



**BAFT Response:  
Public Consultation on Implementing the Final Basel III Reforms in the EU**

**January 3, 2020**

BAFT welcomes the opportunity to respond to the [Public Consultation on Implementing the Final Basel III Reforms in the EU](#). The industry supports the Basel Committee's recalibration of the existing framework which is aimed at addressing specific weaknesses in the pre-crisis Basel Framework. The Basel III reforms are specifically intended to reduce variations in reported risk-weighted assets, which make it challenging to compare capital ratios across banks, to reduce existing incentives for banks to minimize risk weights when using internal models, and to restrict modelling choices for low-default portfolios.

BAFT is an international financial services industry association whose membership includes a broad range of financial institutions throughout the global community. One quarter of BAFT's members are headquartered in Europe. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT member banks provide leadership to build consensus in preserving the safe and efficient conduct of the financial system worldwide. BAFT closely monitors the impact that new regulatory initiatives could have on the provision of trade financing and payment services that support real economic commerce. To that end, our comments and recommendations are focused on the impact of the Final Basel III Reforms on trade finance exposures.

Global trade relies upon accessible financing for trade transactions. Trade financing assists customers with their import and export requirements, by providing import/export financing and trade risk mitigation. Trade finance, as a transaction banking product, is a core banking business serving the real economy. Trade finance exposures are diverse in nature, smaller in value, shorter in tenor, self-liquidating and exhibit different behavior and payment patterns from other corporate banking exposures. BAFT believes that the appropriate regulatory treatment for the financing of transaction banking services will ultimately have a positive effect on global markets and will spur job creation and growth within national economies.

In the lead up to the publication of the final Basel III framework, BAFT provided recommendations to the Basel Committee highlighting the low-risk, self-liquidating characteristics which differentiate trade finance from other types of financial products. BAFT considers that there are sound reasons and detailed evidence<sup>1</sup> for the final Basel III framework to treat trade finance as a separate asset class. However, the existing Basel III framework treats trade finance exposures within the broader bank and corporate asset classes. Therefore, BAFT and other industry groups will continue to put forth data to justify a more sustainable and supportive treatment for trade finance liabilities within those asset classes. The trade finance industry also prioritizes global consistency in the implementation of the Basel framework in order to minimize regional divergence, as is the case with the implementation of NSFR ratios.<sup>2</sup>

As the European Union begins the process of developing a Commission proposal to implement the final Basel III reforms, BAFT encourages the Commission to take into consideration the impact on trade activities and consider utilizing discretion when implementing the Basel III framework in the fashion outlined in our responses to the consultation. In our view, implementation in this manner can meet the stated policy goals as a prudent regulator while supporting the availability of essential trade finance for European importers and exporters.

We look forward to further dialogue on these important issues. For further information, please contact Diana Rodriguez, Senior Director, International Policy at [drodriguez@baft.org](mailto:drodriguez@baft.org).

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<sup>1</sup> The ICC Trade Register provides evidence as to the low risk nature of trade finance, and in particular, its low risk relative to other forms of corporate and bank lending products. <https://iccwbo.org/publication/icc-trade-register-report/>

<sup>2</sup> BAFT, and other industry groups have advocated for an NSFR flat rate of 5% in Europe, in line with the NSFR ratio in the U.S. While this was not achieved, a significant reduction in the spectrum of rates was obtained, 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.

### 1.1.2.2. IDENTIFICATION OF SHORT-TERM EXPOSURES TO INSTITUTIONS

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**QUESTION 10: In your view, what are the relative costs and benefits of using the original maturity as opposed to the residual maturity for identifying short-term interbank exposures? Please provide relevant arguments and evidence to substantiate your views.**

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The Basel Committee allows a jurisdiction, at national discretion, to keep applying the effective maturity instead of the fixed maturity treatment of 2.5 years. BAFT's members consider that maturity is a key risk driver for Trade Finance exposures and therefore that maturity remains appropriate to use in the future IRB approach.

Paragraph 107 of the Final Basel III framework states that for the IRB Foundation approach, effective maturity can be chosen by the National supervisor. Paragraph 111 further states that "the one-year floor also does not apply to the following exposures:

1. Short-term self-liquidating trade transactions. Import and export letters of credit and similar transactions should be accounted for at their actual remaining maturity.
2. Issued as well as confirmed letters of credit that are short term (i.e. have a maturity below one year) and self-liquidating."

Residual maturity captures the actual risk at all moments. Original maturity would gradually overstate risk, increasing as a facility reaches maturity. The change in the capital consumption due to the introduction of original maturity would lead industry demand to suffer. The cost will be transferred to the clients using the products concerned and will either limit the client's possibilities to sell their products or trigger alternative cheaper and possibly riskier products to the market. In our view, introducing original maturity would be counterproductive to reaching the objectives set out for the European community.

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**QUESTION 11: What are your views on the extension of the scope of the preferential treatment for short-term interbank exposures under Basel III from three to six months for exposures to institutions that arise from the movement of goods across national borders? To what extent would the change in definition change the amount of exposures benefitting from the preferential treatment? Please provide relevant evidence to substantiate your views.**

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Changing the definition of short-term interbank exposures from three to six months for exposures to institutions that arise from the movement of goods across national borders would have a positive effect on institutions' delivery of trade finance products. Expanding the time horizon would permit the majority of trade finance products to fall within the newly defined time parameters.

By definition, short-term trade finance products have short contractual maturities and are often issued on a transaction-by-transaction basis (i.e. they are not revolving facilities). This provides banks with the ability to actively manage their risk by ceasing to underwrite trade business for customers with deteriorating credit quality.

The ICC Trade Register shows that the average contractual maturity for trade finance products is 114 days for import Letters of Credit, 131 days for export Letters of Credit, 144 days for loans for

import/export, and 607 days for performance guarantees. There is however significant variation in the maturities within products, highlighting that banks are willing to underwrite a wide variety of business, even within individual products.

An important observation is that time to recovery is much shorter for trade finance products – six months or less on average – compared with over one year for other asset classes (Figure 11 in the ICC Trade Register). This is due to the inherent characteristics of trade finance products and the underlying collateral, and helps drive low LGD values for trade finance products. Trade finance products have significantly lower time to recovery than other comparable asset classes (Figure 40). One possible explanation is that banks can take ownership of underlying goods for trade finance products and sell them quickly, depending on the product. This results in the exposure being held on the balance sheet for a short period of time.

### **1.1.3.1. TREATMENT OF UNRATED CORPORATES**

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**QUESTION 14: What other measures, if any, could be taken to increase the risk-sensitivity of the standardised RW treatment of corporate exposures which currently have no external rating? Please elaborate and provide relevant evidence.**

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Europe's economy depends in large part on 25 million SMEs, most of them unrated that will suffer reduced availability and higher cost of credit thanks to Basel III output floors. Further, in the treatment of unrated corporate exposures in jurisdictions where external ratings were previously allowed, the revised standardised approach now assigns a 100% risk weight for externally unrated corporate exposures. An unintended consequence of the regulation is that unrated subsidiaries of corporates with an investment grade external rating of the parent company will also attract a 100% risk weighting.

The impact will be significant for European Banks where corporate external ratings are far less common. Given that many corporates use trade finance facilities, trade as an asset class is also affected. There is a strong case for arguing that, where the parent company is externally rated, their unrated subsidiaries should be assigned a notched rating from the parent, or a risk weight of 65% if it is deemed to be an investment grade corporate in line with internal bank criteria set for investment grade companies.

### **1.1.3.2. TREATMENT OF SPECIALISED LENDING (SL)**

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**QUESTION 16: Views are sought on the costs and benefits of implementing the specific treatment of SL exposures provided by the Basel III standards (paragraphs 44-48). In particular, how does this treatment compare with the current treatment in terms of risk-sensitivity, impact on RWAs and operational burden? Please provide relevant evidence to substantiate your views.**

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Generally, several conditions affect the risk level of specialized lending projects like:

- The type of jurisdiction (geography),
- Legal framework tied to the project,
- Commitment of sponsor,
- Monopoly/semi monopoly environment,
- Feed in tariff based/publicly supported,
- Equity injection, and
- Type of asset.

A standardized framework puts the projects' special conditions on a par, capturing neither seniority nor deal structure, and it even encourages possibilities of risk arbitrage. Infrastructure projects should be discounted, based on predictable publicly supported cash flow and sponsorship.

#### 1.1.8.1. DEFINITION OF COMMITMENT

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**QUESTION 55: What is your view on the national discretion to exempt certain arrangements for corporates and SMEs from the definition of commitments? In your view, which arrangements should be exempted from the definition of commitment, if any? Please provide relevant evidence to substantiate your views.**

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Unconditionally Cancellable Commitments (UCCs) are essential for financing the economy. They enable banks to grant financing solutions to corporate clients with the possibility to monitor and restrict any drawings before any sign of weakness is identified. As an example, undrawn Trade Finance lines are often provided on an uncommitted basis, requiring a prior agreement of the bank before any drawdown by the client. The same situation is encountered in case of undrawn lines for discounting receivables. The Basel Committee is vague in directing regulators on the treatment of UCCs and suggests that the use of discretion during implementation is appropriate.

Specifically, the Basel Committee allows jurisdictions to exempt, under national discretion, certain arrangements from the definition of commitment, provided that four conditions are met. Therefore, we suggest the adoption of the following definition for commitments:

“Commitment means any contractual arrangement that has been offered by the bank and accepted by the client to extend credit, purchase assets or issue credit substitutes. It excludes arrangements that satisfy the following conditions:

- i. the bank receives no fees or commissions to establish or maintain the arrangement and,
- ii. the client is required to apply to the bank for the initial and each subsequent drawdown and,
- iii. the bank has full authority over the execution of each drawdown, regardless of the fulfilment by the client of the conditions set out in the facility documentation, including situations of overdrafts, where clients can draw but the bank monitor clients exposures and can interrupt drawing at any time, and

- iv. the bank's decision on the execution of each drawdown is only made after assessing the creditworthiness of the client immediately prior to drawdown (\*).

(\*). condition (iv) is deemed satisfied when banks have monitoring tools procedures to detect any significant deterioration of a client's credit quality."

We would urge the Commission to exclude from the definition of "commitment" unconfirmed arrangements linked to off-balance sheet trade finance instruments as long as the above conditions, outlined by the Basel Committee, are met. This will ensure that these commitments are not unduly penalized by applying a 0% CCF to commitments to Corporates and Financial Institutions that are unconditionally cancellable.

While Basel III restricts (footnote #53 p25) the exempted arrangements to certain arrangements for Corporate and SMEs, BAFT further suggests that the Commission should remove this limitation which is not justified economically if the four above mentioned conditions are met.

### **1.1.8.2. NEW CREDIT CONVERSION FACTORS (CCF)**

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**QUESTION 57: What are the costs and benefits of the new CCF introduced by the Basel III standards? In particular, how does the Basel III treatment of OBS items compare to the current treatment in terms of risk-sensitivity and impact on RWAs. Please provide relevant evidence to substantiate your views.**

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Paragraph 81 of the Basel III Final Framework states that a 50% CCF will be applied to certain transaction-related contingent items including performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions.

In Europe, the current Capital Charge framework for Credit Institutions, defined by the CRR stipulates that these kinds of products receive a 20% CCF as per appendix 1, "Classification of off-balance sheet items".

Beyond the important RWA and leverage impact that such a change would have in the CCF applied to those products, historical figures from Global Credit Data show that a 20% CCF is highly conservative compared with the realized CCF (around 8%). Applying a 50% CCF as proposed by the Basel Committee therefore does not seem justified or appropriate.

It is important to highlight the fact that European regulators have chosen to apply a more appropriate CCF to this category of commitments when publishing regulation (EU) No 575/2013. We therefore suggest maintaining the same level of CCF (20%).

Should the CCF be increased to 50%, European banks are likely to price technical guarantees at higher rates to clients. The effect will be to discourage these business activities and make it costlier to offer trade finance.

## **1.2.12. OTHER PROVISIONS**

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**QUESTION 94: In your view, which other aspects, if any, should be considered in the context of revising the IRBA? Please elaborate and rank your answers from the most important to the least important aspect.**

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Maturity – Trade finance exposures are diverse in nature, smaller in value, shorter in tenor, self-liquidating and exhibit different behaviors and payment patterns from other corporate banking products. Trade finance related short-term exposures are not part of ongoing financing of an obligor, rather they are a type of payment/transaction facility which facilitates exports and imports for real economy corporates. Consequently, the tenor should reflect the residual maturity as described under question 10 above.

## **1.3.1. REMOVAL OF OWN ESTIMATES OF HAIRCUTS AND USE OF SUPERVISORY HAIRCUTS**

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**QUESTION 98: Do the revisions affect certain exposure classes more than others? Please elaborate and provide relevant evidence to substantiate your views.**

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For special assets like commodities finance (Oil & Gas, Metals and Crops) it is proposed that an LGD of 15% be applied for a fully collateralized exposure, after a haircut of 40%, and 25% for an unsecured exposure. Global Credit Data statistics show actual loss levels of 0.12% for transactions of the following types; Self-liquidating, Liquidity of the underlying goods, Level of control of the bank and Quality of the legal documents (UCP 600/ICC documents). In these cases, a CCF in the range of 5-10% would be realistic including a removed haircut. For L/Cs based on UCP 600/ICC documentation, a general discount should be introduced.