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Basel III and Commodity Trade Finance: An Update

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Banking supervision; Commodity markets; International standards; Risk management

Abstract

Following the financial crisis of 2008, regulators decided to toughen the capital requirements imposed on the banking industry. Through Basel III (additional to Basel II), each national banking regulator has implemented new rules applying to the banking industry. This article updates two previous articles on the same topic and focusses on the impact of these new rules on Commodity Trade Finance (CTF).

Introduction

The Basel accords were introduced in 1988 to set a minimum standard for capitalisation of banks and create a level-playing field for the banking systems of major economies. These accords (known as "soft law" as its implementation by each country is voluntary) have evolved from the early rules (known as Basel I[1]) into a more risk sensitive—and complex—set of guidelines (Basel II), and most recently, as a response to the 2008 financial crisis, into the Basel III accords that are additional (and not substituted to) Basel II. Whilst criticised for its fairly simplistic nature, it is worth noting that Basel I was a 28-page long document that could be understood and implemented by all. Basel II and III, however, total over 1,000 pages and their complexity cannot be underestimated (and this excludes the various European and national implementation regulations).

For a number of years, the trade finance community has been highlighting several issues with the new Basel III accords. There is a feeling that these could have an adverse effect on the industry, with many areas of regulation not reflecting the nature of trade finance—an activity that relates to the "real economy". The move to enhance the regulatory framework, and provide more complete coverage of all risks, seems to have lost some of the specific treatments in certain areas, such as trade finance, that was present in the original regulations.

Ongoing review and discussions between the trade finance sector and the Basel Committee have addressed some of these concerns, but others remain. With the trade finance industry supporting around one third of global trade (and around half of this using letters of credit—one of the oldest banking instruments),[2] ensuring an appropriate solution is of real importance to the economy, hence the keen interest displayed by international organisations that otherwise do not get involved in the details of banking regulations (notably this is the case for the World Trade Organisation (WTO) and the United Nations United Conference on Trade and Development (UNCTAD), given the importance of emerging countries for commodities).

This article serves as an update to two previous articles I have written for the Journal of International Banking Law and Regulation.[3] These have discussed the concerns of the trade finance community with the evolving Basel accords.

In 2011, I published an article on Basel III summarising the concerns of the trade finance community with the newly proposed Basel III accords.[4] It was expected that a number of the changes and planned regulatory areas would have an adverse effect on Commodity Trade Finance (CTF), with an increased capital requirement (and hence cost of trade finance instruments) not necessarily appropriate to the nature of CTF. Proposals were put forward that could help address these issues, with the suggestion also that a focussed trade finance working group be established by the Basel Committee to examine the issues raised.

Since 2011, the Basel Committee has considered the concerns and proposals raised by the CTF industry. Indeed, it has been the aim of the Basel Committee throughout the evolution of the Basel accords to solicit input and data from the finance community. As a result, there have been several published amendments to these original Basel III proposals. With these changes in place, it is necessary to look again at the impact of Basel III on CTF, understand where there are still outstanding issues, and present again some proposals which could improve the situation going forward.

Introduction to Basel III

There have been many changes to the Basel accords since their introduction in 1988, as they have evolved to attempt to better address capital adequacy and enhance stability in the financial markets. Following the financial crisis, there was agreement between governments, financial regulators and banks that more needed to be done to strengthen capital standards in the banking industry. There

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[1] Text of the original Basel Accord can be accessed. Available at: *http://www.bis.org/publ/bcbs04a.htm* [Accessed 3 December 2015].

[2] From estimates given by the BIS Committee on the Global Financial System. "*CGFS Paper 50—Trade Finance: developments and issues*," January 2014.

[3] Gilles Thieffry, "The Impact of Basel III on Commodity Trade Finance: Legal and Regulatory Aspects" (2011) 26(9) J.I.B.L.R. 455–460 and Gilles Thieffry, "The Impact of Basel II on Commodity Trade Finance: A Legal Perspective" (2004) 19(10) J.I.B.L.R. 398–401.

[4] This was at least 2 years prior to implementation of Basel III, leaving plenty of scope for further changes to the regulations.

were areas which the existing (but not fully implemented at the time of the crisis) Basel II capital regulations had underperformed and in some cases not addressed at all.

The result of work by the Basel Committee to address these shortcomings was the introduction in 2010 of the so-called "Basel III" accords. These were put forward in two principal documents, issued by the Bank for International Settlements (BIS):

- "Basel III: International framework for liquidity risk measurement, standards and monitoring"[5]; and
- "Basel III: A global regulatory framework for more resilient banks and banking systems".[6]

Basel III seeks to enhance and strengthen the capital base. Implementation began in 2013 and it is expected to continue until 2019.

There are a number of changes and additions to the Basel II capital definition that impose higher Risk Weighted Assets (RWA) levels, but also important changes to the quality of capital, imposing a greater proportion of higher quality Tier 1 core capital.[7]

In addition, new buffers specifying additional capital to be built up during "good times" are added. The capital conservation buffer will help provide safety in periods of stress, and the counter-cyclical capital buffer will build up capital in the stronger periods of the economic cycle.[8]

As well as measures to enhance capital levels, new consideration is given in Basel III to leverage and liquidity. These were key areas that led to the problems of the financial crisis, and a driving force behind the revision of the Basel Guidelines.

The leverage ratio is intended as a secondary risk independent measure of capital adequacy. It is measured simply as the ratio of total Tier 1 capital over total assets.[9]

The liquidity treatment is introduced as a set of two ratios—the liquidity coverage ratio (LCR) which measures the level of high quality liquid assets to meet short term obligations (essentially ensuring enough funding resources to cover a 30-day period), and the net stable funding ratio (NSFR) which measures the longer term ability to meet funding needs.

The following table summarises these areas of capital regulation included in Basel III, and gives an overview of their implementation timescale and levels[10]:

Basel III capital component	**Description and calculation**	**Implementation schedule**
Tier 1 capital	Core Tier 1 ratio = 4.5%.	4.5% level applies from January 2015.
	To be met with common equity (after deductions).	
Tier 2 capital	Additional capital required to meet minimum capital requirement of 8%.	8% total capital required from 2013.
Capital conservation buffer	An additional buffer of 2.5% to withstand periods of economic stress.	To be phased in from January 2016.
	To be met with common equity.	0.625% from January 2016, 1.25% from January 2017, 1.875% from January 2018 and 2.5% from January 2019.
Counter-cyclical capital buffer	Buffer with range 0–2.5% (to be set by national regulators) to extend capital conservation during periods of excess credit growth.	To be phased in from January 2016.
		0.625% from January 2016, 1.25% from January 2017, 1.875% from January 2018 and 2.5% from January 2019.
Capital for systemically important banks	Higher capital requirement for banks designated as systemically important. Surcharge of 1–2.5% through extension of capital conservation buffer range.	Subject to final review, and to be phased in up to January 2019.
		See EU CRD IV for details.[11]
	(Defined by national regulators based on bank characteristics).	
Leverage ratio	Secondary measure of capital adequacy. Measured as:	Observation period up to January 2018, then incorporation as Pillar 1 requirement.
	Total Tier 1 Capital/Total assets.	
	Set provisionally at minimum 3%.	
Liquidity ratios	Two ratios defined to ensure bank's liquidity coverage:	LCR phased introduction from 2015 (60%) to 2019 (100%).
	Liquidity Coverage Ratio (LCR) measures expected inflows and outflows to ensure enough liquid assets for 30 days under stress scenario.	NSFR introduced from January 2018.
	Net Stable Funding Ratio (NSFR) looks at stable funding over a one-year horizon.	
	(See Basel documentation for details on calculation of inflows and outflows)	

[5] BIS, "Basel III: International framework for liquidity risk measurement, standards and monitoring" December 2010. Available at: *http://www.bis.org/publ/bcbs188.htm* [Accessed 3 December 2015].
[6] BIS, "Basel III: A global regulatory framework for more resilient banks and banking systems" June 2011 (revised version). Available at: *http://www.bis.org/publ/bcbs189.htm* [Accessed 3 December 2015].
[7] Tier 1 capital includes common shares, retained earnings (BIS, "Basel III: A global regulatory framework for more resilient banks and banking systems" June 2011), stock surplus. Full criteria and conditions see Basel III documentation.
[8] For a more complete discussion of the new buffer levels see the Basel documentation: BIS, "Basel III: A global regulatory framework for more resilient banks and banking systems" June 2011.
[9] i.e. gross assets, not risk weighted.
[10] This is correct as at October 2015. It should be noted that several areas of Basel III are still under review/to be finalised.
[11] This is defined for EU in Directive 2013/36 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87 and repealing Directives 2006/48 and 2006/49 ("CRD IV") [2013] OJ L176/338 arts 131–134. The buffer will be set between 1% and 3.5% (made up of Tier 1 common equity) and will depend on the bank characteristics. First calculations place 29 systemically important banks into categories for buffer level, with none in the highest level of 3.5%.

Issues with CTF and Basel III

The changes introduced by Basel III impacted many areas of the banking and finance industry. Trade finance has been one of the sectors where it was felt the changes would have a strong negative impact. Following the release of Basel III, a number of areas of concern were suggested by the trade finance industry.[12]

The overall concern has been that the lack of specific treatment for trade finance and its products (such as letters of credit) does not reflect the specialised and low risk nature of the sector. Letters of credit, for example, are often grouped together with much riskier off-balance sheet derivative products. Many CTF related issues were already raised regarding the Basel II accords. Instead of addressing these issues with the new Basel III accords, further (and potentially more severe) issues arose.

A failure to reflect the nature of the industry will lead to increased capital costs and associated higher cost of business. In their 2011 response to the Basel Committee,[13]BAFT estimate that trade finance product pricing could increase by 18 to 40%.[14]

The CTF industry may suffer from the newly introduced calculation ratios:

- capital calculation—issues with short term maturity;
- capital calculation—issues with using sovereign ratings;
- capital calculation—inappropriate correlation calculation;
- treatment of off-balance sheet items (including letters of credit) under the leverage ratio; and
- poor recognition of trade finance under the liquidity ratio.

Specific issues

Capital calculation—short term maturity

Concerns have been raised with both Basel II and Basel III about the higher expected capital charges for trade finance. One of the main areas that impacted this was a failure to consider the short term nature of trade finance. Basel III proposed that a minimum of a one-year maturity be applied, despite trade finance regularly dealing with much shorter duration transactions. As capital required increases with maturity length, it was felt that this would artificially inflate the costs of trade finance.

The industry has presented data to support the argument that the average maturity is significantly below this one-year minimum. Research work carried out by the ICC as part of their trade finance data collection work[15] has demonstrated an average maturity of all off-balance sheet items, including letters of credit, of just 80 days.

National regulators were given the right to amend this maturity floor at their own discretion, but the ruling guidance from the Basel Committee would be to apply a minimum of one year. Whilst this ability for national regulators to override the minimum may assist in some cases, there is no guarantee it will be permitted in any one jurisdiction, and even if applied it can create a complicated and uncertain environment, particularly for trade finance operations across multiple countries. The only regulator to permit a reduction in this maturity was the UK Financial Services Authority (now FCA). This state of affairs is of concern as it flies in the face of the original goal of Basel II of creating a level playing field in the banking industry and may open doors to regulatory arbitrage.

Capital calculation—sovereign floor

Under the original Basel II and Basel III rules, the rating of bank instruments cannot be higher than that of the sovereign under which the bank is incorporated. This was of immediate concern to trade finance as it means letters of credit may have to carry an unduly high risk weight, especially in the case of emerging countries.

Letters of credit in these cases reduce the risk for exporters, with a confirmed letter of credit providing protection against the importers failure to pay. The concern is that in an emerging country, the need to use the sovereign risk weight will unfairly increase the capital cost of the letter of credit protection.

This would happen in the following way. The risk weight for an unrated bank is 50% (for claims with a maturity of more than three months) and 20% (for claims with a maturity of three months or less). However, these preferential lower risk weights cannot be applied in the case of low income countries, as the sovereign rating would have to replace them. For most countries this would imply a rating of 100% being applied.[16]

Capital calculation—asset value correlation (AVC)

Asset correlation is part of the risk weight calculations in Basel II (and used the same under Basel III). This is designed to reflect the effect of exposures within the same

[12] Mainly through BAFT–IFSA and WTO.
[13] The BAFT–IFSA response is available at: *http://www.esf.be/new/wp-content/uploads/2011/12/BAFT–IFSA-Basel-Talking-Points-2011-12-01-Final.pdf* [Accessed 3 December 2015].
[14] Such an estimate from 2011 does not take into account changes after 2011, such as the alteration of leverage ratio requirements.
[15] Register is available at: *http://www.iccwbo.org/products-and-services/trade-facilitation/icc-trade-register/* [Accessed 3 December 2015]. More details are given in the next section of this paper.
[16] According to the Basel Committee (BIS, "Basel III: A global regulatory framework for more resilient banks and banking systems" June 2011) of the 40 countries defined as low income by the World Bank, only eight carry ratings from S&P. None of these are rated below B- (which would imply a 150% risk weighting), and the rest are treated thus as unrated.

category. It is incorporated into the calculations specified in the Basel accords and defined separately for a number of different asset classes.[17]

The problem faced by trade finance is the level at which the correlation is defined. For retail exposures, separate correlations are provided for a number of product types with differing characteristics (including residential mortgages, revolving retail exposure and other consumer lending). However, for all corporate, sovereign and bank exposures the same correlation is used.[18]

The trade finance community has been lobbying against this since its introduction, arguing that trade finance should be treated separately from other corporate exposures, due to the much lower risk level and default history.

Under Basel III an additional factor has been added for exposures to large regulated financial institutions, and all unregulated financial institutions.[19] This is the AVC factor of 1.25. It is essentially a factor to apply to the asset value. However, there still remains no provision under Basel III for separate recognition of trade finance assets.

Leverage ratio

The introduction of the leverage ratio was one of the most significant changes under Basel III. Although it will not be implemented as a Pillar 1 requirement (for capital calculation) until 2018,[20] its impact and the quite different treatment from that seen for capital calculation so far, is currently being evaluated by banks and by the Basel Committee.

One of the main aims of the introduction of the leverage ratio is that it will form a risk-weight independent secondary measure of capital levels. As such, its method of calculation is very different from the risk sensitive and thorough analysis carried out for under Pillar 1; it is designed to be simple to understand and to implement.

The leverage ratio is calculated simply as the ratio of total Tier 1 capital divided by total assets (both on and off-balance sheet assets).[21] It is this calculation of total assets where it is felt trade finance will be negatively affected. Basel III requires a 100% Credit Conversion Factor (CCF) to be applied to all off-balance sheet items. This will result in trade finance instruments, including all letters of credit, receiving the same treatment as other, much riskier, off-balance sheet items.

This will effectively require banks to hold capital against assets with no reflection of risk level. Clearly there has been strong objection to this from the trade finance industry. If this were to be implemented as proposed, it could have a significant impact on the cost of trade finance instruments, such as letters of credit.

The historic level at which products convert to on-balance sheet commitments warrants a CCF significantly lower than 100%. Moreover, the BAFT in their representation to the Basel Committee in 2011 explained their strong opinion that it is not in line with the aims of the leverage ratio to help prevent deleveraging which could endanger financial stability. As trade finance is supported by the movement of goods and services, it does not lead to such economic dangers. Treating trade finance and its associated letters of credit as such a significant source of leverage therefore seems not only excessive, but also not reflective of the nature of the industry. The treatment and rigour of handling of letters of credit is also relevant here. Once a letter of credit is approved and accepted, it is effectively only held temporarily as an off-balance sheet asset.

Liquidity ratio

The Liquidity Coverage Ratio (LCR) has been introduced since 2015 with a 60% requirement. This will rise 10% each year to reach full implementation in 2019.[22] There have been concerns about the detrimental impact of the LCR on trade finance. It has been designed to reflect the availability of high quality, liquid assets to meet 30-day horizon funding needs. The concern from the trade finance community has been that the calculation of both inflows and outflows for this do not reflect the nature of trade finance.

In the original Basel III proposals, the outflow rate (rate at which contingent assets may need to be funded) for trade finance facilities such as letters of credit was left open to national discretion, and the fear was this would push it into the 5–100% range allowed for other contingent liabilities (with the industry feeling a rate lower than 5% was more appropriate). In addition to this, inflows for trade finance are assumed to be 50% of payments due within 30 days. Under this scenario, banks highlighted concerns with achieving a 100% LCR for trade finance.

Regulatory changes affecting trade finance

Following the concerns raised by the trade finance industry, changes have been made to the Basel III accords in a number of areas. These address many, but not all, of

[17] These Correlation coefficients are specified in the Basel II regulations: BIS, "Basel II: Revised international capital framework" (2006). Available at: *http://www.bis.org/publ/bcbs128.pdf* [Accessed 3 December 2015]. They are defined for corporate exposures in para.273, and for retail exposures in paras 327–330.

[18] There is an adjustment to the corporate correlation used for SME lending, specified in BIS, "Basel II: Revised international capital framework" 2006 para.274.

[19] This is defined in para.102 of the Basel III regulations (BIS, "Basel III: A global regulatory framework for more resilient banks and banking systems" June 2011). A multiplier of 1.25 applies for exposures to all large financial institutions (defined as regulated financial institutions whose total assets are greater than or equal to US $100 billion) and to all unregulated financial institutions, regardless of size.

[20] BIS, "Basel III leverage ratio framework and disclosure requirements" (2014). Available at: *http://www.bis.org/publ/bcbs270.pdf* [Accessed 3 December 2015], para.4.

[21] The ratio is set provisionally at 3%, although there is scope during the observation period up to 1 January 2018, to alter this.

[22] Implementation was scheduled for 1 January 2015. This has been delayed in Europe to 1 October 2015.

the issues. Official changes that have been made since 2010 are reflected in the following three documents issued by BIS[23]:

- BIS, "Treatment of trade finance under the Basel capital framework".[24]
  Update from BIS following consultation with WTO and ICC regarding trade finance. This introduces changes to the Basel III risk weight calculation (including maturity and sovereign floor), and highlights the Basel Committee position with respect to further changes;
- BIS, "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools".[25]
  These form updated proposals for the implementation of the liquidity ratios, and contain a number of specific guidelines for inclusion in the inflow and outflow calculations; and
- BIS, "Basel III leverage ratio framework and disclosure requirements".[26]
  Update to the requirements for the leverage ratio, introducing new concessions for trade finance.

Analysis by trade finance community

Following the release of Basel III, there has been a joint response from the trade finance industry to present its concerns and lobby for change. Much of this has been made via the BAFT–IFSA.

It is fine to propose changes that could be made "in principle" but the Basel process and calculations are very much based on solid historical data and past experience, and such input has made a significant difference in lobbying for changes. Many of the changes that have been made by the Basel Committee have come as a result of analysis work carried out by the trade finance industry.

Aside from lobbying via BAFT–IFSA around the issues described in the previous section,[27] there are some important research and analysis areas which have taken place (in particular the International Chamber of Commerce (ICC) since 2009 (still ongoing) brings together trade finance data from 24 institutions, with around 4.5 million trade finance transactions. The scheme is known as the ICC Trade Register[28] and World Trade Organisation under "The impact of Basel III on trade finance: The potential unintended consequences of the leverage ratio"[29]).

Summary of changes

The changes made since 2011 show the increasing acceptance by the Basel committee to treat trade finance, and its associated products including letters of credit, in a more favourable way. Previously, there were many areas in which the sector was treated in a way that under-estimated its low risk nature. The Basel Committee appears to have accepted this, after consultation with the sector and consideration of data presented.

Changes made now allow letters of credit to be weighted more appropriately when calculating the leverage ratio, as well as consideration of their short term maturity and low risk of issuer when carrying out capital calculation.

Changes will also see more appropriate treatment in low income countries. The increase in risk weight necessary due to a poor rated sovereign would have had a significant effect on business in these economies; this sovereign floor has been universally relaxed.

Summarising the positive direction of the changes so far, Thierry Senechal, senior policy manager with ICC Banking Commission, explains his view:

> "The Basel Committee's amendments on the treatment of off-balance sheet items recognise the intrinsically safe nature of trade finance. They are a constructive step in ensuring balance between prudent regulation, adequate access to trade finance and a sustainable recovery of the so-called real economy."[30]

Detailed description of changes

In the light of the changes made by the Basel Committee, an update on each of the identified issues is now given. The following section will summarise the areas where concerns still remain.

Short term maturity

The Basel Committee has now agreed to reduce the maturity used in capital calculation to the effective maturity for self-liquidating trade finance instruments. This is now included as a guideline within the Basel accords.[31]

[23] Additionally for Europe, the regulations are implemented in CRD IV documentation (CRD IV Directive 2013/36. Available at: *http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013L0036* [Accessed 3 December 2015].
[24] BIS, "Treatment of trade finance under the Basel capital framework" October 2011.
[25] BIS, "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools" January 2013.
[26] BIS, "Basel III leverage ratio framework and disclosure requirements" January 2014.
[27] BAFT–IFSA proposals are available at: *http://www.esf.be/new/wp-content/uploads/2011/12/BAFT–IFSA-Basel-Talking-Points-2011-12-01-Final.pdf* [Accessed 3 December 2015].
[28] Updates and latest information on the Trade Register can be found at the ICC website. Available at: *http://www.iccwbo.org/products-and-services/trade-facilitation/icc-trade-register/* [Accessed 3 December 2015].
[29] Marc Auboin and Isabella Blengini, "The impact of Basel III on trade finance: The potential unintended consequences of the leverage ratio" January 2014. Available at: *https://www.wto.org/english/res_e/reser_e/ersd201402_e.pdf* [Accessed 3 December 2015].
[30] Quoted in *Trade Finance Magazine*, April 2014. Available at: *http://www.tradefinancemagazine.com/Article/3328212/How-Basel-III-rallied-the-trade-finance-industry.html* [Accessed 3 December 2015].
[31] See BIS, "Treatment of trade finance under the Basel capital framework" October 2011.

Prior to this there had been a fear of inconsistent national implementation as regulators were left to use their own discretion regarding a maturity floor. Firming this up, a Basel Guideline will give reliability and confidence in capital calculation across regional jurisdictions. Proposals so far from the EU, Japan and the US are to follow the Basel Committee guidelines in this area.

However, the Basel Guideline only applies to short-term self-liquidating letters of credit (both issued and confirmed). Whilst this applies to a large proportion of trade finance transactions, there are other trade finance instruments where the waiver in minimum maturity is still left to national discretion. The Basel Committee state that "[o]ther trade finance transactions which are not letters of credit can continue to be exempted from the one-year floor, subject to national discretion".[32]

Sovereign floor

Applying the higher sovereign risk weight in cases where the bank is rated lower than the sovereign (or unrated) would have a strong impact in low income countries. Letters of credit are often provided in cases of import to such countries.

After lobbying from the trade finance community regarding these higher risk weights and associated higher capital charge, the Basel Committee[33] proposed to relax the sovereign floor for self-liquidating letters of credit. This will allow banks to take advantage of reduced risk weights, and lower capital requirements for trade finance activities, particularly in emerging countries.

However, there still remain potential differences in this approach under different jurisdictions. There is an alternative option under the Standardised Approach, in which the risk weight is assigned directly based on the sovereign rating.[34] No exception under this option has been made for letters of credit, and there therefore remains the possibility for higher risk weights. Of the major adopters of Basel, only the US is following this approach.[35] In other words, and regrettably, no level playing field is emerging.

Asset Value Correlation

The industry continues to make the argument for a specific correlation to be used in Pillar 1 capital calculations for trade finance. So far no changes have been made in this area. Regulators are following the Basel Committee guidance in this area and not allowing any exemption for trade finance. Treating trade finance as a separate asset class would easily allow a different correlation treatment, and would better reflect the reality of trade finance.

Leverage ratio

The concerns from the trade finance sector that the 100% CCF applied to letters of credit (as well as all other off-balance sheet items) is too penalising has been met with a changing reaction from the Basel Committee over recent years.

The Basel Committee's initial response was to refuse any changes to the CCF's for off-balance sheet items. In their response, they explain:

> "The calculation of the leverage ratio was intentionally designed to be simple and not based on any differential risk weighting. Changing the CCF for trade finance under the leverage ratio would be inconsistent with the core financial stability objectives of the capital framework."[36]

It was confirmed at this time to make the leverage ratio a Pillar 2 (supervisory) element initially, and use the period up to 2018 to monitor further data and implementation, before it becomes a Pillar 1 requirement.[37]

Following further dialogue with the trade finance community, and after consideration of the enhanced data and results from the ICC Trade Register, further changes were announced in January 2014.[38] At this time, the Basel Committee permitted changes to the leverage ratio for trade finance. They justify this with the explanation: "A credible leverage ratio framework is one that ensures broad and adequate capture of both the on and off-balance sheet sources of banks' leverage."[39]

It was confirmed that a reduction of CCFs for the calculation of the leverage ratio would be permitted. A CCF of 20% can be applied to short-term contingent trade finance assets (including short term self-liquidating trade letters of credit).[40] This rule came into effect on 1 January 2015.

Alas, regional implementation of these CCFs at present varies amongst jurisdictions. The EU implementation (CRD IV) already permitted (prior to the Basel Committee changes) a 20% CCF, and additionally includes a 50% CCF for other items such as standby letters of credit and payment bonds.[41] But it is worth remembering that EU directives constitute an obligation to implement rules; opening variation in the implementation (unlike EU Regulations that are directly applicable in each EU Member State). In the US and most Asian countries, the

[32] BIS, "Treatment of trade finance under the Basel capital framework" October 2011.
[33] BIS, "Treatment of trade finance under the Basel capital framework" October 2011.
[34] This is "option 1" under the Standardised Approach, and in this methodology the risk weight is assigned one notch lower than the sovereign rating. "Option 2" is where the Basel Committee have made appropriate changes for trade finance, and allows the use of the bank external credit rating.
[35] It is also likely that the US will grant exception for sovereign ratings for letters of credit.
[36] BIS, "Treatment of trade finance under the Basel capital framework" October 2011.
[37] This gives the scope for potential further changes if they can be justified before 2018.
[38] Published by BCBS as a separate update: BIS, "Basel III leverage ratio framework and disclosure requirements" January 2014.
[39] BIS, "Basel III leverage ratio framework and disclosure requirements" January 2014.
[40] Note that a CCF of 10% is also permitted for commitments that are unconditionally cancellable by the bank at any time (as has always been the case with Basel III).
[41] This is not being included in the Basel Committee guidance, such products would maintain a 100% CCF without national regulatory override.

rules have yet to be finalised. Prior to the Basel Committee changes, the US applied a 100% CCF (no regulatory override). If regulators maintain this uncoordinated approach it will lead to significant global differences in implementation and clear market distortions.

Liquidity ratio

Significant amendments have been made to the LCR in a number of areas.[42] These reflect the definitions of liquid assets, and the conditions for calculations of inflows and outflows. These changes partially reflect the concerns over the LCR for trade finance products.

In particular, recognition has been made that outflow rates for trade finance may be less than 5%. The Basel Committee state that "in the case of contingent funding obligations stemming from trade finance instruments, national authorities can apply a relatively low run-off rate (5% or less)".[43] This is still however left to national discretion rather than being a Basel "rule".

The Basel Committee have not proposed any changes to the 50% inflow rate, which remains of concern to the industry. The EU implementation (CRD IV) diverges from the Basel Committee guidance and will allow a 100% inflow rate to be used for trade finance receivable with maturity at or below 30 days.[44]

Remaining issues

Whilst the changes made to the regulations have in general been positive, there are a number of areas where concerns remain. These relate to both areas that the Basel Committee has not released any change in regulation despite concerns from the industry, and also to areas where differing implementation from national regulators could lead to discrepancies across the trade finance sector.

Areas where direct concern remains include AVC where no changes have been made to the correlation calculations for trade finance, despite provisions being made for other asset classes. Issues remain as well with the LCR, where inflows permitted for trade finance are still considered to be too low.

It should be noted that although no changes have been put forward yet for these areas, there remains the possibility that they may be over the coming few years. Many of the changes that have been released for the regulations have come from continued lobbying from the trade finance community, and the Basel Committee to date have shown their receptiveness to consider justified changes (especially when supported with data).

As well as these industry concerns over areas where trade finance could directly suffer, there are further risks that have been highlighted for other areas. These relate to the areas left to national discretion in implementation, leaving it up to individual regulators to decide on treatment, rather than provide overall standard guidance from the Basel Committee.

Notable areas with differing implementation currently include[45]:

- each European country is introducing its own legislation for Basel implementation. This is in general based on EU CRD, but there are alterations in dates as introduction of national regulations, and passing into local law, is taking place at different dates[46] (i.e. double complexity is introduced in Europe: Basel implementation through the CRD and differing implementation of the CRD among EU Member States);
- there are significant differences globally for the leverage and liquidity ratios. Several areas are left to national discretion and will therefore likely diverge from Basel standards;
- under the liquidity ratio implementation, the EU CRD is allowing enhanced inclusion in the LCR ratio, whist other regulators are not. Basel Guidelines specify a 50% inflow rate for trade finance receivables, but the EU CRD will increase this to 100% for those with short term maturity[47];
- outflow rates for the LCR are also likely to differ, with the Basel Guidelines specifing a rate of more than 5%, with the lowering of this being possible, but left to national discretion;
- EU CRD widened the treatment of trade finance under the leverage ratio before such allowances were made by BCBS. This is now being followed by many global regulators, with the current (and possible continued) exception of the US;
- in the US, there is ongoing discussion over the level of the leverage ratio; this may be set higher than the Basel proposed standard, at 5%[48]; and

[42] Covered in BIS documentation: BIS, "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools" January 2013.
[43] BIS, "Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools" January 2013.
[44] Regulation 575/2013 on prudential requirements for credit institutions and investment firms and amending Regulation 648/2012 [2013] OJ L176/1 (EU CRR) art.425 para.2b, states "monies due from trade financing transactions referred to in point (b) of the second subparagraph of Article 162(3) with a residual maturity of up to 30 days, shall be taken into account in full as inflows".
[45] With implementation of Basel III still in early stages, these areas may change, and others may be introduced. The point is that with allowance for national discretion over implementation, such differences could always arise.
[46] 2015 update on regional implementation differences, provided by BIS. Available at: *http://www.bis.org/bcbs/publ/d318.pdf* [Accessed 3 December 2015].
[47] EU CRR art.425 para.2b.
[48] Reported by Bloomberg, January 2014. Available at: *http://www.bloomberg.com/news/articles/2014-01-26/u-s-banks-facing-capital-hole-get-no-leverage-relief-from-basel* [Accessed 3 December 2015].

- the sovereign floor for letters of credit under the Standardised Approach could be applied differently across jurisdictions.[49] This could have significant impact in emerging countries.

The concern on the differences of treatment and implementation has been identified by the BIS itself. In November 2015 the BIS indicates:

> "The Committee will continue to promote *consistency of implementation* practices across its member jurisdictions. This will include analysis of outcomes in order to support financial stability and a level playing field. The key elements of the Committee's implementation strategy for 2016–17 will be to:
>
> - continue monitoring the adoption of Basel III standards;
> - complete the remaining jurisdictional assessment reports on the *consistency of implementation* of the risk-based capital requirements, continue the planned jurisdictional assessments of LCR implementation and conduct annual post-assessment follow-up procedures;
> - assess the implementation of SIB frameworks in member jurisdictions; and
> - review the Committee's implementation mandate and strengthen the RCAP process where appropriate, taking into account the findings and recommendations of a study commissioned by the Committee on this topic. The Committee's review will include consideration of how to assess the implementation of new or revised Basel standards."[50]

The impact of such differences in treatment will be felt in a number of ways. It will create a more complicated, and unpredictable, implementation of the Basel accords, with different rules to be implemented for institutions, and lending activities, in different countries. More importantly however, it could lead to divergent regulatory treatment across different jurisdictions—going against one of the major goals of Basel II. Where more favourable treatment is permitted by a particular national regulator, capital requirements and hence cost of providing trade finance instruments, could be lower than in a stricter regulatory jurisdiction. This brings the possibility for regulatory arbitrage, and for competitive distortions and inequality in the trade finance market.

Such inequality could be prevented with more solid guidance from the Basel Committee. The trade finance sector should continue to lobby for this.

Suggested way forward

The Basel Committee has tried to make Basel III a more complete and robust framework to prevent a repeat of the 2008 financial crisis. There remains strong indication that it has not been fully designed to reflect the nature and risk profile of trade finance. There are still strong concerns remaining. As such, the industry will suffer under current proposed regulation. These issues the industry still has with Basel III have been summarised above. When dealing with trade finance, it is always important to remember the direct impact on the real economy (hence the involvement of the WTO and UNCTAD, as invariably increased cost and/or market distortions will find their way to end consumers and commodity producers).

Indeed, as Basel III implementation proceeds, there is less scope for further changes to be made. Whilst discussions will no doubt continue between the industry and the Basel Committee, and there remains the possibility of further changes, there are bolder solutions which could be considered.

Trade finance as a separate asset class

I propose that one measure which could be implemented is to treat trade finance as its own asset class, not just as a subset of corporate lending. This would most effectively be achieved by moving trade finance to the standardised approach, even for banks that use the IRB approach for other corporate areas. Risk weights would then be defined based on the nature and legal and operational structure of the transaction. Support for the level of these risk weights could be obtained from the ICC trade finance register work, based not on the credit risk of the borrower at all, but on the structure of the transaction, in particular on the lenders' control over financed physical goods and the legal structure used (in particular moving away from the dual system secured/unsecured, but including intermediary situations notably taking into account quasi-security structures).

This proposal would address many of the remaining concerns with Basel III. Correlation would be defined separately for trade finance assets (and in any case would not have to use the specified formulas under the IRB treatment for corporate risks). Liquidity and leverage ratios rules could also be defined separately, or the decision could be made to exempt trade finance from these ratio calculations. Additionally, national regulators would have a clear treatment to follow for trade finance assets, lessening the possibilities for regulatory arbitrage and competitive differences.

To support this approach, it is important that the work by the ICC on the Trade Finance Register continues. This could provide support for the level to set risk weights and help demonstrate to the Basel Committee the specific

[49] See earlier section on positive changes to Basel regulations. The Basel Committee is removing the requirement to floor the risk weight for letters of credit at the level of the sovereign rating, but only under one of two possible approaches to calculation.
[50] BIS, Implementation of Basel Standards—A Report to G20 Leaders on Implementation of the Basel III Regulatory Reforms (November 2015), p.7.

nature of trade finance. The Basel Committee have already shown their willingness to support changes that are well supported by historical data and analysis.[51]

Such a treatment of trade finance as a separate asset class would also have benefits for investors, potentially creating a secondary market for securitised assets.[52] There have already been a number of initiatives established,[53] and a more consistent framework would only aid this area.

Treating trade finance as a separate asset class is not an entirely new idea. Under the original Basel rules,[54] assets are directly risk weighted based on risk of default. Under this system, trade finance letters of credit received a risk weight of 20%. This was changed under Basel II with a more sophisticated, and risk sensitive approach that would rely too on external ratings or banks' internal assessments of risk.

As an alternative to this proposal, further changes could be made to the regulations to better suit trade finance. However, making trade finance "fit" with other asset classes, and also obtaining agreement to follow a similar treatment from all national regulators, will likely result in an inferior solution.

Whatever further changes are made to the regulations and whatever approach is taken, it is likely that regulators will proceed with caution. They can, and should, take note of a recent study regarding the failures of Basel II.[55]

Impact on the trade finance sector

Whatever the final situation and further changes that may be introduced by the Basel Committee, it is likely that additional capital will be required to support trade finance activities, and the associated cost of providing trade finance risk mitigation products will increase. What effect will this rising capital "cost" have for trade finance?

Naturally, a rising capital requirement, and with it cost of trade finance products, would likely lead to a decrease in trade finance volumes.[56] Aside from the decrease in volumes however, the industry could be impacted in other ways.

It is possible that the industry would see consolidation. An increased cost may lead to the termination of smaller operators and increased merger activity, resulting in a smaller number of larger providers.

There may also be a shift to move trade finance assets off the balance sheet, most likely through the use of securitised products. This has already been seen in a number of areas. If a bank can demonstrate risk transfer (and retain a senior tranche which is rated) they can obtain capital relief.[57]

And, of course, if the use of letters of credit is prohibitively expensive, other financing methods could be used instead, such as a simple overdraft facility. Regulators however should take note here, as by discouraging the use of letters of credit, the chosen alternative may in fact increase the overall risk level! Why create an incentive to drop tried and tested structures that have proven their resilience and safety over the years and substitute it by what could be riskier structures assessed by a fragmented regulatory regime (which Basel II was supposed to substitute by a unified level playing field)?

[51] For example, the change to capital calculation with the removal of maturity floor and sovereign risk weight use.
[52] Discussed in *Trade Finance Magazine*, April 2014. Available at: *http://www.tradefinancemagazine.com/Article/3328212/How-Basel-III-rallied-the-trade-finance-industry.html* [Accessed 3 December 2015].
[53] Including TradeMAPS (a joint venture between Citibank and Santander) and Deutsche Bank's Internet Trade Finance Exchange.
[54] Basel I introduced in 1988.
[55] R. Lall, "Why Basel II failed and why any Basel III is doomed. Working paper 2009/52" Global Economic Governance Programme, Oxford University, 2009. Available at: *http://www.globaleconomicgovernance.org/sites/geg/files/Lall_GEG%20WP%202009_52.pdf* [Accessed 3 December 2015].
[56] Standard Chartered Bank in 2012 estimated this could be up to a 6% reduction, although this was before changes to the leverage ratio were announced. See Allen & Overy, "Trade Finance and Basel III" July 2012. Available at: *http://tinyurl.com/p5a4ktc* [Accessed 3 December 2015].
[57] A good example of this is reported by Allen & Overy in their advising on such a transaction for Standard Chartered Bank at Allen & Overy, "Trade Finance and Basel III" July 2012.