International Chamber of Commerce
The world business organization

Position Paper

Prepared by ICC Commission
Banking Technique and Practice

ICC response to the Basel Committee Consultative Document on "Strengthening the Resilience of the Banking System"

Highlights

- The Basel Committee proposal
- The Impact on Trade Finance Instruments
- Potential Implications
- ICC Recommendations

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ICC response to the Basel Committee Consultative Document on “Strengthening the Resilience of the Banking System”

1. The International Chamber of Commerce

1.1. The International Chamber of Commerce (“**ICC**”) is the largest, most representative business organization in the world. Its thousands of member companies in over 120 countries have interests covering every sector of private enterprise.

1.2. The ICC Banking Commission is the leading global rule-making body for the trade finance industry; as well as a worldwide forum for trade finance experts whose common aim is to facilitate international trade finance. The Banking Commission has more than 500 members in 70 countries, many of them from emerging countries.

1.3. The Banking Commission is known for producing universally accepted rules and guidelines for documentary credits, documentary collections, bank-to-bank reimbursements and bank guarantees. ICC’s voluntary market-based approaches have often been praised for leveling the playing field in trade finance practices. In recent years, the Commission has developed strong market intelligence capabilities to serve the trade finance industry and to fill the information gap from a global perspective.

1.4. Our comments, which have been developed through extensive consultations with our member companies, are set out in the following order: (i) a short review of the key features of trade financing; (ii) detailed comments on the proposals applicable to trade products; and (iii) a number of recommendations. Please do not hesitate to let us know if any elaboration/clarification of our views would be of use.

2. Trade finance and world trade

2.1 World trade inherently relies upon reliable, adequate, and cost-effective sources of financing, both long-term (for capital investments) and short-term (to fill the time-lag between the production of goods and receipt of payments). The latter, known as “trade finance”, has been associated with the expansion of international trade in the past century, and has generally been considered a routine operation—providing fluidity and security to the movement of goods and services.

2.2 Best-estimates suggest that the bank-intermediated trade finance underpins around 30 per cent of world trade. Trade finance facilities provided by banks to importers and exporters can include:

a) commitments such as opening letters-of-credit (“**LCs**”); accepting and confirming LCs; and issuing performance guarantees, bid bonds and standby letters of credit;

b) financing such as negotiation and discounting of export bills, pre-export financing, post-export financing and import financing.

2.3 Trade finance has historically maintained a low risk profile in comparison with other financial instruments. This primarily reflects the fixed, short-term maturity of trade finance products, and the fact that exposures are liquidated by cash upon maturity. In addition, the transactional nature of trade financing allows banks to carefully manage exposures.

2.4 The global financial crisis gave rise to concerns about a significant shortfall in the supply of trade finance—particularly in developing and emerging economies. At the April 2009 London Summit, the G-20 agreed on an ambitious package of measures to support the flow of trade finance to businesses. Despite these impressive commitments, however, a survey undertaken by ICC in September 2009 indicated that concerns remain as to the ability of the banking sector to meet any significant upturn in demand for credit in the current environment.

3. The Basel Committee proposals and trade finance

3.1. In the context of the proposed leverage ratio calculation—and in view of ICC's core mandate to promote and facilitate international trade—we have been concerned to note the potential implications for trade finance of the proposals set out in paragraphs 232 – 233 of the consultative document, related to the introduction of a new framework to limit the build-up of excessive leverage in the banking system.

3.2. Without commenting on the appropriateness of a new mechanism to limit bank leverage, ICC has been concerned to note that the proposals group trade products with a number of other instruments which exhibit significantly different characteristics. It is our contention that this approach is unjustified; and, moreover, is liable to lead to an overall reduction in the supply of trade finance. A detailed analysis of the proposals is set out in the paragraphs below.

4. The leverage ratio constraint and "off-balance sheet" items

4.1. Under the current Basel II framework, the most frequently used Credit Conversion Factors ("CCF") for off-balance sheet trade products are:

- 20% for "trade-related contingencies"—i.e. contingent liabilities that arise from trade-related obligations underpinned by the movement of goods or the provision of services (e.g. LCs and shipping guarantees); and
- 50% for "transaction related contingencies"— guarantees that support certain performance obligations of a borrower, the calling of which are contingent on the overall performance (rather than financial position) of the borrower (e.g. performance guarantees).

These CCFs are used to adjust the risk weighted asset calculation to reflect the fact that not all of the off-balance sheet exposure will necessarily convert to on balance sheet exposure.

4.2. Paragraphs 232 and 233 of the consultative document propose, however, to increase the CCF for all off-balance sheet exposures—including trade products—to 100% for the purposes of calculating a leverage ratio constraint. We understand that this proposal is based on the view that:

a) all off-balance sheet items are a significant source of leverage within the financial system; and

b) the failure to include off-balance sheet items in the measure of exposure creates an "incentive to shift items off the balance sheet to avoid the leverage ratio constraint".

4.3. ICC considers that this blanket approach to "off-balance sheet" items under the proposed leverage ratio, is based on a fundamental misunderstanding of both the operational context and the mechanics of trade financing. Specifically:

a) it is difficult to maintain that trade-related exposures are a source of significant leverage as the underlying transactions are driven by genuine economic activity—e.g. the sale of goods or services;

b) as trade transactions are originated at the request of a client, these types of facilities are unlikely to be established to avoid leverage constraints;

c) trade related exposures are also unlikely to contribute to fluctuation in asset prices as they are short-term in nature and liquidated by payment at maturity.

4.4. What is more, the conversion of contingent trade products from off- to on-balance sheet is not automatic—and in almost all cases is detached from an event of default—with draw-downs contingent on compliance with documentary requirements. This process contrasts with credit substitutes, including financial standby letters of credit and guarantees, which are often honoured where a complying demand is made or at maturity, only after a statement of breach is presented—i.e. with much less documentation and particularly third party documentation. Also, the default of the counterparty—unlike in credit default swaps—does not in itself automatically crystallize the conversion of a trade documentary credit and similar instruments from off- to on-balance sheet. A more detailed review of the conversion cycle for off-balance sheet trade products is provided in Annex 1, below.

4.5. We are also aware of concerns related to the proposals to assign a 100% CCF to unconditionally cancellable commitments, which would include commitments for trade-related and transaction-related contingencies (as these are often offered on an unconditionally cancellable basis). We would ask that the Basel Committee gives further consideration to how this may impact on structure of trade financing and the responsiveness of provision.

5. Potential implications and ICC recommendations

5.1. Increasing the CCF to 100% for trade- and transaction-related contingencies for the purposes of calculating a leverage ratio could adversely affect the provision of trade finance instruments since banks may well be able to achieve higher yields with non-trade products. Consequently, where the leverage ratio becomes the "binding constraint", banks may choose to increase the cost of providing trade products; or only selectively offer these products to customers.

5.2. It is our fundamental concern that this cycle will adversely impact on the supply of cost-effective trade credit, thus compounding existing, well-known market constraints. Such a situation would likely risk a significant dislocation of trade—contrary to the G-20 London Summit agenda to promote trade as engine of renewed growth.

5.3. As such, ICC recommends that if a leverage ratio is to be adopted, **off-balance sheet trade products should be allowed to retain the CCF values used by banks under the current "risk weighted assets" calculation.** This would point in the same direction as foreseen in the "additional option for impact assessment" in the consultative document, which would allow financial institutions to "Apply a lower (positive) CCF for unconditionally cancellable commitments or Basel II standardized CCFs".

5.4. Given the broader concerns that exist about the impact of Basel II on trade financing, we suggest that it may be timely for the Basel Committee to establish a **specialist trade finance "working group"**. Such a group, we believe, would be well placed to examine some of the issues that arise when applying the existing regulatory framework to trade facilities, as well as the trade-related aspects of the Basel Committee's proposals. ICC would be delighted to participate in the work of such a group if this would be of use.

Annex 1 – Conversion cycle of contingent trade exposures from off- to on-balance sheet

A. Import Letters-of-Credit

Import LCs are trade-related contingencies which are currently prescribed a CCF of 20% under the Basel II standardised/foundation approach.

In its simplest form, an import LC is normally issued by a bank on behalf of a purchaser of merchandise or a recipient of services, in favour of a beneficiary, usually the seller of the merchandise or provider of services. The issuer (usually a bank) irrevocably promises to pay the seller/provider if presented with documents which comply with the terms and conditions of instrument.

In this way, the obligation of the bank to pay the beneficiary is contingent not only on the exporter delivering the correct documents as detailed in the LC, but also on all requirements of the instrument being complied with. As such, with one or two minor specialist exceptions, an LC will remain an off-balance sheet exposure until the documents are presented and honoured by the bank—usually in accordance with the provisions of a standardized code of practice, the ICC Uniform Customs and Practice for Documentary Credits (**"UCP 600"**).

Until this event occurs, there is a probability that the LC might never convert to an on-balance sheet exposure even in the event that the importer defaults. In this connection, it is instructive to note that the majority of documents presented to issuing and nominated banks are discrepant. When this occurs, there is no obligation on the bank to waive the documentary discrepancies and make payment, unless the applicant waives the discrepancies or documents complying with the credit are presented within its validity. The experience of trade professionals is that documents are seldom compliant. Previous ICC research has estimated that around 70% of documents are discrepant on first presentation.

Furthermore, if the documents are compliant and/or accepted by the issuing bank, the latter normally has pledge on these documents which usually give control on the underlying goods. So, in case the issuing bank accepted the documents but does not feel comfortable with the credit risk on its client/applicant, the bank can withhold the documents and the related goods. This inherent "collateral" reduces the loss ratio banks have with utilised import LCs.

B. Confirmation of Letters-of-Credit issued by other banks

In some cases an exporter may not be comfortable with the credit worthiness of the bank that issues the LC. In this case, the exporter may request its bank to "confirm" the LC. When a bank adds its confirmation it provides a commitment to pay the exporter once compliant documents are presented and all terms and conditions of the L/C are complied with. Again, LC confirmations are trade-related contingencies which are currently prescribed a CCF of 20% under the Basel II standardized/foundation approach.

From the perspective of the confirming bank, the risk of an exposure is contingent on three factors: (i) compliant documents being presented; (ii) any additional terms and conditions of the LC being complied with; and (iii) the issuing bank failing to honour its commitment to pay.

Historically, where an issuing bank fails to honour its commitments, sovereigns and multilateral development banks have usually intervened to ensure that trade commitments in the issuing bank's country are given priority in any rescheduling. This further reduces the risk that an off-balance sheet exposure will crystallize into on-balance sheet exposure in the case of a counterparty default.

A special form of confirmed LCs are those whereby the confirming bank has incurred a deferred payment undertaking but, in addition to this, has also financed (funded) its own deferred payment undertaking. As long as a confirmed LC is not funded or financed it remains off-balance, but from the moment such financing is undertaken by the confirming bank, the latter has to change its risk/commitment from off- to on-balance sheet.

C. Performance Standby Letters-of-Credit and Guarantees

Performance standby letters-of-credit ("**SBLC**") and performance guarantees are forms of transaction related contingency that support certain performance obligations of a borrower. Under the Basel II standardized approach these transaction-related contingencies are currently ascribed a CCF of 50%.

Prior to providing a performance SBLC or performance guarantee, a bank will check that there is an underlying commercial contract and that the calling of the instrument is triggered by a performance event, usually evidenced by documentation—and not the customer failing to pay monies. As such, even in the event of default, a contingent SBLC will not necessarily result in an on balance sheet exposure.

As an example, take a performance SBLC where drawings under the instrument are conditional upon the applicant not fulfilling its obligations to the agreed standard specified in the underlying contract. However, it should be noted that SBLCs are normally documentary in nature, with compliance being determined by examination of the documents presented.   In many cases, a bankruptcy filing on the part of the applicant will not impact performance under existing commercial contracts, therefore providing no justification for a drawing under the performance SBLC.

D. Demand Guarantees

In contrast to the above products, Demand Guarantees are ascribed a CCF of 100%. This is because the Basel Accord is specific in stating that bank guarantees or standby letters of credit that are direct credit substitutes (i.e. financial in nature) must have a CCF of 100%. As such the proposed changes in the Basel consultative document will only change the CCF under the proposed leverage ratio for transaction related contingencies.

The International Chamber of Commerce (ICC)

ICC is the world business organization, a representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world.

The fundamental mission of ICC is to promote trade and investment across frontiers and help business corporations meet the challenges and opportunities of globalization. Its conviction that trade is a powerful force for peace and prosperity dates from the organization's origins early in the last century. The small group of far-sighted business leaders who founded ICC called themselves "the merchants of peace".

ICC has three main activities: rules-setting, dispute resolution and policy. Because its member companies and associations are themselves engaged in international business, ICC has unrivalled authority in making rules that govern the conduct of business across borders. Although these rules are voluntary, they are observed in countless thousands of transactions every day and have become part of the fabric of international trade.

ICC also provides essential services, foremost among them the ICC International Court of Arbitration, the world's leading arbitral institution. Another service is the World Chambers Federation, ICC's worldwide network of chambers of commerce, fostering interaction and exchange of chamber best practice.

Business leaders and experts drawn from the ICC membership establish the business stance on broad issues of trade and investment policy as well as on vital technical and sectoral subjects. These include financial services, information technologies, telecommunications, marketing ethics, the environment, transportation, competition law and intellectual property, among others.

ICC enjoys a close working relationship with the United Nations and other intergovernmental organizations, including the World Trade Organization and the G8.

ICC was founded in 1919. Today it groups hundreds of thousands of member companies and associations from over 120 countries. National committees work with their members to address the concerns of business in their countries and convey to their governments the business views formulated by ICC.

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