November 17, 2016

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Ladies and Gentlemen:

We understand the Basel Committee on Banking Supervision ("Basel Committee" or "the Committee") is currently preparing for resolution of its ongoing work on the Basel III package of reforms. With that in mind, BAFT felt it appropriate to share some additional analysis conducted since our previous comments on the sum of the Committee proposals and its impacts on trade finance specifically.

BAFT is an international financial services trade association whose membership includes a broad range of financial institutions throughout the global community. 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.

As BAFT represents the transaction banking segment of financial institutions globally - including the trade finance and cash management business lines - we are particularly concerned about the impact that new regulatory initiatives could have on the provision of these crucial financing and payment services that support real economic commerce. To that end, BAFT's comments are primarily focused on issues for these particular sectors of the banking industry.

I. Introduction

As the Committee is aware, BAFT has offered comment letters in regards to two of the Committee's consultations over the past year: *Revisions to the Standardized Approach for credit risk* and *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*, respectively. The latter submission was offered in partnership with the International Chamber of Commerce ("ICC"). Both documents attempt to detail the uniquely low risk nature of trade finance, offer evidence as to why we believe the individual consultations as proposed do not properly reflect appropriate treatment of the asset class, will damage the trade finance line of business and global trade more widely, and, in the cases where we disagree, offer alternatives to the Committee's proposals as appropriate.

You may refer to our earlier letters that detail in depth, and with backing from the ICC Trade Register among other sources, 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. The ICC Trade Register illustrates the quality of the trade finance business as an asset class, doing so on the basis of industry data as well as expert analysis and qualitative observations. Additionally, we would refer to those earlier letters our suggestions for evidence-based modifications to some of the Committee's proposals. In our view these modified proposals can meet the stated policy goals of the Committee without unduly harming trade finance. As stated prior, and worth reiterating today, we understand and are sympathetic to the Committee's concerns regarding the accuracy of models that are based on portfolios with low default as a primary characteristic. It is why leading banks and industry groups have spent significant time and resources on data pooling efforts, such as the ICC Trade Register and other sources.

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That said, we believe it crucial to again demonstrate the significant danger to trade finance, which provides vital support for global trade and economic growth, if the proposals remain unchanged. The models included in this letter reflect the basis for industry concern regarding the proposals has revolved around the overall increases in capital that may result from the proposals, and the difficulty that the variety and sheer number of proposals present to institutions as they weigh impacts. In this letter we demonstrate the tangible price and capital impacts on specific lines of business and more importantly, on specific client segments. Companies such as those who build and improve major infrastructure in countries (developed and emerging) across the world, as well small and medium size enterprises that provide lifeblood for the global economy, will be most severely impacted. We applaud the Committee's repeated statement that this is "not an exercise in increasing regulatory capital requirements"[1], but the effect of these proposals may result in just the opposite.

As you'll see below, for trade finance, our models show that capital requirements will increase by around 36%, and pricing will need to increase an estimated 60%-100% depending on the product.

We believe that the Basel III reforms have been implemented at an uneven pace, thus the full impacts remain to be seen. What we do know from the available data, however, should give pause to increasing greater burdens when it comes to both capital and pricing. The most recent evidence of this comes from a report issued by Oliver Wyman[2] in August 2016. This paper was sourced from over 100 academic papers, more than 100 letters or studies by the industry, and nearly 200 references and research papers from official sources. This new analysis reinforces our arguments that the totality of reforms results in significantly higher capital increases, higher prices, and diminished lending. Specifically, the report showed the following:

- There will be a significant impact on bank lending with much higher costs for the end users of financial services, primarily households and businesses that borrow or invest.
- Median estimates of potential increases in credit spreads of 60 to 84 basis points, depending on the region
- Loan volumes on bank balance sheets are estimated to decline as well, with an average decline across the studies of 2.6% for a 1 percentage point increase in required capital ratios.

This letter is intended to bring those impacts to greater light. Some of the data and arguments we include have been offered in our previous letters. However, we felt it necessary, as the Committee makes its final considerations, to include some of the recent analysis that demonstrates the modeled impact of the proposals.

II. Proposed Model Changes

As articulated in our earlier letters, we believe the Committee's proposed modeling changes to move to the Standardized approach is misguided. We would note a number of problems, including:

[1] Coen, William. Speech at the panel discussion at the 2016 Annual Membership Meeting of the Institute of International Finance, Washington DC, 7 October 2016. <http://www.bis.org/speeches/sp161007.htm>

[2] Oliver Wyman. "Interaction, Coherence, and Overall Calibration of the Post Crisis Basel Reforms." 9 August 2016. < http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/aug/post-crisis-basel-reforms.pdf>

- The changes lumps risk weights into a few external rating categories, resulting in a lack of differentiated risk between obligors. This would run contrary to one of the stated objectives of the Basel Committee, namely, that of promoting a more risk sensitive approach within banks.

- The proposals will increase capital requirements for unrated banks and subsidiaries of banks with no external ratings in jurisdictions which allow external ratings and all banks in jurisdictions that do not allow external ratings. Further, as the number of unrated banks is concentrated in emerging markets, credit capacity is likely to diminish and become more expensive for emerging market banks.

- The use of floors in general will give limited recognition to collateral and tenor, resulting in adverse unintended impacts on trade finance despite the well-documented short term nature of exposures in trade finance, and the very effective collateralization and risk mitigation options available and in common use in export finance. The outcome of the proposed approach will clearly be to raise capital requirements for trade exposures. It is because of these principle differences in the models that we foresee severe negative impacts on both capital and pricing for these instruments.

III. Impacts on Price

As detailed in our response to the consultation, *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches,* the move away from the IRB approach will likely result in higher capital consumption, and thus higher prices for customers. These customers include corporates, SMEs, and financial institutions in global correspondent networks.

We model the potential impact on pricing for a suite of Trade Finance products, below. The following scenarios are reflective of current market practice and pricing. **As you'll see, the models demonstrate that banks seeking to maintain comparable returns will face pressure to increase margin income by 60 to 100%.** While banks may have a choice not to pass on this increase, it's highly unlikely. Since the move away from the IRB approach will be across a broad spectrum of banks who currently use these internal models, it will directly impact the competitive landscape in trade finance.

However, even in the event where financial institutions choose to absorb a portion of the increase, the market impact may remain significant. As evidenced below, a US$500,000 import letter of credit, which might cost US$1,300 under current circumstance, could become as expensive as US$2,400 under the proposed revised requirements. These key changes to proposed requirements include:

- The proposed move from the IRB approach to the Standardized approach, whereby externally rated risk weights of 20%/50%/100%/150% would apply.
- Where external ratings are not recognized, an application of 50%/100%/150% risk weights.
- And, for exposures less than 90 days, an application of a 20% risk weight.

Scenario 1: Bank obligor moving from IRBA to STD

Export L/C Confirmation (180 days)	A-IRB Approach	STD Approach
ECAI Rating	A	A
EAD (CCF 50%)	50	50
RWA	11.7	25
Margin Income	50bps	50bps*
Return on RWA (RoRWA)	2.5%	1.2%
Return on Equity (RoE)	23.5%	11%
*Margin Income will need to **increase** to 100bps (100% increase) to achieve same RoRWA and RoE		

Scenario 2: Large Corporate obligor moving from IRBA to STD

Financial Guarantee (1 year)	A-IRB Approach	STD Approach
ECAI Rating	BBB-	BBB-
EAD (CCF 100%)	100	100
RWA	48.57	100
Margin Income	150bps	150bps*
Return on RWA (RoRWA)	1.6%	0.8%
Return on Equity (RoE)	14.6%	7.1%
*Margin Income will need to **increase** to 280bps (87% increase) to achieve same RoRWA and RoE		

Scenario 3: Mid-Market Corporate obligor moving from IRBA to IRBF

Import Loan (16 days)	A-IRB Approach	F-IRB Approach[1]
PD / LGD	BB+ / 25%	BB+ / 45%
EAD (CCF 100%)	100	100
RWA	33.48	60.26
Margin Income	200bps	200bps*
Return on RWA (RoRWA)	2.2%	0.9%
Return on Equity (RoE)	20.5%	8.7%
*Margin Income will need to **increase** to 320bps (60% increase) to achieve same RoRWA and RoE		

We would again call your attention to the significant increase in margin income that will be required to achieve the same RoRWA and RoE.

We further illustrate impact on pricing by comparing capital consumption under the current IRB approach with the capital consumed under the standardized approach for a receivable finance/supply chain loan and an overdraft for an 'A' rated obligor.

IRB Approach			
Overdraft/Revolving line		Receivables Finance	
Rating	*A*	*Rating*	*A*
LGD	*45%*	*LGD*	*45%*
EAD	*10,000,000*	*EAD*	*10,000,000*
Maturity	*1 year*	*Maturity*	*90 days*
RWA	1,528,191.66	RWA	1,016,244.72
Margin(bps)	*60*	*Margin(bps)*	*45*
RoRWA	**2.3%**	**RoRWA**	**2.5%**
Capital	122,255	Capital	81,300
RoE	**21.8%**	**RoE**	**23.8%**

Standardised Approach			
Overdraft/Revolving line		Receivables Finance	
Rating	*A*	*Rating*	*A*
Risk weight	*50%*	*Risk weight*	*50%*
RWA	5,000,000	RWA	5,000,000
Margin(bps)	*60*	*Margin(bps)*	*45*
RoRWA	**0.7%**	**RoRWA**	**0.5%**
Capital	400,000	Capital	400,000
RoE	**6.7%**	**RoE**	**4.8%**

As you can see, there are significant increases in the requirements for capital. Under the IRB approach the overdraft is priced higher to reflect the higher risk in the product compared to the structured receivable finance transaction. A move to the standardized approach will remove this incentive and favour the overdraft as it will be more profitable than a receivable finance transaction.

We believe the proposed solution of using the Standardized models will result in a less risk sensitive approach. This is become the risk weights are lumped into a few external rating categories. This will increase capital requirements for unrated banks and subsidiaries of banks with no external ratings in jurisdictions which allow external ratings and all banks in jurisdictions that do not allow external ratings. This will have particularly acute impact in emerging markets. As the Committee is aware, the number of unrated banks is concentrated in emerging markets. Thus, credit availability will diminish and in emerging markets – who need affordable financing the most - costs will increase.

IV. Impacts on Capital

The proposed move away from the IRB approach will result in an increase in capital requirements. We evidence this below by constructing a hypothetical portfolio of bank related trade finance exposures on the IRB advanced approach, and assessing the capital requirements impact on the standardized approach. As detailed earlier in this letter, the higher capital requirements will likely translate into higher prices for customers. Specifically, this increase in capital is derived from the reduced risk sensitivity of the modeling, which is driven by moving away from IRB models to blunt external risk weights. We believe this results in an overstatement of risk and a subsequent increase in capital requirements. You'll note that triple digit percentage increases are expected on the lowest risk (AAA to A-) exposures.

Exposure Type: Banks

All numbers are in USD '000

Rating scale	RWA based on current parameters	RWA based on proposed changes	Expected RWA movement(USD)	Expected RWA movement(%)	Capital based on current parameters	Capital based on proposed changes	Expected Capital movement(USD)	Expected Capital movement(%)
AAA to AA-	*55*	*181*	*126*	*230%*	*4*	*14*	*10*	*230%*
A+ to A-	*19,378*	*95,159*	*75,781*	*391%*	*1,550*	*7,613*	*6,062*	*391%*
BBB+ to BB-	*12,155*	*20,621*	*8,466*	*70%*	*972*	*1,650*	*677*	*70%*
B+ and below	*210*	*214*	*4*	*2%*	*17*	*17*	*0*	*2%*
Total	**31,797**	**116,174**	**84,377**		**2,544**	**9,294**	**6,750**	

We have also simulated the impact of moving segments of the corporate portfolio from the Advanced IRB approach to the Foundation IRB approach by constructing a hypothetical portfolio of trade finance exposures. **This model indicates that capital increases by approximately 36%.** We would strongly argue, that this would be at odds with the Committee's prior statements to keep capital increases within reasonable limits.

Exposure Type: Corporates

All numbers are in USD '000

Rating scale & Exposure Type	Portfolio weight	RWA based on current parameters	RWA based on proposed changes	Expected RWA movement(USD)	Expected RWA movement(%)	Capital based on current parameters	Capital based on proposed changes	Expected Capital movement(USD)	Expected Capital movement(%)
Corporates-assets >€50bln	60%	381,704	537,313	155,609		30,536	42,985	12,449	
AAA to AA-		*447*	*2,957*	*2,510*	*562%*	*36*	*237*	*201*	*562%*
A+ to A-		*14,856*	*74,104*	*59,248*	*399%*	*1,188*	*5,928*	*4,740*	*399%*
BBB+ to BB-		*312,198*	*414,095*	*101,897*	*33%*	*24,976*	*33,128*	*8,152*	*33%*
B+ and below		*54,203*	*46,157*	*8,046*	*15%*	*4,336*	*3,693*	*644*	*15%*
Corporates-assets≤€50bln, turnover>€200mln	30%	337,920	440,875	102,954		27,034	35,270	8,236	
AAA to AA-		-	-			-	-		
A+ to A-		*2,848*	*8,043*	*5,194*	*182%*	*228*	*643*	*416*	*182%*
BBB+ to BB-		*259,179*	*320,672*	*61,493*	*24%*	*20,734*	*25,654*	*4,919*	*24%*
B+ and below		*75,893*	*112,160*	*36,267*	*48%*	*6,071*	*8,973*	*2,901*	*48%*
Corporates-assets≤€50bln, turnover<€200mln	10%	114,093	155,137	41,044		9,127	12,411	3,284	
AAA to AA-		-	-			-	-		
A+ to A-		*1,431*	*2,440*	*1,008*	*70%*	*115*	*195*	*81*	*70%*
BBB+ to BB-		*87,237*	*106,733*	*19,496*	*22%*	*6,979*	*8,539*	*1,560*	*22%*
B+ and below		*25,424*	*45,964*	*20,540*	*81%*	*2,034*	*3,677*	*1,643*	*81%*
Grand Total		**833,717**	**1,133,325**	**299,607**		**66,697**	**90,666**	**23,969**	

V. **Conclusion:**

There has been significant work and commitments from both regulators and financial institutions alike to strengthen the capital base and resilience of the industry over the last 8 years. While in a much better overall position, bank balance sheets are constrained, there is competition across the industry for limited bank capital, and real strategic decisions are being made within institutions about the allocation of that capital and sustainability of certain businesses. The required capital increases that would result from the Committee's current proposals will potentially decimate the trade finance business, and in particular, in emerging markets where trade finance is needed the most.

As we've detailed before, trade finance, is a long standing, low risk, stable source of financing supporting real economic growth. The advantage this business brings is that is has a low risk and comparative capital cost. If the latter characteristic is distorted by significantly higher capital requirements then it will weaken the attractiveness of that business compared to other more profitable lines, and will likely cause banks to discontinue offering trade financing.

The sum of the proposals in their current form and the move away from the IRB approach specifically, will distort decision making and behavior at the business level and give a result that is actually counter to the objectives of policymakers and regulators: to drive and promote a sound, sustainable, robust, and trade-driven international system.

We urge the Committee to review these findings and to carefully consider the modifications to the proposals we offer in our previous letters. We look forward to further dialogue on these important issues going forward. For further information, please contact John Collins, Vice President, International Policy at jcollins@baft.org or +1-202-663-5514.

Very truly yours,

Tod R. Burwell

Tod R. Burwell
President and Chief Executive Officer