This chapter discusses issues related to the treatment of trade credit by international regulators. Although trade finance traditionally received preferential treatment regarding capital adequacy ratios on grounds that it was one of the safest, most collateralized, and most self-liquidating forms of finance, the introduction of the Basel II framework led to complaints inside and outside the World Trade Organization (WTO) about its potential adverse effect on the supply of trade finance during financial crises.

With the collapse of trade and trade finance in late 2008 and 2009, the regulatory treatment of trade credit under Basel II became a public issue, and a sentence in support of trade finance made its way into the communiqué of G-20 leaders following the April 2009 London Summit, calling on regulators to exercise some flexibility in the application of prevailing rules (G-20 2009). As the removal of obstacles to the supply of trade finance became a priority in the context of the WTO and of the G-20, new proposals on capital adequacy by the Basel Committee on Banking Supervision (BCBS), in the context of the making of Basel III, have spurred new policy discussions. The trade finance community hopes that the debate will lead to a better understanding of the two (trade and regulatory) communities’ objectives and processes, eventually resulting in a set of regulations that is right and fair.
Basel I and Basel II: Apparently Similar but Different

Traditionally, short-term trade finance has been considered one of the safest, most collateralized, and most self-liquidating forms of finance. In the Basel I framework, assets are risk weighted based on the borrower’s risk of default, ranging from the lowest risk weight (0 percent for the world’s best government bonds) to a 100 percent risk weight (or more, in successor arrangements) for standard corporate loans. A 100 percent risk weight meant that the capital to be set aside for such loans had to be no less than 8 percent (minimum capital ratio to assets) of its notional value. The logic of this regulatory system—as well as its successor arrangement—was to protect financial institutions against risks of insolvency in case of default on their assets by accumulating enough capital to cover possible losses in difficult times, each category of asset being weighted in relation to estimated, historical risk.

The low-risk character of trade finance was reflected in the moderate rate of capitalization for cross-border trade credit in the form of letters of credit (LCs) and similar securitized instruments under the Basel I regulatory framework put in place in the late 1980s and early 1990s. The Basel I text indicates that “short-term self-liquidating trade-related contingencies (such as documentary credits collateralised by the underlying shipments)” would be subject to a credit conversion factor equal or superior to 20 percent under the standard approach. This meant that for unrated trade credit of $1 million to a corporation carrying a normal risk weight of 100 percent and hence a capital requirement of 8 percent, the application of a credit conversion factor (CCF) of 20 percent would “cost” the bank $16,000 in capital.

The basic text and CCF value for trade finance was kept largely unchanged under the Basel II framework. In particular, short-term, self-liquidating, trade-related contingencies (such as LCs) remained subject to an unchanged 20 percent CCF. However, issues of pro-cyclicality, maturity structure, and credit risk have arisen under the Basel II framework. In an internal-rating-based and risk-weighted assets system, the amount of capitalization to back up lending depends on the estimated risk at a particular time and for a particular borrower. For financial institutions without the resources to operate their own models of credit risk estimation, the standardized approach would provide guidelines of how to manage risk and allocate capital according to the wider proposed set of economic risk categories.

External credit ratings for cross-border lending under Basel II are based on benchmarks provided by international commercial agencies. More sophisticated financial institutions rely on an “advanced internal rating-based” approach to estimate such credit risk themselves, taking into account a number of compulsory
criteria. Among the most-contested criteria is that, under Basel II, the country risk cannot be worse than any counterparty risk in that country; therefore, any deterioration of the country risk during a recession, for example, will automatically and negatively affect the country risk regardless of the underlying creditworthiness of that counterparty. The subordination of the risk weighting of end borrowers to that of the country risk is one reason why there are still 30 to 40 countries in the world in which access to trade finance at affordable rates is difficult—because recent sovereign defaults in Eastern Europe, Central Asia, or Africa still have a negative effect on the rating of individual counterparties.

Although even regulators acknowledge that the Basel II framework is inherently pro-cyclical in design (with capital requirements increasing in low cycle), trade finance professionals consider that banks face higher capital requirements for their trade assets relative to other forms of potentially riskier domestic assets, notably during crises. The reason is the high intensity of the banks’ trade lending to midmarket companies and customers in developing countries. As the International Chamber of Commerce (ICC) indicates, “The capital intensity of lending to mid-market companies under Basel II is four to five times higher than for equivalent transactions under Basel I” (ICC 2009).

Regulators generally temper the professionals’ remarks with the following arguments. First, the 20 percent CCF recognizes that trade credits are normally less risky than ordinary loans. Second, acknowledging that the bulk of the trade finance business is in the hands of large international banks, the regulators also suggest that, under the advanced internal rating-based approach, these institutions can determine their own estimates of the appropriate CCF to apply to a trade finance commitment when calculating the required amount of capital to back it up. Depending on historical loss experience, particularly if it is low, the capital required under the advanced internal rating-based approach could be lower than under the standardized approach.

Finally, perhaps the most difficult issue now facing trade financiers is the maturity cycle applied to regulation of short-term trade lending. Although trade finance lending is usually short-term in nature (markets indicate that more than two-thirds of lending is 60–90 days), the Basel II framework applies a de facto one-year maturity floor for all lending facilities. Because capital requirements increase with maturity length, the capital costs of trade finance are felt to be artificially inflated. If capital costs were instead to be applied for the exact maturity of self-liquidating instruments, considerable amounts of capital could be freed for trade finance.

Although the U.K. Financial Services Authority waived the one-year maturity floor, no other authority followed through immediately after the G-20 London Summit, when the Leaders Statement asked regulators to support trade finance by
applying the rules more flexibly (G-20 2009). The Basel Committee responds that, subject to supervision discretion, the floor does not apply, for example, to short-term, self-liquidating trade transactions; import and export credit; and similar transactions. So the issue was not so much related to the rules of Basel II, but rather to how jurisdictions have implemented them.

At least, there might be a need for clarification within the competent regulatory circles. When one looks at the text of paragraphs 321 and 322 of the Basel II framework (BCBS 2006), the drafting clearly poses the principle of application of the one-year maturity floor to lending assets (Article 321) but indicates

short-term exposures with an original maturity of less than one year that are not part of a bank’s ongoing financing of an obligor may be eligible for exemption from the one-year floor. After a careful review of the particular circumstance of their jurisdictions, national supervisors should define the types of short-term exposures that might be considered eligible for that treatment. The results of these reviews might, for example, include some transactions such as: . . . some short-term self-liquidating transactions. Import and export letters of credit and similar transactions could be accounted for at their actual remaining maturity.

One the one hand, the text can be read as applying the one-year maturity principle unless some categories of short-term assets are exempted after review. On the other hand, the text could be read as clearly defining the exemptions to the rules and advising regulators to perform due diligence when providing for such exemptions. However, no regulator to date has conducted reviews apart from the U.K. Financial Services Authority.

**Basel III Proposals**

Notwithstanding the treatment of trade finance in the Basel II framework, on January 10, 2010, BCBS made new proposals to the Committee of Governors of Central Banks and Heads of Supervision of the Bank for International Settlements (BIS). These proposals, contained in a Consultative Document (“Strengthening the Resilience of the Banking Sector”), were opened for public comments in spring 2010 (BCBS 2010). The 279 comments from financial institutions, including commercial banks and export credit agencies, were published on the BIS website (www.bis.org). After an ongoing process of consultation, BCBS was scheduled to propose final recommendations by the end of 2010.

One of the Basel Committee’s key proposals to reduce systemic risk is to supplement risk-based capital requirements with a leverage ratio to reduce incentives for leveraging. The intention of reducing such incentives is relatively consensual and has been shared by economists, regulators, and bankers. The idea, under
paragraphs 24–27 of the BCBS draft proposals, is to impose such a leverage ratio, in the form of a flat 100 percent CCF to certain off-balance-sheet items (BCBS 2010).

The WTO’s view is certainly not to challenge the well-founded principle of creating a leverage ratio to discourage the accumulation of off-balance-sheet items that could potentially become toxic for the financial system as a whole. On the contrary, its director-general has been on the record in calling for a strong, rules-based international cooperation on financial regulatory matters, not least because in the 1995 ministerial Decision on Coherence in Global Economic Policy Making, WTO ministers called for a stable financial environment. The current efforts of BIS and the Basel Committee are undoubtedly strengthening the international economic architecture as a whole.

Under paragraph 232 of the new Basel proposal, though, the leverage ratio would apply to “unconditionally cancellable commitments, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities” (BCBS 2010). The trade finance industry must examine the implication of this provision. Clearly trade credit exposures have never been used as a source of leverage, in particular given that they are supported by an underlying transaction that involves either movement of goods or the provision of a service.

The question of why off-balance-sheet trade exposures are not being automatically incorporated into the balance sheet (to avoid the leverage ratio) is one of process. The processing of LCs, which are highly documented for the financial transactions’ own security, involve off-balance-sheet treatment at least until the verification of the documentation is finalized—a process that has existed for a long time. The financial crisis has resulted in even greater scrutiny of such documentation. The rigor of the document verification process is at the very heart of what an LC is, and it concurs to its safety. Given the high rejection rate of poorly documented LCs (up to 75 percent for first submissions) and the fact that, if definitively rejected, the LC might not even enter the balance sheet, it is argued that the off-balance-sheet management of these exposures is necessary and usually only a temporary treatment of what would eventually become an on-balance-sheet commitment.

The banking community argues that the application of the leverage ratio to off-balance-sheet LCs would increase banks’ cost to offer such risk mitigation products. That cost will either be passed on to customers, making it even more difficult for smaller businesses to trade internationally, or, absent incentives to issue LCs, customers may simply choose to use on-balance-sheet products such as overdrafts to import goods (because these carry less-stringent documentary requirements) that may be far riskier for the banking sector in general.
Finally, the issue has some importance for developing-countries’ trade. Open-account financing is not as appreciated by developing countries as by developed countries. Traditional LCs bring more security and are more appreciated. Given that world trade is likely to be driven by South-South trade in the future, the prudential treatment (and cost) of LCs is critical for developing- and emerging-market economies.

BCBS representatives argue that the adoption of a leverage ratio would have the effect of placing a floor under the risk-based measure and thereby help contain the buildup of excessive leverage in the banking system, one of the sources of the recent financial crisis. A leverage ratio per se is not risk-based. For example, cash items and AAA-rated government bonds would also be included at face value, although they are not subject to capital requirements under the risk-based measures. Conceptually, the leverage ratio also implies that all off-balance-sheet items would be included in the calculation using a flat 100 percent CCF, and hence, trade finance would not necessarily be at a disadvantage relative to other high-quality assets. But it is clear to regulators that the leverage ratio would help contain banks’ building of an excessive, systemic position even in what appear to be low-risk activities, but that could pose severe risks in periods of systemwide stress. BCBS is nonetheless prepared to take account of the quantitative impact of its proposals based on the results of a comprehensive study it is conducting.

What is important at this stage is that the trade finance community and regulators speak based on facts and figures, not only on principles. The Basel II framework requires a minimum of historical data to establish the maturity structure and the safe character of specific financial instruments, but it has not always been easy for banks to isolate trade finance data from other credit exposure. For this purpose, under the sponsorship of the WTO Expert Group on Trade Finance, the Asian Development Bank and the ICC launched in November 2009 a pilot project to create an International Trade Finance Loan Default Registry, aimed at collecting data on trade finance operations and showing that the default rate for such business is one of the lowest in the industry (ICC 2010). The database has been operational since spring 2010, and the data are likely to be most instrumental in the discussion between the trade finance community and regulators on some of the regulatory aspects of both Basel II and the making of Basel III. On June 1, 2010, a first official and direct meeting took place to discuss some of these issues, with a view to reach a fair and just regulation for trade finance.

Conclusions

In the economics of regulation, there can be doubts about the ability of public authorities to adopt fully independent points of view. A recent paper argues that
the Basel II framework did not fail because it was too ambitious but rather because creators fell short of their aim of improving the safety of the international banking system (Lall 2009). Intense and successful lobbying by the banking sector was, according to the paper, largely responsible for the failure of regulators and supervisors to impose sufficiently stringent standards.

For the same reason, Lall believes that recent proposals to reregulate the international banking system are likely to meet a similar fate. Drawing on recent work on global regulatory capture, the paper presents an interesting theoretical framework, emphasizing the importance of timing and sequencing in determining the outcome of rule making for international finance (Lall 2009). Lately, though, G-20 leaders have shown great resolve in amending international prudential regulation to strengthen the international financial system and avoid the repetition of past regulatory failures. To this aim, the Financial Stability Board has been reinforced in its mission to present important reforms, commensurate to the magnitude of the recent financial crisis.

The matters involved in financial regulation are inherently complex and require the understanding of all sides. In matters that are at the crossroads of trade and financial regulation, there should be a thorough examination of both cultures and instruments. In this regard, there should certainly be some middle ground in attempting, on the one hand, to prevent toxic assets from spreading throughout the financial system and harming its transparency through off-balance-sheet vehicles and, on the other hand, seriously disrupting a long-standing process for securing trade credit instruments.

For this reason, the trade finance and the regulatory communities should understand one another’s processes and objectives; they are not necessarily at odds. The trade finance community believes it promotes a cautious model of banking that has clearly been financing the sustained expansion of international trade without major hurdles until the recent crisis. The two communities should be encouraged to develop a mutual understanding and to meet regularly during the comment period to reach a consensus on processes and, hence, on a new regulatory framework that can be both right and fair.

References


Trade Finance during the Great Trade Collapse