INTERNATIONAL CHAMBER OF COMMERCE
The world business organization

BAFT

June, 2016

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Reducing variation in the credit risk-weighted assets - constraints on the use of internal model approaches

Dear Ladies and Gentlemen,

The International Chamber of Commerce (ICC) Banking Commission and BAFT (Banker's Association for Finance and Trade) welcome the opportunity to respond to the proposal published by the Basel Committee on Banking Supervision (BCBS or "the Committee") entitled '*Reducing variation in credit risk-weighted assets* – constraints on the use *of internal model approaches'* ("Consultative Document" or "the proposal").[1]

By way of background, the ICC Banking Commission is a leading global standard setting body for the banking industry. For over 85 years it has a key role to play in bringing the industry together and promoting cooperation and stability in cross-border trade by providing a forum for professional exchange among it's over 600 members in 93 countries.

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

As the ICC and BAFT represent the transaction banking segment of financial institutions globally - including the trade finance and cash management business lines - we are particularly concerned about the impact that new regulatory initiatives could have on the provision of these crucial financing and payment services that support real economic commerce. To that end, our comments on the proposal are primarily focused on issues for these particular sectors of the banking industry.

[1] Basel Committee on Banking Supervision: Consultative Document, Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches; March 2016

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We are appreciative of Committee's willingness to consider input from a wide variety of stakeholders. With that said, we believe a number of elements in the consultation document demand further review and modification if it is to reach the Committee's goal of creating a simpler, more effective, and more risk sensitive approach for financial institutions. This letter highlights our fundamental belief that the proposal can have unintended consequences undermining economic growth, job creation and cross-border commerce facilitated by trade finance. Further, the effects of these limitations will most critically fall on small and medium sized enterprises and emerging economies.

Specifically, we offer recommendations around three key themes:

1. We believe the sum of the proposals in the document may result in a less risk-sensitive approach, thus overstating risk, and ultimately reducing availability and increasing cost of trade finance, a low-risk business that facilitates commerce and growth in the real economy.
2. We believe the proposal will ultimately have negative unintended consequences for corporate clients, particularly SME and emerging market clients, who are most dependent on availability of affordable trade finance.
3. We strongly recommend that the IRB approach continue to be considered, with suitable caveats built into the models to achieve the goals of the Committee.

We offer further comments on these items below.

The ICC Banking Commission and BAFT appreciate the opportunity to respond to the specific queries raised by the BCBS in the consultation paper.

Very truly yours,

Emily

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I. Introduction and Main Themes

The International Chamber of Commerce (ICC) Banking Commission and BAFT welcomes the opportunity to respond to the '*Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches'* consultation paper from the Basel Committee on Banking Supervision (BCBS), and to continue the constructive, substantive and informed dialogue that has evolved over years of ongoing engagement.

The Banking Commission is one of numerous Policy Commissions operating under the auspices of the ICC, and thus strives to take a broad view of the issues and work areas which shape its remit. As mentioned earlier, BAFT represents the transaction banking segment of financial institutions globally - including the trade finance and cash management business lines. Accordingly, the following observations are submitted for consideration by the BCBS, both as expert commentary arising from the work of both organizations, but also with an eye to the wider economic, trade and development context within which trade banking services are provided to the international community.

Regulated financial institutions – primarily banks – still provide the majority of traditional trade finance today, including Documentary Letters of Credit, Documentary Collections, Standby and Guarantee products, and loans or risk mitigation solutions derived from these various instruments.

While market sizing is a difficult exercise, conservative estimates quoted in The Committee on the Global Financial System (CGFS) publication, '*Trade Finance: developments and issues'*[2]*,* January 2014, suggest that bank-intermediated trade finance is at about 40% of total merchandise trade globally by value, when inter-firm credit and open account transactions are included in the estimates. With annual merchandise trade approaching US$20 trillion, the importance and impact of trade finance is easily appreciated.

The linkages between trade and the creation of economic value are well-established, and even in the difficult post-crisis environment, expectations are that these linkages will normalize, with trade ultimately regaining its long-held position as a driver of global GDP growth. What is relatively recent outside of a small group of practitioners is the appreciation of the linkage between trade financing (including traditional trade finance, fast-growing supply chain finance, and the risk mitigation capabilities of each) and the successful conduct of trade.

Today, it is clear not only to banks but corporates, regulatory authorities and policymakers alike, that access to trade financing – on a timely and affordable basis – is essential to the conduct of international commerce. It is equally clear, and has been illustrated in analyses by the World Trade Organisation (WTO), the ICC, the African Development Bank and others, that access to trade finance is important to developing and emerging markets, particularly as they seek to pursue growth and prosperity by accessing global supply chains. Relatedly, as start-up firms target international markets much earlier in their lifecycle, the small and

[2] The Committee on the Global Financial System: Publications Number 50: "Trade Finance: developments and issues.": http://www.bis.org/publ/cgfs50.htm

medium enterprises (SME) segment – recognized as critical to economic health from Organisation for Economic Co-operation and Development (OECD) markets to emerging, developing and frontier markets, are increasingly in need of adequate levels of trade financing.

Developing markets and SMEs are two constituencies most keenly affected by shortages in trade finance, and they also happen to be the constituencies most in need of these crucial financing instruments. While observers note that global liquidity has shown signs of normalization, closer examination of the reality "on the ground" reveals that liquidity is still concentrated at the top end of geographic and corporate markets, for a variety of reasons. Financial inclusion, generally, and access to trade financing specifically, requires a nuanced combination of market dynamics, effective and targeted policy initiatives and appropriately balanced regulatory oversight.

It is in this wider context that considerations of regulatory treatment and capital adequacy requirements linked to trade finance ought to be viewed: with a clear focus on the development and economic impact of regulatory requirements, and with an eye to risk-aligned treatment of trade finance products by regulatory authorities at the BCBS as well as at regional and national levels of regulatory authority.

> *The situation on the prudential front looks better than it did a few years ago, thanks to the institutional dialogues opened by the WTO and the Basel Committee, and the data support provided by the ICC. There is no doubt that such initiatives have contributed to improving the policy coherence between the prudential and central bank community on the one hand, and the trading community on the other.*
>
> *"Trade Finance and SMEs: Bridging the Gaps in Provision", WTO, 2016*

The ICC and BAFT fully support and acknowledge the need for thoughtfully designed, robust regulatory regimes on numerous fronts, and remain committed to contributing to the positive dialogue that has evolved on these matters, particularly over the last several years.

While the Banking Commission appreciates that there is limited sympathy in the market for cost-related impacts of regulation – including capital cost – it is a commercial and economic reality that bank balance sheets today are generally constrained, that there is significant competition across the industry for allocation of limited bank capital, and that hard-dollar as well as capital costs factor into strategic, long-term decisions about allocation of capital and the returns associated with various financial services lines of business. At the same time, the explicit and implicit pressure to reduce overall risk exposures in support of prudential regulatory objectives, coupled with a systemic sensitivity around reputational risk, further reduce the willingness of certain banks to engage in cross-border business, particularly in markets that are perceived to be relatively higher-risk.

At the same time, the specific treatment of trade finance assets under the evolving regulatory regime could carry implications for the availability and pricing of trade finance, and the evolution of the sector's stability and resilience.

"Trade Finance: developments and issues", January 2014, CGFS

The ICC Banking Commission and BAFT, our stakeholders, and our numerous advocacy partners, including the Institute of International Finance (IIF), Association for Financial Markets in Europe (AFME), the World Trade Organisation (WTO), the Berne Union and the various multilateral institutions (all of which maintain significant trade finance programs) are aligned on these macro-issues.

While we appreciate that it is difficult for authorities to bestow differentiated regulatory treatments to a large number of financial sector products or lines of business, we believe that the unique characteristics of trade finance have been well and objectively demonstrated in the research, analytics and advocacy work conducted over the last several years.

Those unique characteristics can be observed at the level of economic value-creation (certainly in terms of scope and global reach) described above, as well as in the extremely favourable default and risk profile of the business overall, as demonstrated for the last seven years through the authoritative ICC Trade Register.

The ICC Trade Register, well-known to regulatory authorities and market stakeholders, illustrates compellingly the quality of the trade finance business as an asset class, doing so on the basis of industry data as well as expert analysis and qualitative observations.

In the end, the intention of advocates for trade finance is to propose and arrive at a risk-aligned regulatory treatment of trade finance, with the understanding that risk models, data collection and analytics and overall advocacy efforts can and should improve year-over-year. It is the unintended, restrictive consequences of fundamentally necessary regulatory frameworks that must be avoided, while concurrently ensuring the continued health and sustainability of trade flows, the robust engagement of banks in the business of trade, and access to adequate (and increasing) levels of trade and supply chain finance for SMEs and for developing and emerging markets in particular.

II. Summary of Issues and Recommendations

The ICC and BAFT acknowledge the Basel Committee's concerns and challenges around modelling and its desire to reduce variations in risk weighted assets. It is our opinion, based on the industry sponsored work done through the ICC Trade Register, that there are alternative solutions which can address many of the committee's concerns.

As noted in the foregoing section, the analysis at the core of this submission seeks to highlight what the ICC Banking Commission, BAFT and our numerous advocacy partners and stakeholders perceive to be a series of unintended adverse implications on international trade, arising from the changes proposed by the Basel Committee on Banking Supervision (BCBS).

We all support the need for prudential regulation of the financial sector. Our dialogue with member banks and with ICC National Committees, BAFT Chapters and Councils and others is consistent with this objective, shared with the BIS and with regional and national regulatory authorities.

At its core, this submission seeks to ensure that the Basel Committee fully appreciates the importance of avoiding unintended adverse impact on trade activity resulting from regulatory expectations that are not aligned with the risk character of trade finance. Further, it aims to ensure that we do not collectively take a step back in our efforts to achieve a balance between regulation and assurance of access to adequate levels of trade finance, particularly for SMEs and developing markets.

We wish to highlight the following specific issues and recommendations for consideration by the Basel Committee:

- Bank and Other Financial Institutions Exposures (Section 6)

<u>Basel Committee Proposals:</u>

- The Committee proposes removing the IRBA approach. As such, all exposures would move to the Standardised Approach whereby externally rated risk weights of 20%/50%/100%/150% would apply.
- Where external ratings are not recognized, rated risk weights of 50%/100%/150% would apply.
- For exposures less than 90 days, a 20% risk weight would apply.

<u>Concerns and Issues:</u>

- We believe these proposals would result in a less risk sensitive approach. Consequently, we believe risk could be overstated.
- Further, we are concerned about a knock on impact in the form of increased capital and pricing.
- Finally, there will likely be a potential reduction in financing capacity, with particular adverse effects on SMEs and developing economies.

Recommendations:

- Banks should be able to continue to use their internal IRB models with suitable caveats being built into LGD and EAD estimates.
- Data pooling should be used as a means for determining conservative values for PD, LGD and EAD risk parameters.
- Where permissible, use of the IRBF approach should be allowed.
- Where the IRBF approach is not permissible, a risk bucketing approach – such as the one proposed by the IIF – should be used.

■ Corporate Exposures (Section 7)

Basel Committee Proposals:

Segments the portfolio into three buckets with varying risk measurement approaches:

- Large Corporates belonging to consolidated groups with assets greater than EUR50 billion moves to the Standardized approach, where externally rated risk weights of 20%/50%/100%/150% apply. Where external ratings are not recognized, a 100% risk weighting is applied. A 100% risk weighting also applies to unrated entities within jurisdictions where external ratings are recognized.
- Corporate exposures belonging to consolidated groups with assets less than or equal to EUR50 billion and revenues greater than EUR200 million move to IRBF approach.
- Corporate exposures belonging to consolidated groups with assets less than or equal to EUR50 billion and revenues less than EUR200 million move to IRBA approach.

Concerns and Issues:

- We believe these proposals will result in a reduced risk sensitivity of the portfolio.
- Further, we believe a result of these proposals would be a potential overstatement of risk for high quality customers.
- We expect a likely consequence would be a knock on impact in the form of increased capital and pricing.
- We believe these proposals have the potential to shift product mix away from trade finance with resultant reduction in financing capacity.

Recommendations:

- Corporate portfolios should be allowed to keep the IRB approach, with suitable caveats being built into LGD and EAD estimates, the areas of prime concern for the Committee.
- Data pooling should be used as a means of benchmarking and estimating conservative LGD and EAD estimates.
- Where data pooling and conservative estimates of risk parameters don't meet the required modelling standards, the IRBF approach should be used.
- Clarify the use of notching parent company external ratings for determining subsidiary ratings.

- Specialised Lending – Commodities (Section 8)

Basel Committee Proposals:
- The IRBA approach should be removed for specialized lending and only the Standardised and the Slotting approaches should be utilized, with applicable risk weights of 70%/90%/115%/250%, respectively.

Concerns and Issues:
- We believe these proposals do not recognize the structured and collateralized nature of transactions.
- As the slotting approach is not granular, we believe there will be a substantial loss of risk sensitivity.
- A consequence of these proposals will likely be an increase in capital and pricing.

Recommendations:
- We recommend the introduction of specific, objective scorecard criteria. Banks that satisfy these criteria should be distinguished from banks which do not meet these criteria.
- Keep portfolio on IRBA/IRBF approaches for banks which satisfy specific objective criteria which makes them eligible to use these approaches.
- For portfolios on the slotting approach, granularity of risk weights should be expanded, in line with the proposals made by the IIF.

- Probability of Default (PD) & Loss Given Default (LGD) Floors (Section 9 and 10)

Basel Committee Proposals:
- Corporate PDs is adjusted to 5bps,
- LGD is adjusted as follows: Unsecured: 25%, Secured: Varies from 0% to 20% depending on collateral

Concerns and Issues:
- We are concerned with the use of floors in general as it limits collateral recognition

Recommendations:
- Data pooling and Trade Register data should be used to establish conservative LGD estimates at a granular product level.
- Where risk modelling standards set are not met, IRBF parameters for unsecured exposures should be considered.
- It is our opinion BCBS should allow for recognition of a broader range of collateral.

- EAD Floors (Section 11)

Basel Committee Proposals:
- A CCF floor of 50% on the IRBA is proposed,
- The BCBS recommends removing 0% CCF for Unconditionally Cancellable Commitments (UCC).

Concerns and Issues:

- We believe a 50% floor is arbitrary and is applied too broadly across a whole suite of products.
- We do not believe that the proposals are reflective of actual CCF values for a range of products.
- We believe there is a lack of definitional clarity in the use of terms like commitments, credit conversion factors (CCF).

Recommendations:

- Two tiered CCF values should be utilized, in line with product characteristics.
- The Committee should clarify that CCF can be used as a proxy to determine, not only the on balance sheet values of trade products like L/C and guarantees, but also the undrawn balances, which is essentially the difference between current exposures and limits.
- We would ask the Committee to redefine the UCC as uncommitted facilities and lines.

■ Maturity (Section 12)

Basel Committee Proposals:

- The maturity parameter is to be based on expiry date of the facility under the IRBA approach.
- Under IRBF 2.5 year fixed maturity parameter.

Concerns and Issues:

- Proposals not in line with actual risk profile of transactions as Trade exposures with shorter tenors have a lower risk profile than exposures with longer tenors.

Recommendations:

- Reconfirm for Trade exposures the maturity floor waiver (MFW) given in 2011 is still relevant for both IRBF and IRBA approaches

■ Credit Risk Mitigation (Section 13)

Basel Committee Proposals:

- The Committee recommends removing the double default approach

Concerns and Issues:

- We believe the removal of an approach which is methodologically correct will overstate risk and potentially result in reduced financing capacity

Recommendations:

- We strongly recommend keeping the double default approach

III. Key Comments and Recommendations

1. Trade Finance is a low default, low risk portfolio

The International Chamber of Commerce and BAFT acknowledge the Basel Committee's significant concerns on excessive variance in reported risk-weighted assets (RWA) stemming from limitations in the use of risk models and the low default nature of some of the assessed portfolios. As Trade Finance (TF) is a segment of the broader asset classes of Banks and Corporates within the Basel framework, it is deemed to be a low risk-low default portfolio. However, it is the opinion of the ICC that Trade is a low risk portfolio characterized by short tenors, strong collateral and high quality counterparties. This is illustrated by the ICC Trade Register (TR), an industry initiative first launched by the Asian Development Bank and now sponsored by the ICC. The Trade Register has become widely recognized as an authoritative source of credit related risk data, and a reference point for addressing many of the regulatory concerns pertaining to the use of Internal Ratings Based (IRB) models.

The ICC Trade Register:

- Seeks to iteratively align definitions, methodology and analytical approach with the approach taken by the Basel Committee, to facilitate dialogue based on common reference points and to ensure useful year-on-year comparisons.
- Pools trade finance related default data covering a broad spectrum of short-term trade finance and long-term export finance products, from a consortium of 23 leading international banks to establish that trade finance is homogenous in character and low risk. We would note that data pooling overcomes the lack of robust data at individual bank level, enables a portfolio-level dialogue across products and across markets and assists in the normalization of data. The 2015 edition of the ICC Trade Register reports that data to date covers exposures totalling US$7.4 trillion.
- Uses risk parameters common with the Internal Ratings Based Approach (IRBA) like Probability of Default (PD), Loss-Given-Default (LGD) and Exposure-at-Default (EAD) to estimate Expected Loss (EL) and Unexpected Loss (UL) for trade finance and export finance exposures.
- Acknowledges the significant challenges in modelling LGD and estimating Credit Conversion Factors (CCF) as part of modelling EAD and therefore makes conservative assumptions in estimating both parameters. The Trade Register notes that these challenges stem from definitional, methodological and practice based issues within banks.
- Estimates PD in line with the methodology underlying the IRB approach.
- Recognises the need to further align the underlying methodologies for estimating LGD and EAD in line with regulatory expectations.
- Establishes the need to expand the range of trade products covered by the Register.

The ICC Trade Register has, in past years, provided fairly detailed explanatory text and transactional case studies to further illustrate the character of the trade finance business. This element of the Trade Register Report[3] demonstrates the direct link between certain product and transaction characteristics, and the attractive risk profile of trade finance. The contingent nature of Documentary Credits and the reality that banks are under no obligation to effect payment in the event of non-compliant presentation of documents are examples here, and directly relevant to the risk character of trade finance.

The tables below outline the PD, LGD, maturity (M) and EL tables from the 2015 report which establishes the low risk nature of Trade Finance.

Total customers and default rate by product[13], 2008-2014[14]

Product	Total # obligors	Total # defaulted obligors	Obligor default rate	Moody's rating for comparable default rate[15]
1. Export L/C	92,881	36	0.04%	Aaa-Aa
2. Import L/C	113,026	333	0.29%	Baa
3. Performance Guarantees	181,626	773	0.43%	Baa-Ba
4. Loans for Import/Export	145,021	1,050	0.72%	Ba

Average reported maturity by product, 2008-2014

Product	Weighted average contractual maturity (days)	Min	Max
1. Export L/C	128	52	335
2. Import L/C	123	31	162
3. Performance Guarantees	611	27	1,155
4. Loans for Import/Export	166	52	417

[3] ICC: *2015 ICC Trade Register Report, Global Risks in Trade Finance*, December 2015. ICC Trade Register 2015 downloadable here: http://www.iccwbo.org/Data/Documents/Banking/General-PDFs/ICC-Trade-Register-Report-2015/.

Exposure-weighted LGD by product, 2008-2014

Product	1 - recovery rate (exposure weighted)	Time to recovery (t) (years)	Discount on recoveries and costs (2%)			LGD		
		Discount rate (r)	5%	9%	13%	5%	9%	13%
Export L/C	38%	0.49	3%	5%	6%	41%	42%	44%
Import L/C	26%	0.19	3%	3%	4%	29%	29%	30%
Performance Guarantees	49%	0.58	3%	4%	5%	53%	54%	55%
Loans for Import/Export	30%	0.65	5%	7%	9%	35%	38%	40%

Expected Loss calculation by product, 2008-2014

	Customer default rate	EAD	LGD	Customer EL	Transactional EL	Exposure-weighted EL
Export L/C	0.04%	100%	42%	0.02%	0.00%	0.01%
Import L/C	0.29%	100%	29%	0.09%	0.02%	0.02%
Performance Guarantees	0.43%	8%	54%	0.02%	0.01%	0.01%
Loans for Import/Export	0.72%	100%	38%	0.27%	0.08%	0.06%

2. Risk Sensitivity and its impact on Trade portfolios

Capital is a critical building block of bank business models, increasingly so as a direct result of prudential regulation and the mandate and efforts of the Basel Committee and numerous regional and national regulatory authorities.

Accordingly, any material shift in regulatory capital requirements will have significant impact on the banking sector and on the wider global economic system, in terms of access to timely and affordable trade finance across markets and client segments.

There is a direct link between risk and capital consumption, yet the low risk character of trade finance is not yet adequately taken into account, to allow for equitable, risk-aligned capital adequacy expectations relative to trade finance portfolios. This creates a misalignment between desired policy outcomes around inclusiveness and access to trade financing, and the decisions that bank executives and boards are incentivised to make, based upon capital cost.

Decisions surrounding products and services, pricing and geographies to focus on will be driven to a significant extent by the capital consumed by different products and services. As capital consumed is a function of risk, the proposed move away from IRB models, can only be termed as a shift away from a risk sensitive approach which will distort capital allocation decisions and may result in overstating risk for high quality assets while understating risks for low quality assets, as the Standardised approach by definition is not risk sensitive. Further, as the standardised approach will not provide any incentive for risk sensitive behaviour there will be a knock on impact on product/transaction pricing which tends to be risk based.

Further, as banks are required by current regulations to show that components used in the calculation of regulatory capital are also used for internal purposes, they tend to use IRB risk parameters PD, LGD, EAD and maturity (M) for transaction pricing, provisioning and stress testing. However, the proposed move away from the IRB approach will create a multiplicity of systems and processes for banks which will make capital management and accounting more complex and less robust and will require banks to make business decisions which may have unintended adverse consequences on the global availability of trade finance.

3. Pricing

As pricing decisions must incorporate adequate compensation for risk, and a return on shareholders' capital, the move away from the IRB approach is likely to result in higher capital consumption and will therefore likely lead to an increase in pricing to end-clients including corporates, SMEs and financial institution clients in global correspondent networks.

The potential impact on pricing is illustrated conservatively below for a suite of Trade Finance products.

Note while banks may have a choice not to pass on this increase, this is commercially untenable as the move away from the IRB approach will be across a broad spectrum of banks on the IRB approach, directly impacting the competitive landscape in trade finance.

The likelihood of price increases being passed on to the end customer is high.

Scenario 1: Bank obligor moving from IRBA to STD

Export L/C Confirmation (180 days)	A-IRB Approach	STD Approach
ECAI Rating	A	A
EAD (CCF 50%)	50	50
RWA	11.7	25
Margin Income	50bps	50bps*
Return on RWA (RoRWA)	2.5%	1.2%
Return on Equity (RoE)	23.5%	11%
*Margin Income will need to **increase** to 100bps (100% increase) to achieve same RoRWA and RoE		

Scenario 2: Large Corporate obligor moving from IRBA to STD

Financial Guarantee (1 year)	A-IRB Approach	STD Approach
ECAI Rating	BBB-	BBB-
EAD (CCF 100%)	100	100
RWA	48.57	100
Margin Income	150bps	150bps*
Return on RWA (RoRWA)	1.6%	0.8%
Return on Equity (RoE)	14.6%	7.1%
*Margin Income will need to **increase** to 280bps (87% increase) to achieve same RoRWA and RoE		

Scenario 3: Mid-Market Corporate obligor moving from IRBA to IRBF

Import Loan (16 days)	A-IRB Approach	F-IRB Approach[1]
PD / LGD	BB+ / 25%	BB+ / 45%
EAD (CCF 100%)	100	100
RWA	33.48	60.26
Margin Income	200bps	200bps*
Return on RWA (RoRWA)	2.2%	0.9%
Return on Equity (RoE)	20.5%	8.7%
*Margin Income will need to **increase** to 320bps (60% increase) to achieve same RoRWA and RoE		

The foregoing scenarios, reflective of current market practice and pricing, demonstrate that banks seeking to maintain comparable returns will face pressure to increase margin income by 60 to 100%. Even in the event where financial institutions choose to absorb a portion of the increase, the market impact may remain significant. A US$500,000 import letter of credit with the most basic of features, which might cost US$1300 under current circumstance, could become as expensive as US$2400 under the proposed revised requirements.

4. Product/Capital Allocation

As noted earlier, balance sheet and capital constraints are creating situations of significant and vigorous internal competition for capital within financial institutions. In this context, cost of capital and returns (together with the relationship value of a line of business or product) combine to influence strategic direction, as well as investment decisions aimed at product development, channel expansion and the overall institutional commitment to a particular offering.

Trade finance, in terms of profitability, is perhaps best characterized as solid annuity business generating adequate returns. The comparative advantage of this business has been, and remains, in its favourable risk profile and competitive capital cost. To the extent that the proposed shift in capital requirements dilutes or distorts the latter characteristic of the trade finance business, it will weaken this line of activity relative to other bank businesses, and make it increasingly difficult to persuade senior executives to allocate significant capital to this critical enabler of international business, development and economic growth.

The move away from the IRB approach is likely to distort product allocation decisions and will influence behaviour at the business level which is commercially sound, but out of step with the objectives of policymakers and regulatory authorities seeking to promote a robust, sustainable, trade-driven international system.

This is illustrated below by comparing the capital consumption under the current IRB approach with the capital consumed under the standardised approach for a receivable finance /supply chain loan and an overdraft for an 'A' rated obligor.

IRB Approach			
Overdraft/Revolving line		**Receivables Finance**	
Rating	*A*	*Rating*	*A*
LGD	*45%*	*LGD*	*45%*
EAD	*10,000,000*	*EAD*	*10,000,000*
Maturity	*1 year*	*Maturity*	*90 days*
RWA	1,528,191.66	RWA	1,016,244.72
Margin(bps)	*60*	*Margin(bps)*	*45*
RoRWA	**2.3%**	**RoRWA**	**2.5%**
Capital	122,255	Capital	81,300
RoE	**21.8%**	**RoE**	**23.8%**

Standardised Approach			
Overdraft/Revolving line		**Receivables Finance**	
Rating	*A*	*Rating*	*A*
Risk weight	*50%*	*Risk weight*	*50%*
RWA	5,000,000	RWA	5,000,000
Margin(bps)	*60*	*Margin(bps)*	*45*
RoRWA	**0.7%**	**RoRWA**	**0.5%**
Capital	400,000	Capital	400,000
RoE	**6.7%**	**RoE**	**4.8%**

The example indicates that while under the IRB approach the correct incentives are created with the overdraft being priced higher to reflect the higher risk in the product in comparison to a structured receivable finance transaction, the move to a standardised approach will remove this incentive and will favour booking of an overdraft as it will be more profitable than a receivable finance transaction.

This adverse unintended consequence is further exacerbated by the interplay with the leverage ratio and the liquidity requirements under Basel III. Where the Leverage Ratio is a binding constraint there is an incentive to book low quality higher risk assets. When combined with the liquidity requirements which require banks to invest a fair share of assets in low yielding high quality assets this will put additional pressure on returns, further impacting capital and product allocation decisions.

As Trade Finance is a low risk and relatively lower yielding asset class than some of the other asset classes the incentive to shift away from Trade Finance will be high.

5. Interplay with Accounting Standards

Accounting standards in general and specifically The International Financial Reporting Standards (IFRS-9) increasingly converge with the IRB approach, as they use risk parameters like PD, LGD EAD and M which are similar but not identical to those utilized in the Basel models, as a base to calculate accounting provisions. The move away from the IRB approach will only accentuate differences between the accounting system and the risk based regulatory capital requirements even though the objective of regulatory authorities was to bridge this gap.

This development will adversely impact transparency and will make bank financial statements more complex and significantly more difficult to understand.

6. Bank and Other Financial Institution Exposures

A. Summary

Trade Finance exposures are often a fairly significant part of the overall Bank portfolio and play a critical role in financing and facilitation of export/ import trade and capital projects (i.e. exports, infrastructure) between countries. The linkages between trade activity and foreign direct investment flows are increasingly strengthened by commercial and global sourcing patterns and the nature and “anchor markets” of cross-border supply chains.

While there is a broad range of trade products to facilitate exports and imports, they tend to cluster around letters of credit, accepted bills of exchange and promissory notes which are essentially short-term in nature, as well as project related guarantees (bid/advance/performance/retention) which tend to be of longer maturity. As banks are key players in providing this financing and risk mitigation capacity, the proposal to move this portfolio to the standardised approach is very likely to raise capital requirements disproportionate to the risks inherent in these exposures.

The ICC Banking Commission and BAFT acknowledge the challenges in modelling low default portfolios and agrees with the view of the Basel Committee that these challenges relate primarily to LGD and EAD modelling more so than to PD.

The Trade Register report clearly and consistently substantiates this view. However, we have reservations about the proposed solution of using the Standardised approach, as outlined in brief below.

The proposed approach:

- Lumps risk weights into a few external rating categories, resulting in a lack of differentiated risk between obligors. Consequently, this will represent a dialling back on one of the key stated objectives of the Basel Committee, namely, that of promoting a more risk sensitive approach within banks. Will increase capital requirements for unrated banks and subsidiaries of banks with no external ratings in jurisdictions which allow external ratings and all banks in jurisdictions that do not allow external ratings. Further, as the number of unrated banks is concentrated in emerging markets, credit capacity is likely to diminish and become more expensive for emerging market banks.

- Will give limited recognition to collateral and tenor, resulting in adverse unintended impacts on trade finance despite the well-documented short term nature of exposures in trade finance, and the very effective collateralization and risk mitigation options available and in common use in export finance. The outcome of the proposed approach will clearly be to raise capital requirements for trade exposures. Note as the tenor benefit under the standardised approach is restricted to transactions with an original maturity less than 90 days, the benefit will be limited.

The proposed move away from the IRB approach will result in an increase in capital requirements and this is illustrated below by constructing a hypothetical portfolio of bank related Trade Finance exposures on the IRB advanced approach, and assessing the capital requirements impact on the standardised approach. The higher capital requirements will likely translate into customer level pricing increases, or might be partially absorbed by banks as part of a business strategy.

It is also probable that the changes will drive a reduction of trade-related capacity and exposure among banks. Such outcomes have already been observed in the past, as banks wrestled with risk or credit capacity constraints, and a similar response arising from capital constraints can be anticipated. We note prior communications from the Basel Committee, indicating a preference for keeping capital requirements increases to reasonable levels, and observe that this intention does not align well with the proposed changes, certainly as relates to the business of trade and export finance.

Relatedly, the ICC Banking Commission and BAFT, along with industry stakeholders and clients are watching with great care, the fast-paced developments and evolutions in the financing of international supply chains, and are mindful of the adverse impacts on this nascent proposition, of a negative regulatory precedent in the traditional trade finance space.

Exposure Type: Banks

All numbers are in USD '000

Rating scale	RWA based on current parameters	RWA based on proposed changes	Expected RWA movement(USD)	Expected RWA movement(%)	Capital based on current parameters	Capital based on proposed changes	Expected Capital movement(USD)	Expected Capital movement(%)
AAA to AA-	*55*	*181*	*126*	*230%*	*4*	*14*	*10*	*230%*
A+ to A-	*19,378*	*95,159*	*75,781*	*391%*	*1,550*	*7,613*	*6,062*	*391%*
BBB+ to BB-	*12,155*	*20,621*	*8,466*	*70%*	*972*	*1,650*	*677*	*70%*
B+ and below	*210*	*214*	*4*	*2%*	*17*	*17*	*0*	*2%*
Total	31,797	116,174	84,377		2,544	9,294	6,750	

B. Recommendations

The ICC Banking Commission and BAFT proposal, respectfully submitted for consideration by the Basel Committee, is to keep bank exposures on the IRB approach with suitable caveats being built into the models in use.

The IRB approach will address the issue of risk differentiation, unrated banks being penalized with higher capital requirements and give due recognition to short-tenors, the caveats on LGD and EAD modelling should address the concerns raised by the Committee on low default portfolios.

Specifically, we recommend:

- The continued use of the IRB approach with stringent rules requiring banks to demonstrate that they have a sufficient number of defaults to develop meaningful models. Where defaults are not sufficient, external data pooling should be allowed. In this context, the ICC Trade Register can serve as a useful source of independent data pooling and a benchmark for comparing individual bank estimates of PD, LGD and EAD for Trade Finance exposures.
- Given the methodological issues surrounding LGD modelling it is recommended that LGD values be set by regulatory authorities and if the Trade Register is used as the reference source then LGD values for Trade Finance exposures can appropriately be set in a conservative range between 40% and 45%.
- In a similar manner, CCF values can be set by regulators for EAD models. As CCF values will vary by product the use of foundation values as a proxy is one alternative recommended for consideration. Note the Trade Register acknowledges many of the methodological issues in modelling EAD and assumes a conservative value of 100% for all Trade Finance exposures in the report, despite the fact that product and transaction characteristics can result in a significantly lower EAD in practice. Note, that as EAD values in practice are lower than 100%, this is not a recommendation to adopt a 100% CCF for all trade finance products.
- Alternatively, the Committee may choose to use the IRB-Foundation approach for these exposures and fix LGD and EAD values at the foundation parameters but allow the maturity floor to be relaxed below the minimum floor value of 1 year.

- If the Committee chooses to go with standardised approach, it is our opinion, that the risk bucketing approach proposed by the IIF, which gives IRB models a role to play in combination with more granular risk weights under the standardised approach is the right option to pursue.

7. Corporate Exposures

A. Summary

The ICC and BAFT acknowledge the Basel Committees' concerns surrounding excessive variability in reported RWAs and the data limitations for portfolios where defaults are historically low. We do however; have some reservations on the proposed solutions, as outlined below.

- For the universe of corporate exposures which will move to the standardised approach there are sufficient data points to reliably estimate risk parameters (i.e. PD, LGD and EAD) and the Trade Register because it pools data from a consortium of banks, is a useful benchmark for this, though it is recognized that trade finance is only a sub portfolio of the broader corporate portfolio.

- The proposals do not provide a risk sensitive outcome for segments of the corporate portfolio and when combined with the fact that many of these corporates and their subsidiaries will not be externally rated, these portfolios will be subjected to punitive increases in capital requirements. Based on the analysis of the Trade Register report provided above, it is our considered opinion that there is a strong case for keeping these portfolios on the IRB approach.

- In the following illustrative scenario a US$10 million receivable finance loan with a maturity of 90 days, the IRB approach will encourage banks to lend to stronger rated obligors as the ROE will be determined by risk based parameters and the return will reflect risk-based income, conversely the move to the standardised approach which is less risk sensitive will incentivize lending to high yield customers, where banks can generate higher returns for the capital deployed, though risks are much higher.

IRB Approach					
Receivables Finance					
Rating	*AA*	*Rating*	*A-*	*Rating*	*BB*
LGD	*45%*	*LGD*	*45%*	*LGD*	*45%*
EAD	*10,000,000*	*EAD*	*10,000,000*	*EAD*	*10,000,000*
Maturity	*90 days*	*Maturity*	*90 days*	*Maturity*	*90 days*
RWA	592,699	RWA	1,738,309	RWA	8,458,495
Margin(bps)	*20*	*Margin(bps)*	*59*	*Margin(bps)*	*350*
RoRWA	**1.9%**	**RoRWA**	**1.9%**	**RoRWA**	**1.8%**
Capital	47,416	Capital	210,101	Capital	676,680
RoE	**17%**	**RoE**	**17%**	**RoE**	**17%**

Standardised Approach(with rating)					
Receivables Finance					
Rating	*AA*	*Rating*	*A-*	*Rating*	*BB*
Risk weight	*20%*	*Risk weight*	*50%*	*Risk weight*	*100%*
RWA	2,000,000	RWA	5,000,000	RWA	10,000,000
Margin(bps)	*20*	*Margin(bps)*	*59*	*Margin(bps)*	*350*
RoRWA	**0.6%**	**RoRWA**	**0.6%**	**RoRWA**	**1.5%**
Capital	160,000	Capital	400,000	Capital	800,000
RoE	**5.2%**	**RoE**	**6.1%**	**RoE**	**14.3%**

- As outlined above, with corporate exposures which move to the standardised approach the increase in capital requirements is material. This is further illustrated below by constructing a hypothetical portfolio of Trade Finance exposures on the advanced approach and then assessing the portfolio level capital impact when these exposures move to the standardised approach. To offset the impact of higher capital requirements banks will either choose to pass on these increases to customers or absorb these increases as part of a broader business strategy. Alternatively, many of these corporates may choose to borrow from other non-bank, potentially unregulated channels and banks may increasingly be disintermediated.

- We have also simulated the impact of moving segments of the corporate portfolio from the IRBA approach to the IRBF approach by constructing a hypothetical portfolio of Trade Finance exposures which indicates that capital increases by approximately 36%. We note this is at odds with the Basel Committees' objectives of keeping capital increases within reasonable limits, as noted earlier in the context of the bank-level treatment of this issue. We would further note that the potential fallout of the increases in capital requirements is a likely withdrawal of financing capacity by global banks in many emerging markets.

Exposure Type: Corporates

All numbers are in USD '000

Rating scale & Exposure Type	Portfolio weight	RWA based on current parameters	RWA based on proposed changes	Expected RWA movement(USD)	Expected RWA movement(%)	Capital based on current parameters	Capital based on proposed changes	Expected Capital movement(USD)	Expected Capital movement(%)
Corporates-assets >€50bln	60%	381,704	537,313	155,609		30,536	42,985	12,449	
AAA to AA-		*447*	*2,957*	*2,510*	*562%*	*36*	*237*	*201*	*562%*
A+ to A-		*14,856*	*74,104*	*59,248*	*399%*	*1,188*	*5,928*	*4,740*	*399%*
BBB+ to BB-		*312,198*	*414,095*	*101,897*	*33%*	*24,976*	*33,128*	*8,152*	*33%*
B+ and below		*54,203*	*46,157*	*8,046*	*15%*	*4,336*	*3,693*	*644*	*15%*
Corporates-assets≤€50bln, turnover>€200mln	30%	337,920	440,875	102,954		27,034	35,270	8,236	
AAA to AA-		*-*	*-*			*-*	*-*		
A+ to A-		*2,848*	*8,043*	*5,194*	*182%*	*228*	*643*	*416*	*182%*
BBB+ to BB-		*259,179*	*320,672*	*61,493*	*24%*	*20,734*	*25,654*	*4,919*	*24%*
B+ and below		*75,893*	*112,160*	*36,267*	*48%*	*6,071*	*8,973*	*2,901*	*48%*
Corporates-assets≤€50bln, turnover<€200mln	10%	114,093	155,137	41,044		9,127	12,411	3,284	
AAA to AA-		*-*	*-*			*-*	*-*		
A+ to A-		*1,431*	*2,440*	*1,008*	*70%*	*115*	*195*	*81*	*70%*
BBB+ to BB-		*87,237*	*106,733*	*19,496*	*22%*	*6,979*	*8,539*	*1,560*	*22%*
B+ and below		*25,424*	*45,964*	*20,540*	*81%*	*2,034*	*3,677*	*1,643*	*81%*
Grand Total		833,717	1,133,325	299,607		66,697	90,666	23,969	

B. Recommendations

The ICC and BAFT propose keeping the internal modelling approach in place, with safeguards being built into these models to address the Basel Committees concerns. Further recommendations include:

- Keeping the IRB advanced approach in place for large corporate groups with assets in excess of EUR50 billion and corporate groups with assets less than or equal to EUR50 billion and revenues greater than EUR200 million, as sufficient data points exist to model PD, LGD and EAD for this segment.

- Introduce data pooling as a means of overcoming paucity of data at individual bank level and combine this with standard benchmarks of default data points necessary to model portfolios to overcome the issue of low defaults. In this context the Trade Register report has the potential to serve as a useful reference point for data pooling and benchmarking exercises.

- Alternatively, as the concerns surround LGD and EAD modelling, introduce regulatory determined LGD and EAD values. These LGD and EAD values should be at a product level and will differ with the nature of the product. Once again in this context the Trade Register becomes a useful reference point for determining LGD and EAD values for Trade products.

- If the concerns raised by the Basel committee are not addressed by the proposed solutions outlined above then allowing the use of the IRBF approach for all corporates is an alternative to be considered.

- The proposed solutions will also address the issue of many corporates and their subsidiaries not having external ratings which results in punitive capital charges being applied to these corporate exposures.

- Clarify that where parent-subsidiary relationships exist and the parent is the majority shareholder in a subsidiary, then the principle of notching the parent company's external rating to determine a subsidiaries rating will be allowed. In this context, also providing a clear definition and examples of what constitutes a 'Group' will be helpful.

8. Specialised Lending – Commodities

A. Summary

The ICC and BAFT agree with the Basel Committee's view that a shortage of historical default data combined with the unique characteristics of this asset class makes modelling for this segment a difficult exercise. We believe some recognition should be given however, to the work done by a few leading banks in investing time and resources to build IRB compliant models and in using data pooling as a means of validating their PD and LGD estimates for these portfolios.

In this context please refer to the '*Discussion Paper on Capital Treatment of Commodity Finance*'[4] jointly sponsored by Association of Financial Markets Europe (AFME), Global Credit Data (GCD) and ICC.

We have concerns over the proposed solution of using the IRB slotting approach. These are outlined in brief below.

- The slotting approach is not risk sensitive as it buckets exposures into four categories. Therefore by definition is not representative of the underlying risk characteristics of a wide range of transactions within this portfolio
- Risk weights assigned to these categories are overly conservative and not reflective of the true underlying risks. Risk weights for the commodities portfolio average between 33% and 52%, depending on whether one uses a maturity assumption of 1 year or 2.5 years. This is also illustrated by the GCD data provided by a group of 8 banks in *the 'Discussion Paper on Capital Treatment of Commodity Finance'[5].* These RWA numbers indicate a substantial gap between historically observed default and loss rates and the risk weights under the slotting approach
- As commodities lending is at the forefront of the real economy facilitating the financing of physical commodities, supply chains and the conversion of these commodities into finished goods, any increase in capital requirements has the potential to reduce financing capacity and adversely impact a sector that is already in crisis, with knock on implications for developing markets where these commodities are typically sourced.

B. Recommendations

To address the potential unintended consequences of the current proposal the ICC and BAFT recommend the following:

- The IRBA/IRBF approaches for commodities lending should be kept within the Specialized Lending category, by making a distinction between banks that have made the investment in setting up a dedicated operational and risk management framework for managing commodities as a unique asset class and banks that have not chosen to go down this path. A scorecard based criteria to determine which banks qualify to use the advanced approaches combined with data pooling as a means of overcoming the lack of historical data to estimate PD should allay many of the concerns raised by the committee around risk modelling for this portfolio. As this portfolio tends to be structured and short-term in nature there is a case for allowing the maturity floor waiver (MFW) in line with the dispensation given by the Basel Committee in 2011 to Trade Products.

[4] Discussion Paper on Capital Treatment of Commodity Finance: http://www.iccwbo.org/Data/Documents/Banking/General-PDFs/Commodity-Finance-Discussion-Paper_10122015_Final/
[5] Idem

Further, as commodities lending tends to be structured, collateralized and managed closely with the help of specialized transaction management units there is a case for recognizing commodities within the collateral framework.

- For banks which do not meet either the criteria applicable to dedicated units set up to manage commodities lending or the standards for IRBA/ IRBF modelling the slotting approach will be the preferred alternative. However, to make it more risk sensitive, the ICC is in agreement with the IIF proposal to expand the range of rating categories with lower risk weights being recommended for structure and collateral specific elements. In this context, the data submitted to GCD is a useful reference point for determining the expanded risk weights, despite the reality that only 8 banks contributed to the data set.
- Given the complex nature of commodities, banks with no dedicated independent units to manage commodities lending, should remain on the standardised approach.

9. Probability of Default (PD)

Given that the Basel Committee's findings confirm a high degree of consistency in banks' assessments of the relative riskiness of obligors, it appears reasonable to allow banks to model PD. The ICC Trade Register substantiates this point and provides a useful benchmark for assessing obligor PDs, even though it is restricted to a set of corporate customers with Trade Finance exposures.

While the use of floors will adversely impact high quality credits at the expense of low quality credits which is counterintuitive from a risk management perspective, the use of a 5bps floor for PD is considered to be moderate in light of the fact that no exposure is really risk free and the adverse impact is likely to be limited to a few portfolios.

10. Loss-Given-Default (LGD)

The ICC and BAFT acknowledge the concerns of the Basel Committee surrounding the modelling of LGD and the lack of sufficient data points to model this parameter.
The Trade Register Report substantiates this view, as the data points available to model LGD are considerably fewer in number than the data points available to model PD. The Trade Register report identifies the practice in many banks of aggregating exposures and recovery data at customer/facility level without being able to break these down to transaction/product level information as the primary reason for not being able to estimate LGD at a product level for trade exposures.

Other contributing factors include the use of varying discount rates, differing practices, processes in the treatment of defaulted loans and product substitution in a work-out situation within banks which often results in a Trade Finance exposure being settled by a debit to the overdraft or operating account.

To address these issues, we consider the introduction of conservative LGD values based on data pooling and more granular product level information or the use of IRBF values to be appropriate for unsecured exposures.

For secured exposures the case for increasing collateral haircuts is recognized and the removal of the minimum collateral requirement is welcome. However, we note that the increase in collateral haircuts and the calibration of the secured LGD floors are extremely conservative as there is a degree of overlap and is only appropriate where there is a lack of recovery data to support the modelling of the LGD parameter. Given the nature of trade products where the structure of the transactions gives banks a degree of control which lends itself to higher recovery rates and lower LGD values there is a case for removing the proposed LGD floor for the IRBA approach and allow banks to model accurate LGD values when supported by robust data[6].

11. Exposure at Default (EAD)

A. Summary

The ICC concurs with the Basel Committee's view that practice-based differences in the banks' estimates of Credit Conversion Factors (CCF) have contributed materially to variances in RWAs. However, it is our considered opinion that practice based differences have arisen at least in part because of definitional issues surrounding CCF, commitments and transaction related contingencies.

These issues require regulatory clarification and guidance, as summarized below:

Definition of CCF: the dual use of CCF as a means of: (i) estimating off-balance sheet exposures and (ii) as a proxy for the estimation of the likelihood that undrawn commitments when made available for off-balance sheet exposures will be drawn, has been the source of varying practices within banks. Whilst an off-balance sheet exposure and a commitment to create an off-balance sheet exposure are similar in nature, they are not identical. It is recommended, that either the definition of CCF be revised or a clarification be made to include the use of CCF as a proxy to determine the utilisation of undrawn commitments.

Definition of Commitments: while the clarification given on the definition of commitments is useful, it is our opinion that the use of the term 'Unconditionally Cancellable Commitment (UCC)' only adds to the existing confusion around terminology and its varying interpretations.
Doing away with the term UCC and substituting it with the word 'uncommitted' would provide much needed clarity.

[6] See ICC Trade Register Report, 2015.

Further, there is a clear need for updating and clarifying the meaning of terms such as:

- Limits
- Facilities and Lines
- Committed versus Uncommitted
- Revocable versus Irrevocable Commitments
- Conditional versus Unconditional

Updated examples of what constitute revocable and irrevocable commitments would also be useful, together with an overhaul of the definitions in part 1 of the glossary of the 1986 paper (which contains definitions / descriptions of guarantees and similar contingent liabilities) many of which are unhelpfully misleading in light of current banking practice.

Definition of Transaction Related Contingencies: a formal definition of transaction related contingencies for products which fall within the ambit of this definition, along with recognition that products may share overarching limits will reduce variability and promote comparability across reported risk weights.

EAD Estimation Methods: the lack of definitional clarity and regulatory guidance has contributed to varying interpretations and by extension, to banks adopting differing approaches to estimating EAD.

The proposals outlined by the Basel Committee imply the use of a single approach namely the 'fixed horizon method' however, as banks have adopted differing approaches to EAD estimation, and as modelling drawdown behaviour of unutilised limits is different from modelling likelihood of an off balance sheet exposure becoming an on balance sheet exposure, the Committee should consider the benefits and the consequences of requiring a single approach.

Unconditionally Cancellable Commitments (UCC): the Committee's proposal to remove the 0% CCF for UCC will have a material impact on the availability of credit in many markets. In line with our comments made above on UCC, it is the view of the ICC Banking Commission and of our stakeholder community that these are uncommitted unadvised lines and that many Trade Finance and Receivables Finance exposures and related facilities are therefore uncommitted. Typically, these facilities are closely monitored, with drawings subject to meeting specific criteria. Customer facility documentation provides banks with the ability to stop further drawdown and/or demand repayment of existing exposures. Any drawdown, post notification of withdrawal of facility or actual default would be due to failure of operational process, which is accounted for under Operational Risk. The level of drawdown under Trade Finance and Receivables Finance is particularly influenced by business volumes that enable a company to obtain funding for sales or purchases. These often reduce before a company would go into default and therefore the assertion of a high level of drawdown before default (save for wilful fraud e.g. fictitious invoices) is not evidenced in our view.

The 2015 edition of the ICC Trade Register Report evidences that Trade Finance and Export Finance instruments exhibit much lower credit risks, including the risk of drawing when compared with revolving credit facilities or term loans.

It is our understanding that the Committee has assumed that the level of drawing of certain loan facilities, particularly in the SME sector, is highest immediately before a default. While this may be true for the SME sector it does not necessarily apply to larger corporates to the same degree, and specifically does not apply to Trade, Export and Receivables Finance activity.

Further, Trade Finance instruments (governed by various sets of globally recognized ICC rules including the Uniform Customs and Practice for Documentary Credits, for example) and Receivables Finance (governed by ABFA/FCA industry guidelines) are not subject to consumer protection laws, risk management dynamics or reputational risk considerations that might tend to discourage banks to cancel such commitments.

We believe that applying an inappropriate "one-size-fits-all" CCF to Trade Finance and Receivables Finance increase borrowing costs to the real economy and could distort incentives, in particular for promoting global economic growth.

Floor Values: the removal of CCF modelling in most cases combined with the imposition of a single 50% CCF floor across a broad spectrum of off-balance sheet exposures including Trade products will significantly overstate risk for trade products. The resulting CCF values are neither reflective of available Trade Register data or industry experience.

B. Recommendations

We recommend the Committee consider a differentiated risk and practice-aligned CCF to apply for Trade Finance and Receivables Finance facilities where the bank confirms that such facilities are subject to:

a) *Explicit legal confirmation that the bank is not restricted from cancelling the uncommitted credit facility,*
b) *The underlying activity being transacted/financed is Trade or Receivables Finance related, and;*
c) *The bank executes each drawdown under such facility on a case by case (transactional) basis.*

We also ask the Committee to work towards consistent CCFs with the Foundation/Standardised approach and those used under Leverage Ratio. Given the wide range of off balance sheet trade products with differing characteristics the use of a 50% CCF floor is punitive and the use of two tiers of CCF floors at 20% and 50% is recommended.

As Trade Finance exposure is one area where the impact is likely to be significant, it would be helpful to clarify that the CCF of 20% for Documentary Letters of Credit and 50% for transaction related contingent items applicable under the revised standardised approach will also be available under the foundation approach.

Extending these CCF values as floor values to the advanced approach is also recommended and this is based on the analysis provided within the Trade Register Report.

The ICC further recommends that explicit guidance be provided on the CCFs applied to off-balance sheet trade finance exposures (e.g. import L/C, export L/C confirmations, acceptances and guarantees) and officially supported export credits when these products are structured as committed facilities/limits.

As outlined above, these terms are often used interchangeably to reflect varying practices within banks and, the CCF for these facilities should be the exposure/product based CCF of 20% and 50%. We also note that such clarification will provide consistency with the existing standardised approach that when there is a commitment to provide an off-balance sheet item, banks are to apply the lower of the two applicable CCFs (in other words when import L/C, export L/C confirmations and guarantees are structured as commitments/limits/facilities then the product based CCF of 20% and 50% will still apply).

12. Maturity

The ICC and BAFT believe that the requirement to apply the facility expiry date in lieu of the transaction expiry date for the IRBA approach and the use of a fixed 2.5-year maturity for IRBF approach is not justified given that the credit risk in transactions with longer maturity is higher than shorter maturity transactions.

The potential impact of these changes on TF exposures is material, so clarifying that the modifications to the maturity calculations undertaken by the Basel Committee in its 2011, review of the treatment of Trade Finance under the IRB approach will remain, will be helpful. The ICC Trade Register provides valuable data across a broad range of Trade products in establishing the short-term nature of trade products.

We therefore request the Basel Committee confirm that the maturity waiver agreed for Trade Finance remains applicable under the new proposed rules for the IRBA approach. Further, to avoid variation in national interpretation of these regulations, clarification is also required that the maturity floor waiver will be applicable under the IRBF approach. The impact of misaligned treatment of trade finance, particularly on the short-term end of the market, against well-documented average tenors, has material adverse impacts on the capital cost associated to trade finance, and inappropriately nullifies a key characteristic of trade finance exposures which are clearly short term in nature, as demonstrated through the ICC Trade Register.

13. Credit risk mitigation (CRM):

The ICC and BAFT favour keeping the double default approach as the risk of both a borrower and a guarantor defaulting on the same obligation at the same time is substantially lower than the risk of either one of the counterparties defaulting. In Trade Finance transactions where risk is transferred and shared with banks when large value performance guarantees, standby letters of credit and export confirmations are issued, the removal of the 'double default' approach would overstate risk and reduce incentives for banks to book such exposures. Additionally, in emerging markets where there is a reliance on trade credit insurance as a means of hedging risk the removal of this approach has the potential to reduce trade financing capacity.

We also note that the consultative document is silent on the treatment of credit insurance and guarantees when applied across the Standardised, IRBA and IRBF approaches. A clarification on how this will work in practice when the corporate obligor is on the IRBF or IRBA approach and the guarantor is on the standardised approach is necessary. In the absence of a clarification, corporate exposures backed by a bank guarantee may well be treated as unsecured exposures with a knock on impact on pricing and credit appetite for such corporate exposures. This is surely an unintended consequence of the Committee's proposed changes.

14. Eligible Purchased Receivables:

We note that the consultative document does not address the application of the 'top down' approach which allows a portfolio level PD to be determined from the pools expected loss (EL). Given that receivable finance (RF) is a key Trade Finance related product clarifying the use of the top down approach for IRB portfolios will be helpful.

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