

Finance for Development

Banking Commission

Banking Regulation And The Campaign To Mitigate The Unintended Consequences For Trade Finance: A Milestone Report

What are the next steps for ensuring that regulation does not hinder availability of finance and remains relevant in a digital landscape?

FOREWORD

By Olivier Paul, Director, Finance for Development, ICC

International trade flows continue to outpace global GDP growth. Significant gaps remain, however, in the provision of trade finance, particularly for small and medium-sized businesses, most notably in emerging markets. The gap between the demand and supply of trade finance – or trade finance gap – currently stands at US\$1.5 trillion, according to figures from the Asian Development Bank.

Regulation and compliance requirements that have come into force since the 2007 financial crisis, while well-meaning, have unintentionally led to the exacerbation of this financing gap. In order to minimise risk, banks are actively reducing their number of correspondent banking relationships – particularly in emerging markets – thereby affecting companies that need financing the most.

In turn, this paper aims to provide an overview of how the industry can work together with regulatory bodies to help alleviate such negative impacts, promoting a fairer treatment of trade finance within banking regulation.

While the bulk of the regulations discussed throughout the paper relate to European legislation, our work is global in scope, with our meetings – such as the 2019 Annual Meeting in Beijing, and 2018 Technical Meeting in Tbilisi – and working groups gathering trade finance professionals from across the world to help develop rules and standards for global trade.

By taking a look at regulations affecting capital and liquidity requirements, in addition to those aimed at countering financial crime, we can observe the successful work that has been done to date promoting a better treatment of trade finance instruments. With growing interest in the digitalisation of trade finance, we also take the opportunity to look towards future regulatory updates and the opportunities such change brings for the industry.

Discussion and exchange with regulatory bodies is required at the earliest possible stages of the decision-making process, however, if we are to achieve the best results for the industry. As the only private sector Observer to the UN General Assembly and a leading voice for global business across intergovernmental forums, ICC is uniquely positioned at the forefront of discussions, leading the way in making trade finance more accessible for all market participants.

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ACRONYMS

AML – Anti-money laundering
BCBS – Basel Committee on Banking Supervision
BRRD – Bank Recovery and Resolution Directive
CCF – Credit Conversion Factors
CFT – Countering the financing of terrorism
CRD – Capital Requirements Directive
CRR – Capital Requirements Regulation
ECA – Export Credit Agency
EU – European Union
FATF – Financial Action Task Force
G-SIBs – Global systemically important banks
MSME – Micro, small and medium-sized enterprises
NSFR – Net Stable Funding Ratio
KA – Key Attributes of Effective Resolution Regimes for Financial Institutions
KYC – Know Your Customer
LC – Letter of Credit
RSF – Required Stable Funding Factor
RWA – Risk-Weighted Assets
UCC – Unconditionally Cancellable Commitment
US – United States

1. BANKING REGULATIONS – WHERE DO WE STAND?

1.1. Basel III

The Basel Committee on Banking Supervision (BCBS) is the primary global standard setter for the prudential regulation of banks and provides a forum for regular cooperation on banking supervisory matters. Basel III, the third instalment of the Basel Accords – a set of international banking regulation recommendations developed by the BCBS in 1988 – were agreed in 2010 in the wake of the global financial crisis of 2007-2008. A gradual implementation was scheduled between 2013 and 2018. The recommendations aim to address the shortcomings of the pre-crisis regulatory framework and provide a “foundation for a resilient banking system that will help avoid the build-up of systemic vulnerabilities”.¹

As part of the recommendations, a bank's Tier 1 and Tier 2 capital must be at least 8% of its risk-weighted assets (RWA), with an additional buffer of 2.5% requested. What's more, 29 global systemically important banks (G-SIBs) must maintain an additional capital surcharge (common equity requirement) ranging between 1% and 3.5%.

Notes

Tier 1 capital is the core capital of a bank, which includes equity capital and disclosed reserves.

Tier 2 capital represents other sources of capital.

Another important element set out by the framework is the leverage ratio, restricting the build-up of leverage in the banking sector and reinforcing the risk-based requirements with a simple, non-risk-based “backstop” measure.² As such, banks must always maintain at minimum a 3% leverage ratio. G-SIBs must also meet a leverage ratio buffer requirement set at 50% of their higher-loss absorbency risk-weighted requirements. For example, a G-SIB subject to a 2% higher-loss absorbency requirement would be subject to a 1% leverage ratio buffer requirement.

Notes

$$\text{Leverage ratio} = \frac{\text{Capital measure}}{\text{Exposure measure}}$$

1.1.1. European implementation of Basel III

The Capital Requirements Directive and Regulation (CRD & CRR respectively) set the prudential framework for financial institutions operating in the European Union (EU). In turn, CRD IV introduced into EU law the internationally agreed standards for capital requirements, as set out by the Basel III framework. The CRR introduced the binding 3% leverage ratio for all institutions subject to CRD, in addition to a Net Stable Funding Ratio (NSFR). The NSFR is a long-term structural or liquidity ratio set out in Basel III to address liquidity mismatches in banking activity by requiring banks to hold adequate amounts of long-term funding in relation to their on- and off-balance sheet activities.³

¹ BCBS, “High level summary of Basel III reforms”, 2017.

² BCBS, “High level summary of Basel III reforms”, 2017.

³ European Parliament, “Amending capital requirements - The CRD V package”, 2018.

An update to this directive and regulation, CRD V and CRR II, will come into force from 2019, with the aim of encouraging “more sustainable bank financing of the economy, especially in regard to small and medium-sized enterprises”.⁴

1.2. Resolution framework for financial institutions

A second set of regulatory developments following the financial crisis concern the resolution framework for financial institutions. In addition to capital and liquidity requirements, enhancements to resolution regimes were considered an additional important step to ensuring the stability of the banking system. As such, the Financial Stability Board’s Key Attributes of Effective Resolution Regimes for Financial Institutions (KA) were endorsed by the G20 in 2011.

Notes

A “**resolution**” refers to a bank’s restructuring in order to safeguard public interests, including the continuity of the bank’s critical functions, its financial stability and minimizing costs to taxpayers.⁵

In turn, the Bank Recovery and Resolution Directive (BRRD) is an EU framework – implementing the KA and building upon other EU legislations such as CRD and CRR – adopted in 2014 for managing bank failure effectively. This includes recovery and resolution planning and early intervention measures to foster forward looking supervision and crisis prevention, for example.

1.3. Financial crime regulations

Anti-money laundering (AML) and countering the financing of terrorism (CFT) are key priorities for the trade finance industry. In turn, regulation and compliance requirements have been developed to help support global efforts in combating the use of banks and financial institutions for criminal activities.

In 2012, the Financial Action Task Force (FATF) released a revised version of the *International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation* (known as the FATF standards), to which the BCBS provided input. In 2017, the BCBS also released guidelines for *The Sound Management of Risks Relating to Money Laundering and Financing of Terrorism*, building on the FATF standards and the BCBS’ core principles.

Risk management relating to trade-based financial crime is essential for the safety and soundness of the international banking system, helping to protect the reputation of banks and deterring their use to launder, move or raise illicit proceeds. However, the growing number of regulatory and compliance requirements is placing an increasingly large burden on financial institutions, with banks required to apply large internal resources and incur growing costs to ensure compliance.

⁴ European Parliament, “Amending capital requirements - The CRD V package”, 2018.

⁵ SRB, “What is a bank resolution”.

2. UNINTENDED CONSEQUENCES FOR TRADE FINANCE

2.1. Unfair treatment of trade finance

The treatment of trade finance, particularly in the form of short-term letters of credit (LC), has been subject to much scrutiny during the development of Basel III rules. International public institutions representing the trade and development communities requested that the relatively light regulatory treatment accorded to such instruments under previous versions of the Basel framework be by-and-large preserved to avoid penalising trade with emerging markets, which rely heavily on such instruments.

Some 80% of international trade flows involve the recourse to a financial instrument, according to the World Trade Organisation; whether an LC, a technical guarantee, an export credit or another tool.⁶ Hence rules applying to the financing of international trade affect not only banks but also, and perhaps even more significantly, importers and exporters.

Some improvements to the original rules applying to trade finance instruments have been introduced since 2011, such as the removal of a minimum duration of one year for the calculation of RWAs for LCs or the reduction in credit conversion factors (CCF) for off-balance sheet instruments in the leverage ratio. Yet significant challenges remain.

2.2. Lack of standardised implementation across jurisdictions

One of the most critical concerns remains the lack of standardisation across jurisdictions. As the BCBS does not have the authority to enforce its recommendations, it is left to national (or supranational) institutions to write these into their legislation and define the parameters of implementation. Within the EU for instance, the first point of call is the European Commission, followed by the European Parliament and the European Council.

What's more, the recommendations set out within the Basel III framework allow significant room for interpretation. When these international standards are implemented at the national and sometimes even subnational level, each jurisdiction has the right to interpret and adapt them accordingly. Emerging market banks are subject to the resulting ambiguity, as well as variance and inconsistencies between jurisdictions.⁷

Two examples of this lack of standardisation are the implementation of Article 55 of the BRRD and of Basel III's NSFR.

The variance in implementation of Article 55 of the BRRD could be highly detrimental to trade finance in Europe. While the requirement set out under Article 55 came into effect in January 2016, most banks, with the full support from their national regulators, did not apply it for trade finance, because it was not considered well-designed.

Indeed, under the requirement, an LC from a European bank in favour of a non-European client would no longer have the same value (in terms of finance and legal enforcement) compared to the same LC opened by a bank based in the United States (US). This is because implementation of Article 55 requires the introduction of a "bail-in" clause whereby the LC would only be honoured and paid when the issuing bank is in "good shape". This is therefore of importance to the beneficiary, which may be unable to know whether they will be paid by the issuing bank, as it will depend on the credit-worthiness of this issuing bank. In contrast, there is no such requirement in the US. It is clear, therefore, that this creates a disadvantage for

⁶ WTO, "Trade Finance and SMEs", 2016.

⁷ IFC, "Increased Regulation and De-risking are Impeding Cross-Border Financing in Emerging Markets", 2018.

European companies when competing with non-European companies as the latter will issue documents without such a clause.

With regards to the NSFR, the Basel Committee considered that the Required Stable Funding Factor (RSF) for LCs and technical guarantees should be determined by national legislators. As such, the EU Commission and Council recommendation for NSFR was to have a variable rate of 5%-15% depending on the maturity of the transaction (5% for under 6 months; 10% for under 12 months; 15% for over 12 months). These levels were also recommended by the European Banking Authority.

In many jurisdictions outside the European Union, however, the NSFR is either flat – whatever the maturity of the transaction – at a maximum level of 5% or non-existent. This represents another evident disadvantageous regulation at European level.

Notes

The NSFR is expressed as a ratio that must equal or exceed 100%. The ratio relates the bank's available stable funding to its required stable funding, as summarised in the following formula:

$$\frac{\text{Total Available Stable Funding (ASF)}}{\text{Total Required Stable Funding (RSF)}} \geq 100\%$$

A bank's total ASF is the portion of its capital and liabilities that will remain with the institution for more than one year.

A bank's total RSF is the amount of stable funding that it is required to hold given the liquidity characteristics and residual maturities of its assets and the contingent liquidity risk arising from its off-balance sheet exposures.⁹

While these are seemingly European issues, their impact is global, also affecting non-European banks dealing – via their subsidiaries based in the region – with European corporates. As such, the potential negative impact is widespread across the industry.

2.3. Emergence of the trade finance gap

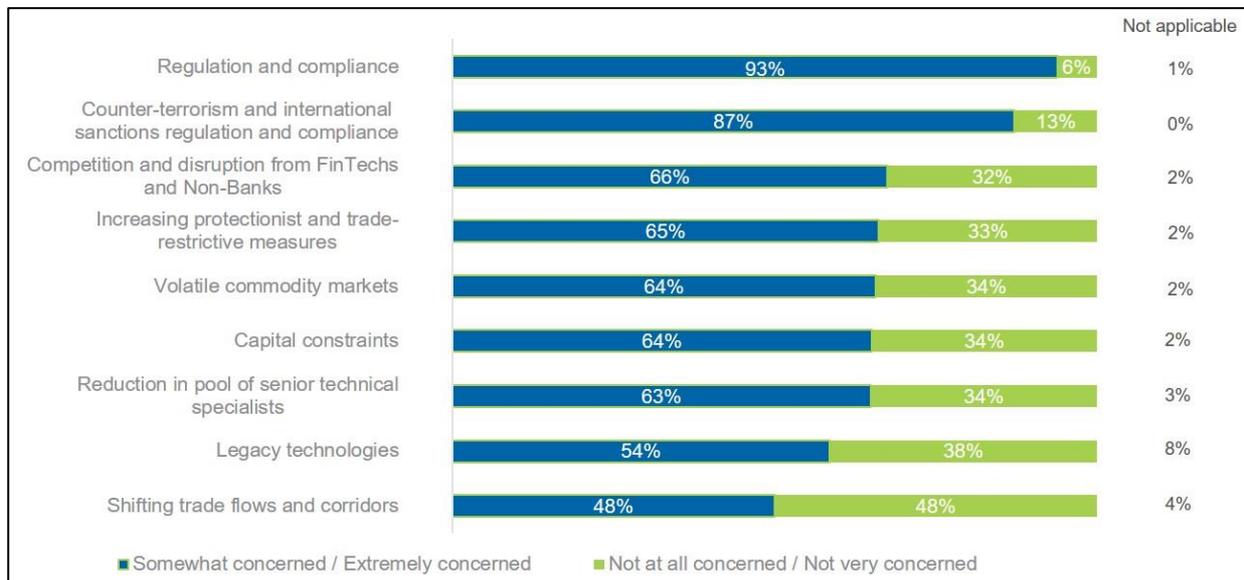
The result of this uncertainty and variance, in addition to the pressure of compliance requirements (especially relating to AML, CFT and KYC, for example), has generated a certain level of “de-risking”, whereby financial institutions terminate or restrict business relationships with clients or categories of clients to avoid, rather than manage, risk.⁹ Results from the 2018 ICC Banking Commission Global Survey on Trade Finance revealed nearly 90% of respondents highlighted regulatory and compliance concerns as a major obstacle to growth (Figure 1).¹⁰

⁹ (NSFR calculation) BIS, “Net Stable Funding Ratio (NSFR) – Executive Summary”, 2018.

⁹ World Bank Group, “The World Bank’s Data Gathering Efforts: De-risking?”, 2016.

¹⁰ ICC, “10th Global Survey on Trade Finance”, 2018.

Figure 1: Banks' main obstacles to growth and concerns relating to the provision of trade finance



Source: ICC's 10th Global Survey on Trade Finance

Capital requirements, while contributing to the resilience of the financial system, have also limited the amount of capital banks have to invest in cross-border banking relationships. Banks are, therefore, reducing their number of correspondent banking relationships and counterparties. A study by the European Systemic Risk Board in 2017 estimated that a one percentage point increase in capital requirements reduces bank lending by some 8%.¹¹

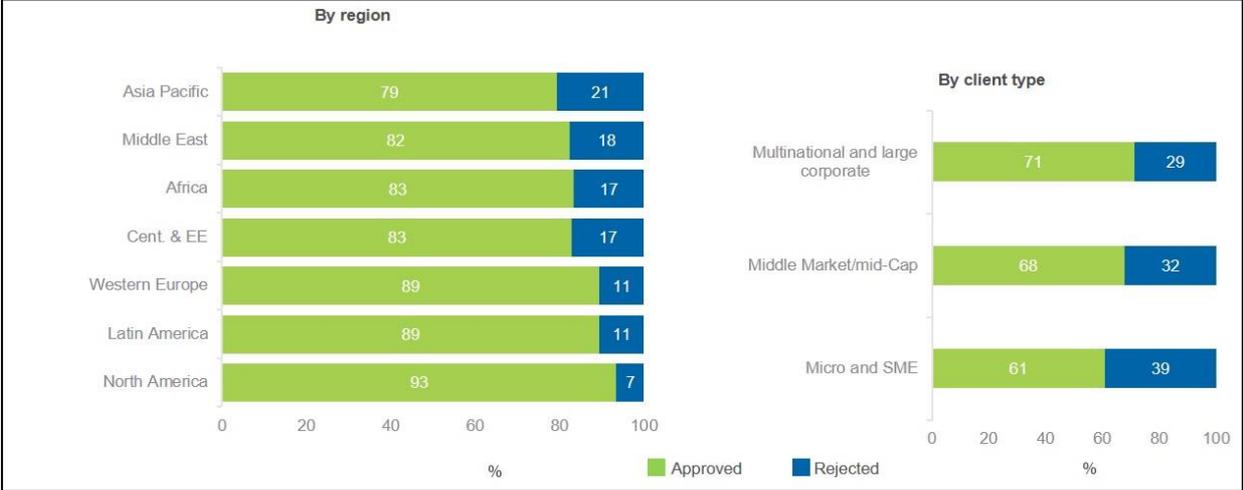
Why is this so significant? Correspondent banking relationships are critical for bridging the link between emerging markets and the global economy. De-risking is also most likely to impact micro, small and medium sized enterprises (MSMEs) in these emerging markets, given they are likely clients of the banks being cut adrift from international trade finance. This only exacerbates the pre-existing gap between the demand and supply of trade finance – or trade finance gap – which currently stands at US\$1.5trillion according to the Asian Development Bank.

Around 40% of financing requests from MSMEs were rejected in 2017 and rejection rates were highest in Asia (21%), the Middle East (18%) and Africa (17%) (Figure 2).¹²

¹¹ ESRB, "The real effects of bank capital requirements", 2017

¹² ICC, "10th Global Survey on Trade Finance", 2018

Figure 2: Trade finance approval and rejection rates across regions



Source: ICC 10th Global Survey on Trade Finance

3. WHAT PROGRESS HAVE WE MADE?

Clarification and harmonisation of regulation are therefore required to encourage banks' use of correspondent banking relationships and improve emerging markets' access to trade finance. While strong and focused regulation is necessary for a healthy financial sector, the phenomenon of de-risking threatens the economic prospects of emerging markets meaning that regulators must address the ever-increasing web of regulation and compliance requirements. ICC, for its part, is proactively working with regulatory bodies worldwide to promote the fair treatment of the industry and increase access to the market.

3.1. Article 55 of the BRRD

Given the disadvantageous impact on trade finance in Europe of Article 55 of the BRRD, the industry – led by ICC – has lobbied significantly for an amendment to the text. Through what is known as a “reverse procedure”, a waiver agreement was secured in 2019. While all European governments must ensure that Article 55 is applied within their jurisdiction, banks can now apply for a waiver with the Single Resolution Board if they consider there to be obvious reasons and explanations that justify not applying the rule.

Henri d'Ambrières, Chair, ICC Regulatory Advisory Group: *“While we initially wished to secure a full exoneration of Article 55, following extensive discussions with regulators at the European level, we were satisfied with the result of the reverse procedure.”*

3.2. NSFR for financial instruments supporting trade finance

As with Article 55, the NSFR ratios represent a common issue for the whole market and, as such, the industry – spearheaded by ICC's efforts – has advocated for fairer treatment of trade finance than originally proposed. The potential negative impact of the NSFR rates across the EU was even confirmed in a text produced by the European Council, citing potential “undue market disruption”.¹³

Given that trade finance is a low-risk business, ICC advocated for an NSFR flat rate of 5%, in line with the NSFR ratio in the US. This was rejected, but a significant reduction in the spectrum of rates was achieved, in line with the European Parliament's proposal. These now stand at 5% for a duration of less than 6 months, 7.5% for less than 12 months, and 10% for over 12 months.

Olivier Paul, Director, Finance for Development, ICC: *“While this result does not eliminate the potentially negative impact of the NSFR rates, we are pleased that it reduces it significantly.”*

¹³ Council of the European Union, “<http://data.consilium.europa.eu/doc/document/ST-14448-2018-INIT/en/pdf>”, 2018: “However, the Presidency would recommend taking on-board certain targeted amendments proposed by the European Parliament to prevent undue market disruption. Specifically, these amendments relate to the calibration of the so called “required stable funding” for certain market transactions (trade financing, factoring, repos and reverse repos).”

3.3. Other notable developments

Other areas where ICC has successfully achieved better regulatory treatment of trade finance include the labelling of forfaiting and factoring as trade finance instruments. Previously not considered as such, aligning them within the same regulatory regime as trade finance instruments allows for a lower RSF rate to be applied to such transactions.

Another example is the exoneration of the leverage ratio for some export credits extended by commercial banks and covered by official export credit agencies (ECAs). In December 2016, the EU Commission suggested an exemption for some export credits. To promote a level playing field among European ECAs and exporters, the exemption was extended to:

- all loans extended in the currency of the ECA;
- all loans, whatever the currency, if the ECA is rated AA- or above.

4. WHAT'S NEXT?

While progress to date promoting the fair treatment of trade finance across jurisdictions has been significant, much work remains to be done. The amendments, exemptions and edits to regulations outlined throughout this paper demonstrate that ICC's – and other industry bodies' – work can be highly effective.

However, for efficient and meaningful change, it is essential that discussions take place from the earliest stages of the decision-making process. A document outlining the finalisation of the Basel III framework was published in 2017 and will be enforced between 2022 and 2027. As such, over the next three years, national regulators will have to translate the Finalisation Package of Basel III into national legislation. Banks have already identified several topics of discussion relating to trade finance, such as the treatment of Unconditionally Cancellable Commitments (UCCs), the minimum durations to calculate RWAs and the treatment of subsidiaries in large groups.

Looking ahead we can expect other changes to come about – both from a regulatory and operational perspective – from the growing digitalisation of the sector. While new technologies may bring security risks – without a high level of safety and confidentiality, mismanagement and misuse of data could become a serious concern – they should also allow for better cost and time-efficiency, aiding fulfilment of compliance and regulation requirements. Indeed, with AML and KYC rules making certain trade finance transactions too risky for banks, distributed ledger technology offers solutions to alleviate this risk, by giving more power to banks and regulators to trace and evaluate financing.

Low profitability and difficulty assessing financial records leave many banks unwilling to transact with MSMEs, especially across emerging markets. Digitalisation offers part of the solution, but industry-wide effort is still needed to help harmonise and simplify cross-border regulatory frameworks, while still ensuring a high level of security for the worldwide economy. Work to date has been positive with ICC's work – via its digitalisation working group – to ensure the e-compatibility of its rules for trade finance and develop standards for digital connectivity one example of progress.

With regulatory adoption and implementation processes taking up to a decade, however, the industry must maintain a proactive approach to promoting a fair regulatory environment for trade finance. The ICC, as the largest and most authoritative voice in trade finance, is at the forefront of these efforts.