



March 11, 2016

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

Re: Revisions to the Standardised Approach for credit risk

Ladies and Gentlemen:

BAFT appreciates the opportunity to comment on the proposal published by the Basel Committee on Banking Supervision (“Basel Committee” or “the Committee”); entitled *Revisions to the Standardised Approach for credit risk* (“Consultative Document” or “the proposal”).¹

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 on the proposal are primarily focused on issues for these particular sectors of the banking industry.

I. Introduction and Main Themes:

BAFT supports and applauds the Basel Committee’s ongoing work to improve and make more resilient the world’s financial services sector. We share the Committee’s belief that a stronger banking sector serves to strengthen global economic growth and provide greater financial service, inclusion, and access to citizens worldwide. We believe, working together, banks and regulators have accomplished a great deal through the design and implementation of the Basel III standards. While our work will never be fully complete, we believe the world’s financial services sector is as safe and sound as it has ever been.

It has been roughly a year since the Committee first issued proposed revisions to the Standardized Approach for credit risk. Since that time the industry has observed the impact of Basel III provisions where implemented, collected more data, and has engaged in additional thoughtful and comprehensive dialogue about the real impact Basel has had on businesses, individuals, and financial institutions that serve them.

We are appreciative of Committee’s willingness to consider input from a wide variety of stakeholders, and for making a number of important modifications from the first consultative document. In particular, we thank the Committee for including comments regarding Credit Conversion Factors (CCF) for off-balance sheet exposures, and the use of external credit ratings in the application of risk weights.

¹ Basel Committee on Banking Supervision: Second Consultative Document, *Revisions to the Standardised Approach for credit risk*; December 2015

However, we believe a number of elements in the revised framework still demand further modification in order to meet the Committee's objectives of finalizing a proposal that balances both simplicity and risk sensitivity.

Specifically, we offer recommendations around three key themes:

- 1) Credit Conversion Factors (CCF) for Off-Balance Sheet Exposures should be further clarified in the context of trade commitments, and the unutilized portion of unconditionally cancellable commitments for trade finance should be applied at 0%.
- 2) The proposed definition of Bank Exposures, recognition of short-term exposures as three months or less, and lack of recognition of the low-risk short-term nature of trade finance should be reconsidered.
- 3) Given the structure, collateral, and other elements specifically related to Commodity Trade Finance, we believe specific, lower risk-weights are appropriate within the Specialized Lending Instrument category.

We offer further comments on these items below.

II. Key Recommendations:

- A.** BAFT recommends providing greater clarity on the application of Credit Conversion Factors (CCFs) for trade finance within Off-Balance Sheet Exposures. Additionally, we urge the Committee to apply a 0% CCF to the unutilized portion of unconditionally cancellable trade finance facilities.

The Committee notes that all CCFs for unconditionally cancellable commitments (UCC) should be greater than 0%, since many of the commitments assigned to this category may only be cancelled subject to certain contractual conditions (therefore, are not really unconditionally cancellable). Based on QIS data and other studies, the Committee recommends a CCF higher than the 10% proposed in the first consultative document. The new proposal is to apply a reduced CCF between 10%-20% only to retail commitments (e.g. credit cards), with all other non-retail commitments currently categorized as UCC being treated as general commitments.² It is unclear what variations for jurisdiction, use of Standardized Approach vs. IRB and mix of commitments are reflected in the QIS data. Nevertheless, BAFT believes that the practical functioning of trade finance, even when structured as part of an unconditionally cancellable commitment, leads to a very rare instance of off-balance sheet exposures being converted to balance sheet exposures.

Off-balance sheet items under the standardized approach will be converted into credit exposures by multiplying the committed but undrawn amount by a credit conversion factor (CCF). For these purposes, commitment means any contractual arrangement accepted by the client (either through a single contract or through the general terms of the instrument) whereby the bank is committed to extend credit, purchase assets or issue credit substitutes.

² Basel Committee on Banking Supervision: Second Consultative Document, *Revisions to the Standardised Approach for credit risk*; December 2015, p. 15.

With regard to the application of CCFs for trade finance, BAFT recommends the following for consideration:

- 1) Provide clarification on whether the noted CCFs for transaction-related contingent items (Annex 1, paragraph 67) and short-term self-liquidating trade letters of credit (Annex 1, paragraph 68) are intended to be applied to exposures, or, also intended to apply to the unutilized portion when structured as committed trade facilities. When applied to the unutilized portion of committed trade facilities, BAFT recommends 0% CCF.
- 2) Adjust the definition embedded within Annex 1, paragraph 68 to recognize the use of trade letters of credit for delivery of services, not just delivery of goods.
- 3) Adjust the calibration of CCF applied to non-financial guarantees and standby letters of credit to 20% as currently outlined in Annex 1, paragraph 67.

The Committee notes that based on the QIS data, the appropriate CCF for unconditionally cancellable commitments is higher than 0%, as exists currently. The Committee also points to the presence of consumer protection laws, contractual conditions, and other reputational considerations that may make UCC not truly unconditionally cancellable in practice. Therefore, the recommendation is to adjust the CCF to 10-20% for retail only (e.g. credit cards), and 50-75% for all other commitments. However, the Committee intends to conduct further analysis on the appropriate definition of this category and its calibration. In that spirit, we urge the committee to consider the practical implications of commitments for trade finance, including unconditionally cancellable commitments. It is not clear within the QIS data, what the actual results for trade commitments were relative to other general commitments, but we believe this warrants a lower CCF and recommend the application of a 0% CCF for unconditionally cancellable commitments for trade finance.

Committed Trade Facilities

The overwhelming majority of trade finance related credit lines made available by banks to their clients are done on an uncommitted basis. A guidance limit may be set as an indicative level of exposure that the lender is willing to provide. In all cases, issuance or confirmation is subject to additional requirements of workability, compliance and fraud screening. By definition, these lines do not meet the Committee's proposed definition of Commitment. It should be clarified by the Committee, that the proposed CCF schedule does not apply to uncommitted trade facilities, which should continue to have 0% CCF for the undrawn portion.

In practice, unconditionally cancellable limits would not be considered commitments from a trade finance perspective. In limited cases, the bank may provide a committed facility, under which, it may issue or confirm trade finance instruments. The obligation undertaken by the bank to issue or confirm transactions up to a set limit still has conditions that individual transactions meet operational workability, compliance, fraud, and potentially additional qualifications. Unlike some other credit commitments, for the bank to issue a transaction under a committed trade facility, there still must be an underlying commercial transaction. Hence, trade facilities are not practically used as a means of providing liquidity under conditions of deteriorating credit, even when structured as a committed facility that is by the Committee's definition, "unconditionally cancellable", such as with credit cards or other retail agreements.

The exposure risk of an issuing or confirming bank of a letter of credit is contingent upon the beneficiary meeting the terms and conditions as set out in the letter of credit. The high rates of presentation of non-compliant documents by beneficiaries, significantly reduces the proportion of letters of credit that the issuing or confirming bank is obligated to pay. Ultimately, the issuing bank has the right to honor or not honor a non-compliant presentation under the letter of credit, and in practice, the bank will require payment from its customer (the applicant or issuing bank) prior to making payment to the beneficiary.

Under presentations of compliant documents, the bank is obligated to pay according to the terms of the letter of credit, and either debits the applicant's (or issuing bank's) account, or makes a claim for reimbursement. In the event of default, the bank is often able to recover funds, either because they have title to the underlying goods or other collateral, or because the trade obligations typically receive priority by the defaulting party and are paid. These trade obligations receive priority in order to maintain ongoing supplier relationships and a source of goods that can ultimately be converted to sales to pay its obligations.

The International Chamber of Commerce (ICC) maintains a Trade Register, which provides an analysis of short term trade finance products and related default rates.³ In the report, over 13 million transactions (covering nearly \$7.4 trillion U.S. dollars) are analyzed over the period covering 2007-2014, inclusive of the financial crisis. The findings include:

Table 1: Analysis of short term trade finance⁴

Product	Transaction Default Rate	Exposure Weighted Default Rate	Obligor Default Rate
Export LC	0.01%	0.02%	0.04%
Import LC	0.08%	0.07%	0.29%
Performance Guarantees	0.17%	0.11%	0.43%
Import / Export Loans	0.22%	0.17%	0.72%

The CCF as defined by Basel and operationalized by banks, is a means to measure the conversion of off-balance sheet exposures to on-balance sheet exposures. These are then risk weighted according to the nature of the counterparty. It is understood that for the purposes of short-term self-liquidating trade letters of credit (and similar), banks will apply a 20% CCF. For the purposes of transaction-related contingent items (standby letters of credit, performance guarantees, and similar), banks will apply a 50% CCF. These CCFs reflect instruments that have already been issued, but not yet drawn.

BAFT believes for the unutilized portion of unconditionally cancellable committed trade facilities the appropriate CCF is 0%. Whereby trade finance transactions are demonstrated to be low risk once issued, with an even lower expected loss, the risk of loss when no transaction has been issued (i.e. unutilized), is practically 0%. Once issued, the exposure would then attract 20% or 50% CCF accordingly. We encourage the Committee to further assess the specific trade related measurements within the QIS data.

Definition of Trade Letters of Credit in Annex 1, Paragraph 68

The application of a 20% CCF as outlined in Annex 1, paragraph 68 applies to issuing and confirmation banks of short-term (maturity below one year) self-liquidating trade letters of credit arising from the movement of goods (e.g. documentary credits collateralized by the underlying shipment). Letters of credit under this category (in practice) are issued subject to Uniform Customs and Practice for Documentary Credits, ICC Publication No. 600 (UCP 600). UCP 600 may also apply to standby letters of credit when the text of the credit expressly indicates that it is subject to these rules. The rules are binding upon all parties unless expressly modified or excluded in the letter of credit.

Within the context of UCP 600, Article 5 states: "Banks deal with documents and not the goods, services or performance to which the documents may relate."⁵ This clause makes clear that documentary (trade)

³ ICC: 2015 ICC Trade Register Report, *Global Risks in Trade Finance*, December 2015.

⁴ ICC: 2015 ICC Trade Register Report, *Global Risks in Trade Finance*, December 2015, p.10

⁵ Uniform Customs and Practice for Documentary Credits, (UCP 600) Article 5

letters of credit are not only used for the movement of goods, but also for related services or performance as outlined in the letter of credit.

We therefore recommend that Annex 1, Paragraph 68 be redrafted to take into consideration the broader practical application of documentary credits. For example:

“A 20% CCF will be applied to both issuing and confirming banks of short-term documentary letters of credit arising from the sale of goods or delivery of services and evidenced by the presentation of documents in compliance with the terms of the letter of credit.”

Definitions of Transaction-Related Contingent Items and Credit Substitutes

In Annex 1, paragraph 67, the Committee proposes a 50% CCF will be applied to certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions). The commonality being that none of these instruments are used as direct credit substitutes. BAFT recommends that the Committee further consider the calibration for non-financial guarantees including standby letters of credit, bid and performance bonds, and other performance-related guarantees and Standby Letters of Credit from the proposed 50% CCF to a suggested 20%

It should be noted that trade finance may be used to support both domestic and international commerce. As such, we also recommend the Committee clarify the definition of trade finance to more appropriately align with the practical use of such products. This includes the definition of “credit substitute”, referenced in Annex 1, paragraph 65, which offers the examples of general guarantees of indebtedness (including SBLC serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances). We believe the definition of a credit substitute should be complemented with further examples to ensure a more consistent application across the industry. For example, a guarantee or SBLC issued to cover credit facilities i.e. generic (non-specific) payment obligations such as repayment of drawn credit facilities would be regarded as credit substitute.

Performance Guarantees exist primarily to protect against unforeseen outcomes such as non-performance or sub-standard performance. Unlike documentary credits covering movement of goods, where the instrument is the primary means of settlement, these transactions are a secondary means of settlement and are only meant to be used when a counterparty fails to produce or perform as required by the underlying contract. Hence, only a small percentage of drawings or demands for payment are expected from these instruments and a significant number expire without payment. Additionally, Performance Guarantees and Standby Letters of Credit may include domestic transactions, further changing the risk profile and character of these products and transactions.

The reference data from the ICC Trade Register as represented in Table 1 evidences the historically low default rates (0.17%) and low rates of conversion on balance sheet, particularly when compared with corporate loans. The analysis of performance guarantees considered over 1.6 million transactions and 181,626 obligors for the data set covering 2008 – 2014.⁶

Through Capital Requirements Directive IV (CRDIV/CRR), the European Union (EU) already adjusted the Standardized Approach CCF for non-financial guarantees and standby guarantees to 20%.⁷ By taking this step, the EU recognized the intrinsic nature of these products and their low rates of conversion on balance sheet. Harmonization of this treatment is very important across all jurisdictions of the Basel

⁶ ICC: 2015 ICC Trade Register Report, *Global Risks in Trade Finance*, December 2015, pp.34-37

⁷ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (CRDIV/CRR): Article 429, Para 10 (b) and (c) and Annex 1

Committee. This will in turn assist in the financing of international trade by lowering the cost of providing these services to importers and exporters. Higher CCFs translate to higher capital requirements for banks and this has the direct implication of higher pricing for clients, even for low risk trade finance products. Increased pricing may lead to a lower number of clients utilizing such products and/or existing clients utilizing a lesser number of such products, which can lead to a reduction in trade flows globally.

- B.** Greater recognition of the short-term, low-risk nature of trade should be reflected in the preferential treatment of short-term Bank Exposures as evidenced by data from the ICC Trade Register report in Table 2 below. We ask the Committee to reconsider the definition of short-term to include trade finance instruments up to one year, and also reconsider the use of residual maturity instead of original maturity in the calculation of risk-weights for short term exposures.

Table 2: Expected Loss calculation by product, 2008-2014⁸

Product	Customer Default Rate	LGD	Customer EL	Transaction EL	Exposure-Weighted EL
Export LC	0.04%	42%	0.02%	0.00%	0.01%
Import LC	0.29%	29%	0.09%	0.02%	0.02%
Performance Guarantees	0.43%	54%	0.02%	0.01%	0.01%
Import / Export Loans	0.72%	38%	0.27%	0.08%	0.06%

Note: LGD at 9% discount rate and 2% costs. Transaction EL and Exposure-weighted EL are based on the transaction and exposure-weighted transaction default rates respectively. The exposure-weighted LGD is used for all EL metrics.

The proposals outlined by the Committee have notable changes from the 2014 proposed revisions to the way bank exposures are treated for the purposes of risk weighting. We are pleased that the Committee has recognized the value of allowing the use of external ratings for rated exposures, and has reversed its earlier proposal to eliminate references to ratings. Nevertheless, BAFT believes that the current proposal could have unintended negative consequences for trade finance exposures to banks, and in particular, exposures to emerging market banks. The concerns stem from the following core issues:

- 1) Short-term interbank exposures are defined as having an original maturity of three months or less. Trade Finance has consistently been recognized as short-term, with maturity less than 1 year, consistent with treatment under other components of the framework.
- 2) The change in preferential risk weight to an original maturity basis from a residual maturity basis has a negative impact on the required risk rating for trade finance exposures to banks.
- 3) The definition of bank exposure being applied to institutions that are “internationally active” and subject to the Basel framework, may result in some bank exposures being treated inappropriately as corporate exposures.

Short Term Nature of Trade Finance

Throughout the Basel framework, trade finance instruments have been recognized as being short-term, and having a maturity below one year. The proposal recognizes this in Annex 1, paragraph 29 in the context of not applying the sovereign floor to short-term (i.e. with a maturity below one year) self-

⁸ ICC: 2015 ICC Trade Register Report, *Global Risks in Trade Finance*, December 2015, p.11

liquidating, trade related contingent items that arise from the movement of goods.⁹ This is also consistent with the recognition of trade being treated as short term under the Leverage Ratio and NSFR. From a practical perspective, in country rescheduling, central banks also look at short-term trade finance exposures as having a maturity of less than one year.

Data made available in the ICC Trade Register demonstrates the short-term nature of trade finance, in particular, import/export letters of credit, and import/export loans.

Table 3: Average Maturity by Product (2008-2014)¹⁰

Product	W/A Contractual Maturity	Min.	Max
Export LC	128	52	335
Import LC	123	31	162
Loans for Import/Export	166	52	417

Banks that add confirmation to another bank's letter of credit, or, extend a loan to another bank in support of its extension of import or export trade finance to its customer, record this exposure against the issuing bank. Under the proposed definitions, it appears that a money market loan and a trade loan to another bank would be treated the same, thus ignoring the low-risk nature of trade and its connectivity to actual underlying commercial transactions.

By using original maturity as the basis for calculating risk weights, as opposed to residual risk-weights, the relative risk weight of trade finance transactions will also be inflated. For example, the External Credit Risk Assessment (ECRA) and Standardized Credit Risk Assessment Approach (SCRA) as outlined in Annex 1, paragraphs 17-28, would have a 30% difference between the base risk weight and preferred risk weight for short-term exposures. Applying this to a 180-day trade loan to an A-rated bank would mean a 15% risk weight increase using an original maturity basis rather than a residual maturity basis. While the actual performance of the instrument and historical risk profile of the instrument does not change, there is a material difference for banks using the Internal Ratings Based approach on a residual maturity basis and banks using the Standardized Approach on an original maturity basis.

BAFT requests the Committee consider the short-term and low-risk nature of trade finance in its definitions of exposures to bank, and its consideration of original vs. residual maturity in calculation of risk weights for short-term exposures.

Emerging Markets Banks

The definition of exposures to banks, outlined in Annex 1, paragraph 13, applies to financial institutions "subject to the prudential standards and level of supervision in accordance with the international practices relevant for such an institution." Inclusive of footnote 34, the definition states "for internationally active banks, 'international practices' means the Basel framework.

BAFT recommends that the Committee consider additional clarification to the term "internationally active". For example, does "internationally active" apply to institutions with only a domestic presence, but supporting international correspondent relationships, international clients, or international transactions? Many banks, particularly, but not exclusively in emerging markets, may not have an international presence, and may have a predominantly domestic client base, but may be engaged in a significant volume of cross-border trade finance and payment activity.

⁹ Basel Committee on Banking Supervision: Second Consultative Document, *Revisions to the Standardised Approach for credit risk*; December 2015, p. 30.

¹⁰ ICC: 2015 ICC Trade Register Report, *Global Risks in Trade Finance*, December 2015, p.43

In addition, as jurisdictions are at different stages of implementation of Basel III, the definition creates the potential for deviations in how bank exposures are treated. We believe this also has the potential to create an uneven playing field that could have a substantial impact on the risk weighting of bank exposures in emerging market jurisdictions, which could in turn impact the flow of cross border commerce in the areas of the world most acutely in need of financial infrastructure support. The proposal will also particularly impact the United States, where only large banks apply Basel III. Further clarification would be helpful to inform whether the proposed approach would mean de facto that obligor banks would have to apply Basel III, both for the calculation of capital and the calculation of risk-weighted assets, even if they do not meet the intended definition of internationally active or the national supervisor has not adopted Basel III.

In addition, as various banks have large funding positions with other banks, the increase in capital requirements based on the exposure methodology outlined will lead to a significant rise in funding costs, as higher capital requirements will exponentially increase the funding prices. This potential double counting should be considered when setting any new risk weights.

BAFT believes that while reconsidering the risk drivers and maintaining the allowance of external ratings, has addressed some of the concerns, further clarification of the definitions, and consistency in the recognition of trade finance as short-term and low risk when measuring bank exposures is critical. The potential exists for undue increases in the risk weights for trade finance exposures, creating negative impacts on cross-border finance and economic activity. We also recommend consideration be given to the use of residual maturity for trade finance obligations, providing consistency for the treatment of trade finance, and ensuring adequate and affordable trade credit can be made available to support sustained economic growth.

- C. Given the structure, collateral, and other elements specifically related to Commodity Trade Finance, we believe specific, lower risk-weights are appropriate within the Specialized Lending Instrument category.

Commodity Trade Finance (“CTF”) is one of the most palpable and important asset classes within Trade Finance for the world economy. Companies utilize these credit lines to facilitate the movement of raw materials to build, grow, and sustain global supply chains. Banks finance these companies using a number of various products, such as letters of credit, guarantees, and trade loans. These products are collateralized by physical commodities that can be quickly liquidated into cash. In practice, banks have invested in dedicated management infrastructure to more effectively manage the portfolios, which have proven effective and sustainable even through the global financial crisis back in 2008.

With that said, we do not believe that the Committee’s current proposal of applying a risk weight of 120% for commodity finance recognizes the often lower risk nature of commodity trade finance transactions. We believe CTF is being unfairly penalized under the proposal because of its borrower specific approach and lack of recognition for the structured nature and securitization of these facilities. If approved in its current form, we believe the proposal could result in the deterioration of this important source of financing for organizations and businesses whose activities present little or no risk to the overarching financial system. By extension, this may drive companies to the shadow banking market or lead to less transparency in financing structures.

Commodity finance is transaction-based, specific to the commodity life cycle being financed, and the structures typically require a high degree of transparency for the entire life cycle of the transaction. Proceeds from the sale of the commodity being financed (across the supply chain) are typically used to repay the obligation. Banks have invested in capabilities to provide both a line of sight to the inventory as well as settlement of the financing.

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Detailed default and loss data for CTF is only available in limited scope. Indicators from active market providers suggest that implied LGDs have historically been below 20%, and depending on the maturity assumptions used, implied RWAs approximate 30-50%. This is well below the proposed simple risk weight of 120%. BAFT encourages the Committee to more closely study data related to the behaviors of CTF portfolios.

With that said, we recognize and support the desire of the Committee to find an appropriate risk approach for CTF and recommend the following:

- Specific, lower risk-weights should be applied by subcategory for specialized lending (including CTF). The structure, collateral and other elements specific to the transaction flow should be taken into consideration. We would urge the Committee to make special recognition of transactions where the exposure is 100% covered by commodity collateral.
- The Committee should recognize and take into account liquid non-financial collateral like, exchange-tradable commodities within the credit risk mitigation framework.

III. Conclusion:

BAFT believes that the appropriate regulatory treatment for transaction banking services will ultimately have a positive effect on global markets, while continuing to provide resiliency in the global financial framework. We strongly believe that thoughtful policy will work to create jobs and economic growth and stability in developed and emerging economies alike. As such, we believe our comments, taken in conjunction with our recommendation on a more considered and longer term view of revisions to the Standardized Approach, will beneficially impact that goal.

In closing, we would urge the Committee to fully consider the low risk that trade finance poses to the global financial system, and its absolute necessity for keeping the international economy both open and fluid. We would urge the Committee to:

- 1) Provide greater clarity on the application of Credit CCFs for trade finance
- 2) Recognize the short term nature of trade finance when considering exposures for banks, as well as the use of original vs. residual maturity in calculation of risk weights for short-term exposures
- 3) Apply specific, lower risk-weights for CTF

We very much appreciate the opportunity to comment on the Committee's proposals and 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,



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President and Chief Executive Officer