April 11, 2014

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

Re: Basel III: The Net Stable Funding Ratio

Ladies and Gentlemen:

The Bankers Association for Finance and Trade (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.

BAFT appreciates the opportunity to comment on the proposal published by the Basel Committee on Banking Supervision ("Basel Committee" or "the Committee"), entitled *Basel III: The Net Stable Funding Ratio* ("Consultative Document" or "the proposal").[1] BAFT welcomes the work of the Committee, through the Basel III framework, in promoting a more resilient banking sector and we agree that a strong banking system is the foundation for sustainable economic growth. As BAFT represents the transaction banking segment of financial institutions globally - including the trade finance and cash management business lines - we are particularly concerned, however, about the impact new regulatory initiatives could have on the provision of these crucial, real economy financing products. To that end, BAFT's comments on the proposal are primarily focused on issues for these particular sectors of the banking industry.

Introduction:

BAFT supports the objectives of the Net Stable Funding Ratio (NSFR) to reduce funding risk over a longer time horizon and to promote greater funding stability in the financial system. We applaud the Committee for their careful review of the original 2010 NSFR proposal and for the revisions which take into account, *inter alia*, the importance of Small and Medium Sized Enterprise (SME) finance and the much needed shift toward a structural approach in the overall definition of the ratio. This approach is an important "business-as-usual" complement to the stressed based calibration of the Liquidity Coverage Ratio (LCR).[2] We note, however, that certain aspects of the proposal do present concerns for key product lines, both in terms of customer availability and end-user affordability. Before finalizing the proposal, the Committee should carefully undertake a Quantitative Impact Study (QIS) on the market effects of the NSFR overall and the Committee should closely examine the interaction of the NSFR with other Basel III standards, including the LCR and the Leverage Ratio.[3] Additionally, we strongly encourage the Committee to evaluate and adjust recommendations in the proposal that impact the Required Stable

[1] Basel Committee on Banking Supervision; *Basel III: The Net Stable Funding Ratio*, January 2014 ("Basel NSFR")

[2] Basel Committee on Banking Supervision; *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools,* January 2013 ("Basel LCR")

[3] Basel Committee on Banking Supervision; *Basel III Leverage Ratio Framework and Disclosure Requirements*, January 2014 ("Basel Leverage Ratio")

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Funding (RSF) factors for trade finance on and off-balance sheet lending and the Available Stable Funding (ASF) factor for operational deposits. Through our comments, we outline the rationale for our suggested changes and address the potential impact of the Committee's recommendations from a business line perspective. These issues, if left unaddressed, could cause unintended consequences for the provision of finance supporting companies and consumers. This could ultimately lead to damaging development effects which are fundamentally at odds with the sensible risk management and pro-growth economic policies espoused by the Basel Committee and the G-20.[4]

Key Recommendations:

1. Adjust the RSF Factor for Trade Finance Loans

The amount of required stable funding under the NSFR is measured based on the broad characteristics of the liquidity risk profile of an institution's assets and off-balance sheet (OBS) exposures. The RSF factors assigned to various types of assets are parameters intended to approximate the amount of a particular asset that would have to be funded, either because it will be rolled over, or because it could not be monetized through sale or used as collateral in a secured borrowing transaction over the course of one year without significant expense. Under the standard, such amounts are expected to be supported by stable funding. In determining the appropriate amounts of required stable funding, paragraph 13 of the proposal outlines certain criteria to be taken into account.[5] Accordingly, paragraph 32 (e) of the proposal assigns a 50% RSF factor for non-HQLA assets (not included in other categories outlined in the proposal) that have a residual maturity of less than one year, including loans to non-bank financial institutions, loans to non-financial corporate clients, loans to retail customers and small business customers and loans to sovereigns, central banks and Public Sector Entities (PSEs).

While we agree with the need to have criteria determining the RSF for assets set out in paragraph 13, we are concerned that the wide scope of paragraph 32 (e) may have negative consequences for the supply of short-tenor on-balance sheet trade finance loans used to support international trade flows.[6] Trade finance loans have three main characteristics which differentiate them from standard corporate loans; a short tenor, a self-liquidating nature, and a low risk of default:

[4] For example, trade finance specifically has been widely recognized as an important driver of economic growth globally, especially in emerging markets. Recently, both the Asian Development Bank (ADB) and the Asia Pacific Economic Cooperation (APEC) Policy Support Unit (PSU) published important surveys in this regard (please see: *Asian Development Bank Trade Finance Survey: Major Findings*, ADB Briefs No. 11, March 2013 and APEC PSU; *Trends in Trade Finance across the APEC Region; October 2013).* The Committee on the Global Financial System (CGFS) of the Bank for International Settlements (BIS) also recently analyzed trade finance from a market and regulatory standpoint, with detailed background on the impact of disruptions on trade finance availability to the real economy and analysis on the short-term, low risk nature of trade products (please see: CGFS Papers No. 50, *Trade Finance: Developments and Issues*; January 2014).

[5] This criteria includes: resilient credit creation, bank behavior, asset tenor, asset quality, and asset liquidity value; *Basel NSFR*, January 2014; Para 13 (a-d)

[6] Trade loans occur when a lender grants a loan to a corporate or bank client to finance clearly defined trade transactions. The proof of the underlying trade transaction comes either from local regulatory practice (*e.g*. currency control), documentary evidence, or from the way the transaction is structured. Such evidence may include shipping documents or other documents that demonstrate the financing to be consistent with the goods or services imported/exported (*e.g.* the tenor of the loan is consistent with the goods being financed). Loans typically come from a flexible short-term borrowing facility and may facilitate a pool of trade transactions (*e.g.* bank loans) or be linked to single transactions. Loans may be made against either corporate risk or bank risk and include import loans and export loans. Import loans are loans whereby financing is provided for the importation of goods or services. These loans are often a bridge to enable importers to pay suppliers on a timely basis, while providing additional time to convert imported goods into cash receipts. Import loans are often made against evidence of shipment and/or supplier invoices. Export loans provide financing for the exportation of goods or services. Export loans are typically needed to fund activities required prior to shipment. Loans may be made to banks to enable them to fund pre-export activity on behalf of their customers.

a. Short tenor: Trade finance related lending is typically short term, with loan tenors between 30-180 days. By setting an RSF of 50% for these short-term assets, it would be assumed that they exhibit the same term funding requirements and behavioral rollover assumptions as a corporate loan with initial tenor greater than six months.

b. Self-liquidating: There is no automatic rollover for funded trade finance loans, as loans are considered on a transactional basis. Trade finance loans are linked to an underlying shipment or trade in goods and services. Despite the client's credit standing, clients are required to submit documentary proof of the underlying trade/shipment. Depending on the structure of the trade financing arranged, such documentary evidence may include proof of shipment, proof of sale/purchase through invoices, quantity and quality certificates, warehouse receipts and other transactional documents. These documents are required for a drawdown of a trade loan. The specific nature of the underlying trade transaction will mean that unlike lending driven entirely by relationships, such as unsecured working capital loans, trade finance will not require to be rolled over.

c. Low risk: Trade finance lending is recognized as low risk with high recovery rates through the possible sale of underlying goods.[7] This differs from the credit quality of maturing commercial loans offered on either an unsecured basis or secured on illiquid fixed assets. In the same way that the standards differentiate between the funding requirements for lending to retail customers (such as the RSF for mortgages in comparison with other types of lending) we would propose that differentiation is also warranted for trade finance loans.

As the underlying trade transactions of trade loans are discrete, short term events, we believe that the 50% stable funding requirement under paragraph 32 (e) is inappropriate and will increase the cost - and reduce the availability - of this vital source of finance made available by financial institutions to support businesses with their import and export requirements.[8]

In considering an appropriate RSF factor for trade finance lending, the potential impact on credit supply brought on by adding an additional regulatory cost should be taken into account. We believe that it would be appropriate to consider a RSF factor in the range of 0-10% for any trade finance lending with residual maturity below 6 months. Using this as a base, 2 full cycles of turnover within 6 months are covered, thereby removing the need to apply maturity mis-transformation to trade finance. This will ensure that more of a bank's stable finance is applied to transactions above 12 months. We further recommend consideration of a 15-25% RSF factor range for drawn trade finance transactions between 6-12 months in duration. As the NSFR is intended to be a "business as usual" metric for banking organizations over the course of 12 months, an RSF factor for short term trade loans in such a range would not harm the overall purpose of the ratio or diminish protection of the franchise.

[7]The International Chamber of Commerce (ICC) reviewed a data set of 8,133,031 transactions between 2008 and 2011 and found an average default rate on import loans of 0.016%, on export loans (bank risk) of 0.029% and on export loans (corporate risk) of 0.021%: International Chamber of Commerce; *Global Risks Trade Finance Report 2013*, Para 3.1, Figure 9.

[8]Applying such long-term stable funding to short-term trade finance loans would have direct consequences on the cost and availability of trade finance products to the end user consumer. For example, analysis by BAFT has found that in a typical funded trade finance transaction (such as an export loan providing financing for the exportation of goods or services) the cost of the transaction could increase as much as 15 to17 basis points on application of a 50% RSF factor compared with 0%. Depending on the institution, this could reflect up to a 50% increase on current pricing. On such a low margin business, a bank would need to make the rational decision to discontinue conducting such trade deals or continue with an increase in the cost of providing those trade financing products to customers. Such an impact would undermine the ability of companies to grow through trade and would hamper economic recovery.

2. Harmonize a Low RSF Factor Recommendation for Off-Balance Sheet Trade Finance Instruments

As with on-balance sheet trade finance lending, off-balance sheet trade finance instruments exhibit the similar short-term, low risk, self-liquidating characteristics which differentiate them from other types of financial products.[9] Clients have no incentive to refinance such transactions on a one-year basis, as these exposures naturally relate to much shorter periods and are directly connected to underlying real-market deals.[10] Additionally, not all OBS trade exposures will necessarily convert to on-balance sheet exposures during the lifetime of the transaction.[11]

Paragraph 37 of the Consultative Document states that RSF factors are assigned to various OBS activities in order to ensure institutions hold stable funding for the portion of OBS exposures that may be expected to require funding within a one-year horizon. For OBS trade finance products, this need for funding is very limited. For trade related contingencies, including commercial letters of credit, a full presentation of documents is needed before a related payment to the exporter/seller is confirmed and the instructing party's (*i.e.,* the bank's client) account will be debited. As such, long-term funding is not necessary for these types of transactions and would not add to the security of OBS trade lending to the real economy. Instead, a high amount of required stable funding set aside for these products would increase the liquidity premium applied by an institution to this type of lending and would ultimately lead to a reduction in availability or an increase in pricing to companies who utilize trade finance in their business operations. As such, we believe these types of products ultimately warrant an appropriately low RSF.

Table 3 of the Consultative Document allows national supervisors to specify the RSF factors for certain trade related OBS obligations based on their national circumstances. There is concern, however, that if jurisdictions use their discretion to require different, or unduly high, RSFs for these products, credit creation may be harmed by adding a large regulatory cost onto a low margin business. This would remove the incentives for banks to benefit from the maturity transformation of shorter term funding into self-liquidating products, harming trade growth.

Trade finance instruments exhibit the same characteristics regardless of country and trade finance is a global, cross-border business conducted in all regions of the world. As such, it is important to ensure global consistency in the implementation of Basel III standards for these types of products. Local capital and liquidity requirements are increasingly becoming the binding local requirement for the subsidiaries and branches of global banks active in various jurisdictions. Unclear standards could cause disparate treatment for banks with a group head office in a developed economy and subsidiaries or branches in an emerging market economy. This could, in turn, inhibit the provision of trade finance to customers in the latter market.

The G-20 has mandated the creation of globally consistent regulatory structures that encourage international trade and growth. In light of the broader perspective of this mandate, defining a reasonable and realistic RSF for contingent trade finance exposures would be preferable to leaving it to national discretion. As such, BAFT recommends that an appropriately low suggested RSF factor of 0% for trade finance OBS obligations be set by the Basel Committee in the final iteration of the NSFR. The timing gap

[9] The average tenor of short-term trade finance products is 90 days and the average default rate against a data set of 8,133,031 transactions is 0.021%: International Chamber of Commerce; *Global Risks Trade Finance Report 2013*, Para 3.1, Figure 9 and Para 3.2, Figure 15.

[10] For further information on types of OBS trade finance products, please see *BAFT Traditional Trade Finance Definitions*; February 2012: www.baft.org/policy/library-of-documents/traditional-trade-finance-definitions .

[11] For discussion regarding the low rate of on-balance sheet conversion of trade finance products, please see: International Chamber of Commerce, *Global Risks Trade Finance Report* 2013; Para 3.3, Figure 16.

that exists between a contingent converting to an on-balance sheet item or being settled through open account only requires short term funding (typically 1-3 days) and would not require any stable funding. This recommended treatment by the Committee would be consistent with guidance in other areas of Basel III where an appropriate structure helps avoid inconsistency in national interpretation and limits potential for regulatory arbitrage.[12]

3. Assign an Appropriate RSF Factor for Export Credit Agency Guaranteed Loans

BAFT believes that Export Credit Agency (ECA) Guaranteed Loans should receive an appropriate RSF factor commensurate with their nature and importance to economic growth and development. Generally, ECA guaranteed exposures can take the form of credits, credit insurance, financial guarantees or a combination thereof. ECAs offer partial or full guarantees covering payment risk for trade related transactions. These guarantees are often transaction-specific and may be evidenced by a variety of underlying trade instruments and financing structures such as letters of credit, trade-related promissory notes, accepted drafts, bills of exchange, guarantees, bid and performance bonds and advance payment guarantees.

Guaranteed Loans supported by ECAs offer considerable benefits to the end-user. These include risk mitigation for a transaction with a particular buyer, financing for international buyers of capital goods and related services, flexible lender financing options for buyers of capital goods and related services in medium/long-term projects, and flexible repayment terms.

ECA finance is less risky than other types of transactions and this type of financing is usually backed by the full faith and credit of the government supplying the guarantee.[13] They differentiate from trade finance loans due to the longer tenor of the transaction (typically longer than one year). Additionally, whereas credit derivatives are generally used to hedge a portfolio of single name risks, guarantees for trade transactions are generally protected/risk mitigated on a transaction by transaction basis and the cost of protection is closely aligned with a percentage of the revenue earned on the transaction. ECA loans are also usually a readily sellable asset in the capital markets.

BAFT agrees that a certain amount of stable funding is appropriate for these types of loans but the RSF factor should be considered alongside their nature as a sovereign guarantee supporting corporate exports. As such, we recommend that ECA guaranteed Loans receive an RSF factor in the range of 15-50%. An appropriate RSF factor will help ensure the continued availability of these types of loans to the real economy.

4. Adjust the ASF Factor for Operational Deposits

The available stable funding amount under the NSFR is measured based on the broad characteristics of the relative stability of an institution's funding sources, including the contractual maturity of its liabilities and the differences in the propensity of different types of funding providers to withdraw their funding. Under Paragraph 21 (b), operational deposits, as defined by the Basel LCR, will receive an ASF factor of

[12] Under the Basel LCR, the Committee agreed that in the case of contingent funding obligations stemming from trade finance instruments, national authorities can apply a relatively low run-off rate (e.g. 5% or less). This guidance assists in avoiding asymmetry in national interpretation of the Basel standards and also appropriately recognizes the internationally consistent nature of trade finance as it relates to liquidity risk management requirements: *Basel LCR*, January 2013; Para 138.

[13] The ICC analyzed medium and long-term trade finance products, often supported by ECA guarantees. In a data set from 2006-2011, the ICC found an average annual transaction default rate of 1.11% for medium and long-term trade finance products; International Chamber of Commerce; Global Risks Trade Finance Report 2013, Para 4.1, Figure 20.

50%.[14] BAFT, however, believes this to be an overly conservative calibration for such highly stable deposits.

The LCR assigns a 25% run-off rate to deposits arising from operational accounts. To be deemed operational, it is understood that the account should exhibit payments and collections being executed on behalf of the client. It is also understood that operational treatment is to be applied across all client segments. This lower LCR outflow factor recognizes the highly stable nature of cash balances linked to operational accounts held by banks on behalf of their clients. Furthermore, the operational qualifications center on the client's utilization characteristics. The qualifying activities in the context of an operational relationship include - for Financial Institutions - "clearing, custody, or cash management activities" that meet certain criteria.[15]

The LCR quite rightly recognizes the stickiness of these deposits and the substantive dependency on the incumbent provider during a 30 day stress scenario. Under the NSFR "business as usual" approach, the same characteristics which bind these account deposits should apply. While we understand the motivation of the Basel Committee to ensure a conservative approach to liquidity risk management, empirical evidence does not support the currently proposed ASF factor for all operational accounts. Such an ASF factor may discourage a bank from attracting the kind of client bank deposits that are reliable even in times of name specific stress. A highly operational banking relationship leads to reliable core deposits even when stress situations occur and these deposits are also reliable as an ongoing business concern over the 12 month NSFR time horizon. As such, BAFT believes that a 75% ASF factor would be consistent with the application of the LCR criteria to define stable operational deposits under the stated NSFR conditions.

Conclusion:

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 in the real economy. We very much appreciate the opportunity to comment on the Consultative Document and look forward to further dialogue with the Committee on these issues going forward. For further information and questions, please contact Matthew L. Ekberg at mekberg@baft.org.

Very truly yours,

Tod R. Burwell

Tod R. Burwell
President and Chief Executive Officer

[14] Operational deposit criteria: *Basel LCR*, January 2013; Para 93-104

[15] IBID; Para 94

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