

# **The Impact of Basel III on Commodity Trade Finance: Legal And Regulatory Aspects**

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# LEGAL ANALYSES

## The Impact of Basel III on Commodity Trade Finance: Legal And Regulatory Aspects

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Banking supervision; Commodity markets; International standards; Risk management

### Basel III overview

In the aftermath of the financial crisis of 2008, governments felt it necessary to toughen capital standards for the banking industry. The implementation of the international capital requirements framework agreed by the Basel Committee on Banking Supervision, known as Basel II, had barely been implemented when the financial crisis occurred (and it was not implemented in all Member Countries, notably the United States), that it was felt necessary to amend and strengthen Basel II in the light of the crisis. This is what is known as Basel III. Basel III is part of the Committee's continuous effort to enhance the banking regulatory framework. It builds on the Basel I and Basel II documents, and seeks to improve the banking sector's ability to deal with financial and economic stress, improve risk management and strengthen the banks' transparency.

Two documents: *Basel III: A Global Regulatory Framework for more resilient banks and banking systems* and *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* present the Basel Committee's reforms to strengthen global capital and liquidity rules with the aim of promoting a more resilient banking sector.<sup>1</sup> Basel III establishes tougher capital standards through more restrictive capital definitions, higher Risk Weighted Assets ("RWA"),

additional capital buffers, and higher requirements for minimum capital ratios. Primary sources for RWA increases include trading market risk, securitisation exposures and over-the-counter ("OTC") derivatives counterparty exposure. As well as rethinking their business models, many banks will need to achieve upgrades in the areas of stress testing, counterparty risk, and capital management infrastructure.

Basel III also establishes new liquidity standards that will drive changes in banks' balance sheet composition to limit illiquid assets, restrict wholesale or unstable sources of funding, and manage higher funding costs. These new standards will have a broad impact across most banks, particularly those that focus on commercial and wholesale banking activities.

At the heart of the financial crisis that we lived through was liquidity. Basel III requires: a) more assets to be of a high quality "liquid" nature (like cash and highly rated government bonds); and b) more of the wholesale funding to be of a long dated and stable nature, so as to minimise the risk of having to renew it at times of stress.

Basel III's increased capital and liquidity requirements will have significant systemic and idiosyncratic effects across the banking industry and capital markets. Higher capital and funding costs should incentivise banks to move toward different business models. Some examples of anticipated changes and opportunities include:

1. Shrinkage of securitisation market and structured credit businesses putting pressure on originate-and-sell lending businesses.
2. Reduced volumes in OTC derivatives and migration to clearing houses.
3. Emphasis in customer facilitation activities with reduction of trading inventories particularly of less liquid assets such as low credit quality, commodity and emerging market instruments—thus reducing the liquidity of those market segments and resulting in block trading opportunities.
4. Expansion of businesses dedicated to trade clearing, trade processing and servicing.
5. Transfer of proprietary trading to hedge funds.
6. Increased competition from less regulated firms and potential loss of human capital to new entrants.
7. New structuring opportunities for banks considering contingent capital instruments.
8. Pricing strategies will be altered in those businesses that over the medium term are not able to deliver acceptable returns.

For many institutions, Basel III's liquidity challenge is likely to be greater than its capital challenge. In anticipation of the Basel III impact on liquidity, firms are likely to reduce the number of their businesses with an

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<sup>1</sup> *Basel III: A Global Regulatory Framework for more resilient banks and banking systems*, publication, BIS, December 16, 2010 available at <http://www.bis.org/publ/bcb189.htm> [Accessed June 24, 2011].

unfavourable liquidity treatment; raise the liquidity of their investments; raise their retail deposits; increase their additional long-term debt and capital; reduce their committed credit and liquidity facilities; reduce their wholesale credit; and adjust their pricing to compensate for the higher cost of funding.

In its October 2010 report, G20 Leaders made recommendations on implementing OTC derivatives market reforms, set out actions and timelines for achieving reforms in the OTC derivatives markets and also considered what future work may be needed on commodity derivatives. The Financial Stability Board (“FSB”) will consider recommendations regarding commodity derivatives market regulation and supervision in the context of the agreed reforms to OTC derivatives

markets more generally, and IOSCO will deliver a final report on supervision and regulation of commodity derivatives markets by the autumn.

The national implementation of Basel III by the Member Countries will begin from January 1, 2013. As part of this implementation, banks in each of the Member States should meet the following new minimum requirements in relation to RWA:

- 3.5 per cent Common Equity/RWAs;
- 4.5 per cent Tier 1 Capital/RWAs; and
- 8.0 per cent Total Capital/RWAs.

In summary form, the following table sets out the major differences between Basel II and Basel III:

BASEL II:	BASEL III:
<b>A. Tier Capital</b>	
Tier 1 capital ratio = 4% Core Tier 1 capital ratio = 2%	Tier 1 Capital Ratio = 6% Core Tier 1 Capital Ratio (Common Equity after deductions) = 4.5%
The difference between the total capital requirement of 8.0% and the Tier 1 requirement can be met with Tier 2 capital.	The difference between the total capital requirement of 8.0% and the Tier 1 requirement can be met with Tier 2 capital.
<b>B. Capital Conservation Buffer<sup>2</sup></b>	
There is no capital conservation buffer.	<ul style="list-style-type: none"> <li>• Banks will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress bringing the total common equity requirements to 7%.</li> <li>• Capital Conservation Buffer of 2.5 percent, on top of Tier 1 capital, will be met with common equity, after the application of deductions.</li> <li>• Capital Conservation Buffer before 2016 = 0%, January 1, 2016 = 0.625%, January 1, 2017 = 1.25%, January 1, 2018 = 1.875%, January 1, 2019 = 2.5%</li> </ul>
<b>C. Countercyclical Capital Buffer</b>	
There is no countercyclical capital buffer.	<ul style="list-style-type: none"> <li>• A countercyclical buffer within a range of 0%-2.5% of common equity or other fully loss absorbing capital will be implemented according to national circumstances.</li> <li>• Banks that have a capital ratio that is less than 2.5%, will face restrictions on payouts of dividends, share buybacks and bonuses.</li> <li>• The buffer will be phased in from January 2016 and will be fully effective in January 2019.</li> <li>• Countercyclical Capital Buffer before 2016 = 0%, January 1, 2016 = 0.625%, January 1, 2017 = 1.25%, January 1, 2018 = 1.875%, January 1, 2019 = 2.5%</li> </ul>
<b>D. Capital For Systematically Important Banks Only</b>	
There is no capital for systemically important banks.	<ul style="list-style-type: none"> <li>• Systemically important banks should have loss absorbing capacity beyond the standards announced by Basel III and work continues on this issue in the FSB and relevant Basel Committees.</li> <li>• The Basel Committee and the FSB are developing a well integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt.</li> </ul>
<b>Total Regulatory Capital Ratio = [Tier 1 Capital Ratio] + [Capital Conservation Buffer] + [Countercyclical Capital Buffer] + [Capital for Systemically Important Banks]</b>	

<sup>2</sup> The purpose of the conservation buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. While banks are allowed to draw on the buffer during such periods of stress, the closer their regulatory capital ratios approach the minimum requirement, the greater the constraints on earnings distributions.

Basel III also involves the implementation of a Leverage Ratio, the transition period for which started on January 1, 2011. It should also be noted that there are signs that regulatory fragmentation is increasing. Switzerland, Britain and the United States are all taking unilateral measures.

## The impact on Commodity Trade Finance (“CTF”)

Trade Finance is fundamental to commodity trade and to international development. This explains the sensitivity of the G20 to CTF and, for example, the involvement of UNCTAD in several leading initiatives.<sup>3</sup> One of the challenges is that there is no universal definition for the term “Trade Finance” and it has different connotations for different people. This may be the root cause of many misunderstandings.

For Basel II, Commodity Finance is:

“structured short-term lending to finance reserves, inventories, or receivables of exchange-traded commodities (e.g. crude oil, metals, or crops), where the exposure will be repaid from the proceeds of the sale of the commodity and the borrower has no independent capacity to repay the exposure. This is the case when the borrower has no other activities and no other material assets on its balance sheet. The structured nature of the financing is designed to compensate for the weak credit quality of the borrower. The exposure’s rating reflects its self-liquidating nature and the lender’s skill in structuring the transaction rather than the credit quality of the borrower.”<sup>4</sup>

Banks, businesses and industry bodies are now concerned that if Basel III is not modified to make allowances for trade financing, international business—vital to securing a return to global growth—will once again be stymied by a lack of available funding. Specifically, the proposed Basel III has raised fears among bankers that trade financing could become prohibitively expensive: the impact on the global economy could be massive—as much as a \$270bn (1.8 per cent) reduction in international trade flows and 0.5 per cent reduction in global gross domestic product (“GDP”), according to estimates from Standard Chartered Bank.

Whilst corporate financing focuses mainly on companies with a stable and solid financial background, but requiring strong working capital to finance their core business, CTF does not base itself on a corporate balance sheet, but on the goods financed. Indeed, one of the major characteristics of international trading companies, except for large corporates, is their relatively low capitalisation. With this method, the banks need to monitor the physical flow of goods since they represent their main collateral.

Effectively, transaction-based financing requires a thorough evaluation of risks and an accurate follow-up of transactions financed.

The third form of financing is in fact a mix of corporate finance and CTF. This third method, including balance sheet analysis and transaction-based financing, has become much more common, and represents the future in terms of commodity trade finance. The purpose of such practice is that banks can back their risks both on collaterals and on a financed company’s balance sheet. This interesting way of financing can be defined as a tailor-made solution for a corporate needing financing depending on the particularities of their activities and their cash flows. This method requires a vast knowledge of the commodity markets and of the businesses seeking financing.

One of the key challenges raised by Basel III for CTF is the principle that off-balance-sheet (“OBS”) instruments are a significant source of leverage for banks, and should be considered in an institution’s overall list of obligations and limited. But planned leverage ratios will not account for the risk profile of a loan, so lower risk trade obligations—such as bonding or letters of credit—may be caught up with other, riskier, OBS instruments.

Some predict that if Basel III is implemented as it currently stands it could lead to a reduction in global trade finance capacity, as well as increases in pricing of as much as 40 per cent. As a result, major trade finance providers are lobbying to secure less stringent capital rules and specific provisions for trade finance.

In an odd way CTF is a victim of its successful history and the low default history rendering CTF portfolio difficult to analyse in a Basel II/Basel III context largely based on default statistical data. As indicated by Donna Alexander, CEO of BAFT-IFSA:

“Trade finance instruments have historically maintained a low risk profile in comparison with other financial instruments. We are concerned that the consultative document does not account for their intrinsically safe structure. We wish to ensure that unintended consequences are avoided, and any changes ultimately adopted do not result in reduced trade flows for trade-focused banks at a time when they are essential to continued economic recovery around the globe.”<sup>5</sup>

Basel III provides that the Basel Committee recognises that OBS items are a source of potentially significant leverage; therefore banks should calculate the above OBS items for the purposes of the leverage ratio by applying a uniform 100 per cent credit conversion factor (“CCF”). Increasing the CCF to 100 per cent for trade-related

<sup>3</sup> See, e.g. the Global Commodities Forum organised by UNCTAD in 2010 and 2011 dedicated to a substantial part to CTF.

<sup>4</sup> Paragraph 224 of “International Convergence of Capital Measurement and Capital Standards—A Revised Framework” (BIS, June 2004).

<sup>5</sup> See *GTR Trade Finance News* April 20, 2011 on [http://www.gtrreview.com/trade-finance/global-trade-review-news/2010/April/Basel-III-causes-concern-in-trade-finance-\\_8133.shtml](http://www.gtrreview.com/trade-finance/global-trade-review-news/2010/April/Basel-III-causes-concern-in-trade-finance-_8133.shtml) [Accessed June 24, 2011].

contingencies for the purposes of calculating a leverage ratio could significantly disadvantage trade finance-focused banks.<sup>6</sup>

When the leverage ratio becomes compulsory, a bank may choose to increase the cost of providing trade products or selectively offer these products to customers, which will undoubtedly impact the perspectives of trade finance. It is not appropriate to apply 100 per cent CCF to trade-related OBS items such as L/Cs and L/Gs in calculation of leverage ratio under Basel III. This calculating method fails to differentiate trade finance products from other riskier OBS financial instruments and denies the historical data that exposures to CTF assets have been overall safe assets to hold. Trade finance products are often of a short-term and self-liquidating nature and closely related to the activities of the real-economy with actual trade background of goods and services. In other words, this sort of transaction is based on the real-economy need of customers and totally satisfies the demand of customers for credit enhancing, settlement and financing in the trade of goods and services. Compared with OBS synthetic financial instruments, it cannot increase market risk.

Consequently, it seems difficult to justify treating CTF related OBS items as the significant source of excessive leverage, adopting 100 per cent CCF to restrain them, and putting CTF exposures in the same category as, for example, a Credit Default Swap on a reference asset not even owned by the bank.

The new liquidity ratios introduced by Basel III—Liquidity Coverage Ratio and Net Stable Funding Ratio—allow national discretion on all other contingent funding liabilities such as trade finance and Letters of Credit when calculating the amount of liquid assets and stable funding required to match the potential liabilities. This discretion could be used by some national supervisors to implement onerous liquidity requirements, which may restrict the availability of trade credit even further.

The new Basel III regulations include an increase on capital requirements for trade finance transactions, which are generally fixed, short-term instruments that are self-liquidating by nature and therefore, low-risk. Therefore, the new proposals have unintended consequences of worsening trade finance conditions for companies—including, small- and medium- sized enterprises—involved in the import/export business, especially in emerging markets.

There were already some recriminations and concerns in the trade finance industry about the effect that Basel II had on trade finance in terms of capital requirements under the standardised approach.<sup>7</sup> As an example of BAFT-IFSA's concerns, according to the Basel committee's consultative paper on strengthening banks' capital requirements, off-balance sheet items are deemed sources of "potentially significant leverage". Trade instruments such as letters of credit and standby letters of credit are included in this category. The Basel Committee has proposed to implement an increased leverage ratio constraint on these off-balance sheet items by increasing the CCF used to 100 per cent. Many believe this move unfairly penalises trade finance assets which are far more secure and safe than other off-balance sheet items. It seems that CTF products do not contribute to excessive leverage as they are tied to client transactions, nor do they contribute to a downward pressure on asset prices as they are short-term and self-liquidating financing tools. BAFT-IFSA proposes for a 20 per cent CCF rate to be applied to trade items, as an increase to 100 per cent will ultimately encourage banks to divert capital to other products instead. This proposal can only seem reasonable to anyone involved in CTF.

It is very positive to see the regulator striving to improve the banking system and aiming to tackle excessive leveraging, one of the focus points of Basel III. This sounds good except for the fact that CTF might end up being an unexpected casualty because it is subject to an off-balance-sheet treatment which would now have to bear a flat 100 per cent credit conversion factor. While there may be some logic in tightening the treatment of some "risky" off-balance-sheet financial instruments, there is less sense in stricter regulation of LC and similar documentary credits. In the communiqué of the Seoul summit in November 2010, the G20 reiterated its concerns, stating that "we agree ... to evaluate the impact of regulatory regimes on trade finance".<sup>8</sup>

In its initial representations, the trade finance industry mainly targeted the estimates of weights for credit risk under the Internal-Ratings based approach of Basel II and the one-year floor for the maturity of exposures. The weights for credit risk, the industry maintained, did not take proper account of the low risks of much trade finance for which various documentary techniques assign and transfer physical and legal control of the goods shipped until payment. As part of the initiative to arouse the interest of the policymakers to the impact on trade finance, the ICC and the Asian Development Bank have

<sup>6</sup> Paragraph 163 of BIS "Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010" indicates: "The Committee recognises that OBS items are a source of potentially significant leverage. Therefore, banks should calculate the above OBS items for the purposes of the leverage ratio by applying a uniform 100% credit conversion factor (CCF)."

<sup>7</sup> See Alexander R. Malaket, "A step backward for trade finance" in *Trade Finance*, November 2009 pp.22–25. Also see Gilles Thieffry, "The impact of Basel II on Commodity Trade Finance: A legal perspective" [2004] *J.I.B.L.R.* 10 pp.398–401.

<sup>8</sup> The G20 Seoul Summit Leaders' Declaration November 11–12, 2010. Available on [http://media.seoulsummit.kr/contents/dlobo/E1...Seoul\\_Summit\\_Leaders\\_Declaration.pdf](http://media.seoulsummit.kr/contents/dlobo/E1...Seoul_Summit_Leaders_Declaration.pdf) [Accessed June 24, 2011]

established the ICC-ADB Trade Finance Default Register.<sup>9</sup> The results have confirmed the ICC's expectations as to the low risks associated with the instruments of trade finance.<sup>10</sup>

In this regard, a somewhat more radical approach to mitigation of the rules of Basel II and Basel III than those put forward so far may be worth considering. This would involve directly addressing the way in which the risks of trade finance are incorporated into the estimation of risk weights in Basel II and Basel III under the Internal Ratings-Based Approach.

It is my contention that it may be possible to categorise trade-finance instruments as an asset class of its own to which the Internal Ratings-Based Approach would not apply, but would be replaced by the Standardised Approach even for a bank applying the Internal Ratings-Based Approach for other asset classes.

Allowing such an exception would involve an extension of the flexibility regarding the adoption of the Internal Ratings-Based Approach across asset classes—something already provided for in the rules of Basel II.

The proposal mooted above to categorise trade-finance instruments as an asset class to which the Standardised Approach would apply, even for a bank applying the Internal Ratings-Based Approach for other asset classes, could be adopted by national regulators, even if it cannot be negotiated internationally, and the flexibility (of Basel III) for an appropriately defined asset class consisting of trade-finance instruments, would be permanent, not temporary.

More recently, the principal focus of the trade-finance industry's criticism of Basel III has shifted to the leverage ratio. For the estimation of the denominator of the leverage ratio, i.e. a bank's on- and off-balance sheet exposures, contingent liabilities, including those associated with trade finance, will have a credit conversion factor of 100 per cent, and not the lower credit conversion factors allowed in the estimation of risk-weighted exposures for the minimum regulatory capital requirements for credit risk of Basel II and Basel III.

In its critique of this use of a 100 per cent credit conversion factor for trade-finance exposures in the liquidity ratio, the ICC has reiterated several of the arguments commonly made concerning the low risks associated with trade finance. The Chamber's recommendation is that "off-balance-sheet trade products should be allowed to retain the credit conversion factors used by banks under the current 'RWA' calculation", a recommendation which would go in the same direction as the option of applying the credit conversion factors of Basel II's Standardised Approach—precisely the option which was to be considered during the consultations on

the Basel Committee's proposals of December 2009 but has nonetheless not been accepted in the document on Basel III of December 2010.

To an outside observer of the choices made by the Basel Committee regarding rules concerning the leverage ratio, trade finance would appear to have been caught up in the consequences of the determination of regulators from the Committee's member countries to take a strong line with respect to off-balance-sheet exposures and other activities which were associated with the shadow banking system that helped to trigger the financial crisis.

There remains the option of persuading the regulators responsible for Basel III's national implementation of the merits of greater flexibility regarding the way in which account is taken of trade finance in the estimation of the liquidity ratio.

Even though Basel III has been presented as an answer to the financial crisis, it brings with it new challenges that are going to have a profound effect on commodities, trade and export finance.

Banks should be allowed to enhance their current default data calculations using available industry data, such as the ICC Trade Finance Default Register once it improves its data quality.

It is inappropriate for the Basel Committee to give the equal treatment to trade-related OBS item as derivatives which are the real source of excessive leverage in the banking system and the real cause of financial crisis. Historically, a very small portion of letters of credit, trade guarantees, and trade standby letters of credit ("SBLC") convert into on-balance sheet exposures.

The Basel Committee allows national regulators to waive the one-year maturity floor for trade finance. However, most of the national regulators have not used their discretion. Even in countries where this is waived, it is waived only for a limited list of trade finance products. The Basel Committee should move forward to encourage national supervisors to waive the one-year maturity floor.

Preferential run-off rate should be given to trade-related OBS items: the national discretion of giving preferential run-off rate, such as 5 per cent or 10 per cent, should be pushed, just as the one-year maturity floor above.

The Basel Committee will evaluate the impact of the regulatory regime on trade finance in the context of low income countries, as requested by the G20. Given the broader concerns surrounding the (unintentional) impact of Basel framework on trade finance, it may be timely for the Basel Committee to establish a specialist trade finance working group. Such a group would be well placed to examine the specific characteristics of trade finance products, the issues that arise when applying the

<sup>9</sup> See [http://www.iccwbo.org/uploadedFiles/ICC/policy/banking\\_technique/Statements/1147%20Register%20Report%20ICC%20Final%20Draft%2021%20September%202010.pdf](http://www.iccwbo.org/uploadedFiles/ICC/policy/banking_technique/Statements/1147%20Register%20Report%20ICC%20Final%20Draft%2021%20September%202010.pdf) [Accessed June 24, 2011].

<sup>10</sup> Data concerning 5,223,357 trade finance transactions with a value of \$2.5 trillion included the following:

- the transactions had a relatively low average maturity of 115 days;
- the transactions had a low incidence of default involving less than 1,400 or less than 0.02 per cent of the total;
- the off-balance-sheet transactions had an even lower rate of default involving only 110 out of 2.4 million transactions;
- the average recovery rate for transactions in default was 60 per cent, implying an average loss given default of 40%.

existing regulatory framework to trade facilities, as well as the trade related aspects of the Basel Committee's current proposals.

It is my contention that a specific category of CTF assets should be recognised by regulators. The key criterion for these assets would be the control over the commodity being financed and the control exercised by the banks over transaction flows (both financial and

physical). The data collected by the ICC and ADB should comfort the regulators to allow a low RWA for assets that have proven their resilience over time. Failure to create such a specific asset category will lead to "second best" solutions and could lead to increased cost which, invariably, will be paid by exporters (mostly in emerging markets) and/or end consumers of the processed commodity.