFT-IFSA Traditional Trade Finance Definitions; February 2012: http://www.baft-ifsa.com/eweb/docs/BAFTIFSATFDefinitions.pdf

[15] 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

10% increase in trade finance support would result in a 5% increase in production and 5% more jobs.[16] Reducing unmet demand for trade finance by ensuring its availability is not diminished by unintended consequences from regulatory initiatives will result in economic growth and job creation.

[16] Asian Development Bank Trade Finance Survey; March 2013: http://www.adb.org/sites/default/files/pub/2013/trade-finance-survey-major-findings.pdf