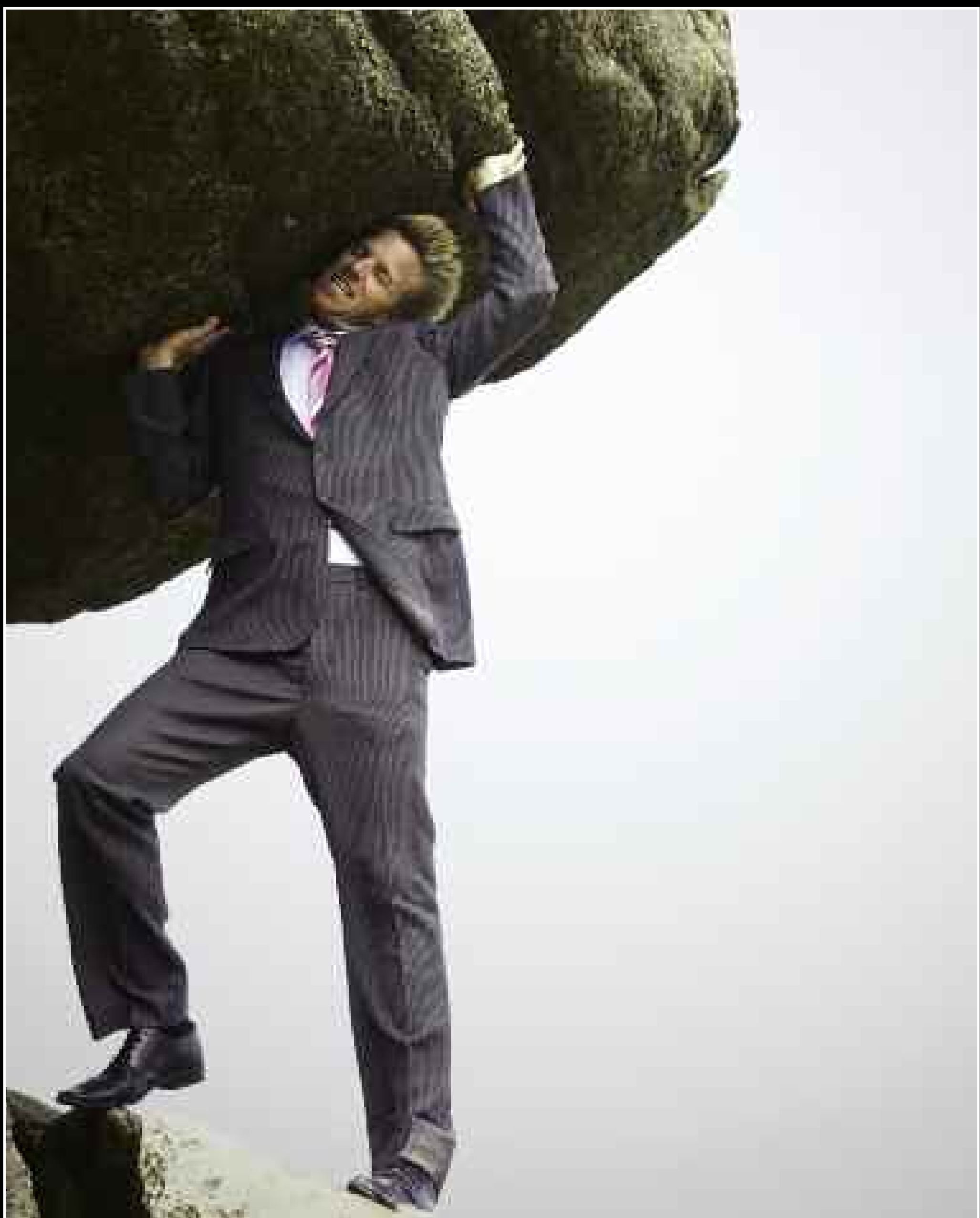
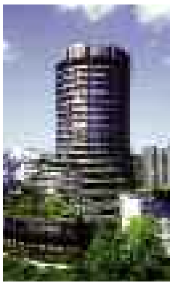
Cover Story

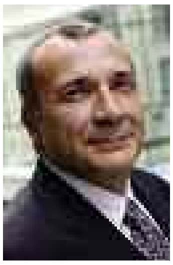
A step backward for trade finance?

Basel II is weighing heavily on trade just when it needs all the help it can get. Alexander R. Malaket explores the state of the dialogue related to the impact of Basel II on the financing of international trade, at a time when authorities around the world acknowledge the critical importance of a robust trade financing system.

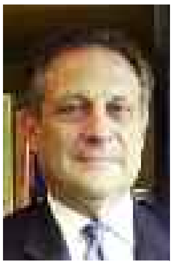




BIS-Tower building in Basel



Jean-Paul Riolacci at BNP Paribas in Paris



Eduardo Klurfan at Scotiabank in Toronto

Trade finance specialists have been voicing serious concerns about the capital adequacy requirements imposed by Basel II on the business of trade finance, noting that regulatory constraints have been detrimental to the conduct of international trade.

As the world begins to see signs of reversal in the global economic crisis, the finger-pointing has begun in some quarters. Private sector financial institutions have been vilified and the regulators charged with their oversight have been characterised as inept and incompetent. The Basel II Accords have been described by some as an utter failure, and in particular have been accused of unbalanced and detrimental treatment of certain lines of business – particularly trade finance.

Jean-Paul Riolacci, global head of GTS at BNP Paribas (BNPP) in Paris comments: "In our view, Basel II was targeting regulation and compliance related to products of a financial nature – not so much those like trade finance that are tied to what is being referred to as 'the real economy' – the movement of goods across borders. Clearly the specific characteristics of trade finance were not taken into account, and this has skewed the capital adequacy requirements to the disadvantage of trade finance as compared to other lines of business. The resulting reduction in available credit is exactly what we do not need at this time."

Trade finance has enjoyed an unprecedented level of profile over the past year, yet the reality remains – that it is a niche business. Even in Canada, which has earned praise for the robustness of the financial sector and for the effectiveness of the regulatory regime in place, there are serious concerns about Basel II.

Eduardo Klurfan, vice president, trade finance and financial institutions at Scotiabank in Toronto states: "Basel II has attempted to progress beyond the rudimentary approach of its predecessor, but still, does not assure equitable treatment to the business of trade finance. Trade finance is defined very narrowly, covering only a limited portion of the business we support. In effect, the current parameters of Basel II overstate the risk, and therefore the regulatory capital, required in support of a trade finance group within a financial institution. This puts trade finance at a disadvantage in the internal competition for capital, and has the ultimate effect of raising the cost of trade finance for those banks implementing Basel II regulation."

Trade finance: a familiar challenge

The treatment of trade finance under the Basel II regime is incorrect and incomplete however, this is not the result of conscious design or malicious intent, but rather a further symptom of a very familiar challenge for trade finance.

With the exception of a few global financial institutions, the business of trade finance is poorly understood. It should come as no surprise, then, that a significant 'understanding gap' exists within regulatory agencies, about the nature of trade finance.

The industry must do better in effectively communicating the nature and importance of its activities. This is equally true in the context of financial institutions as it is in the broader context of financial markets, as well as to important stakeholders and decision-makers such as regulatory authorities.

Donna Alexander, president of the Bankers' Association for Finance and Trade (BAFT), has been in the role for about a year, taking the reins at what is likely the most dramatic moment in trade for decades. From her unique vantage point, Alexander observes: "At BAFT, we are taking a very focused view of Basel II as it relates to trade finance. Our members believe that Basel II has an unintended effect on banks that differs significantly from Basel I, partly because Basel II was written with a pro-cyclical economic environment in mind."

She adds: "We believe that the critical issues raised by Basel II are best addressed and ultimately resolved through vigorous, innovative advocacy for clarification of regulations on the matter and open dialogue with regulators. In the meantime, public-private partnerships borne of the unprecedented collaborative effort prompted by the global crisis are crucial to ensure that any semblance of a global economic recovery stands a fighting chance."

A paper released by BAFT at the recent Sibos event in Hong Kong notes: "...in the current economic situation, Basel II has created additional pressure on banks subject to Basel II that do business in trade finance...BAFT continues to support steps that provide for a more rational treatment under Basel II for trade finance."

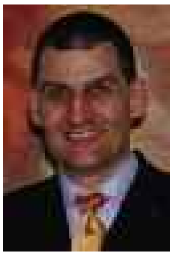
Gilles Thieffry, solicitor (England and Wales), Member of the New York Bar, Avocat au Barreau de Paris at GT Law in Geneva, is a specialist in legal matters related to commodity trade and trade finance. Thieffry sees the global crisis and the requirement to implement Basel II in its present form, as a compound challenge for trade and trade finance. Thieffry says: "Prior to the adoption of Basel II, we warned of its likely negative impact on commodity trade finance although not many agreed with us at the time. Trade finance, it appears to us, was an afterthought in the broader context of the development of Basel II. Trade finance specialists must engage in a dialogue with internal compliance specialists and regulators to better explain the business of financing trade."

Practical implications

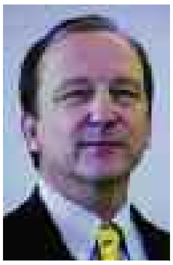
Basel II has imposed a fundamentally inappropriate one year maturity floor on trade finance transactions, thereby removing the fundamental distinction between short-term and long-term transactions.

On another level the question of 'Perfection of Security Interest' and 'Physical Control' of the financed commodity poses another challenge for trade finance, in that, the inability to demonstrate physical or legal control drives the risk assessment back down to the counterparty level. This causes an unfavourable shift in the risk profile of a transaction, particularly in deals where an emerging market is involved.

The effectiveness and usefulness of trade finance transactions (and the instruments upon which these are based) is underestimated in the current approach taken by the Bank for International Settlements (BIS). Trade finance includes documents and mechanisms which➤



Markus Wohlgeschaffen at UniCredit in Munich



Axel-Peter Ohse at Deutsche Bank in Frankfurt

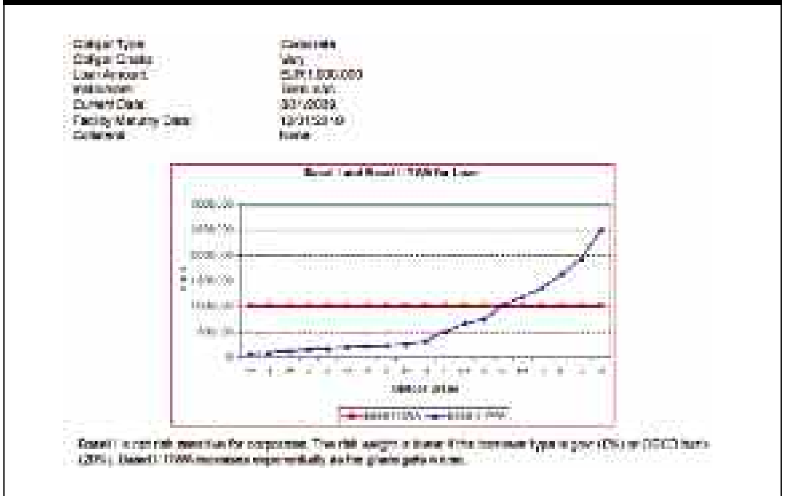
➤help banks to maintain physical and legal control of the asset (the shipment of goods) underlying the financial transaction, and this reality ought to be better reflected in the treatment of trade finance by Basel II.

As one specialist observes, it is entirely possible for a trader with $10 million in equity to take a risk on a $100 million shipment, while still representing a lower risk than a conventional, triple-A rated transaction. Similarly, certain markets are considered high-risk, and exporters based in those markets are placed at the bottom of the credit quality scale, despite the fact that at the country-level, there is a zero default history on pre-export finance.

Markus Wohlgeschaffen, head of global trade finance and services at UniCredit Group in Munich observes: "In our view, it is clear that trade finance is subject to inequitable treatment under Basel II. To provide a specific example, Basel II treats trade finance products such as letters of credit like a cash credit risk that in case of a corporate bankruptcy represents a total loss in trade finance, assigning a 'Loss Given Default' factor of 100%, when we know very well that in trade finance, transaction and instrument-specific characteristics can easily result in full recovery of funds, even if a trading party goes bankrupt. The basic concept of Basel II – maintaining capital in proportion to risk – is sound however, risk must be seen in context, at the level of portfolio, not just transaction. Our industry must articulate and express these concerns with one voice."

Trade finance transactions include documents, mechanisms and structures that clearly and legitimately influence the risk profile of a particular deal, and such characteristics need to be better understood and better communicated to regulatory specialists. The handling of discrepancies under documentary letters of credit provides an indirect and less obvious mitigation mechanism. While senior bankers would never be quoted in this area, the reality is that most export shipments (estimates range from 70% to 80%) involve the presentation of noncompliant documents, which offers an 'out' to bankers in certain circumstances. While the practice of using discrepancies for the sole purpose of avoiding exposure is not condoned (and is in fact frowned upon by the International Chamber of Commerce (ICC) and by purists who seek to protect the integrity of the process), the reality often varies from the textbook scenario.

Comparison of impact on RWA between Basel I and Basel II



Source: Hypovereinsbank/Unicredit Group

The key point is that trade finance transactions, by their nature, include risk-mitigants that are nearly invisible to the uninitiated.

Axel-Peter Ohse, managing director at Deutsche Bank's global transaction banking division in Frankfurt observes: "Specific risk-mitigation features related to trade finance were only recognised at the very end of the Basel II process, and indeed, trade finance has not yet been recognised as a distinct risk class with unique characteristics. On a global basis, the pace of adoption of Basel II varies significantly, and the distribution of banks using the advanced approach, versus other implementation alternatives, is fairly concentrated in Western Europe, with limited adoption in Asia and even less in the Americas."

He adds: "The treatment of trade finance under Basel II is not optimal as only the Advanced Approach allows for some recognition of its specific features. However, it is equally clear that under current circumstances, a client-centric view is critical: liquidity and the availability of lines of trade credit is important; the internal capital issues within banks becomes less critical by comparison, except where pricing is tight, and capital allocation can make the difference."

According to one senior banker, the shift from Basel I to Basel II has been an advantage to US banks in the last two or three years as they have benefitted from simple treatments whilst European and Asian counterparts have been grappling to access data and develop/validate models to achieve lower risk-weighted assets (RWA) usage. However, as the US moves into the preparatory period, to implement Basel II, they are now increasingly at a disadvantage compared to more 'sophisticated' peers, until the catch-up period expires

Pierre Veyres, deputy global head, CIB corporate and transaction group at BNP Paribas takes up the point, noting: "In its current form, Basel II treats certain flavours of trade finance, for banks based in most advanced banking markets, exactly as it treats an overdraft facility. This is clearly inappropriate and incorrect, making trade finance significantly more expensive from a capital perspective, than could possibly be justified."

Basel II and the banks

The Basel II model exhibits some significant gaps in its understanding of the place of trade finance within a broader financial institution. The vast majority of banks and financial institutions do not and are not able to manage loss and risk on a product level, but rather, do so on the obligor level, with the effect that there is little in the way of data to document loss experiences in trade finance. The industry knows that losses under traditional trade finance instruments are generally very small in comparison to obligor losses across a portfolio of bank products, but again, this advantage is not reflected in the Basel II requirements.

Compliance teams within financial institutions –


BIS-Botta building in Basel

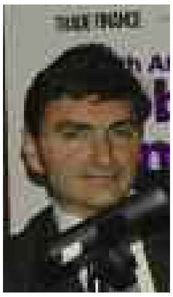
particularly those dealing with the Basel II implementation – possess a rudimentary understanding of trade finance at best, and they, along with line of business executives, missed the opportunity to shape and influence the treatment of trade finance under this regime.

Mike Quinn, managing director, global trade product management at JPMorgan Chase in New York states: "We are addressing Basel II issues on a daily basis and have been managing our balance sheet against Basel II requirements for over a year. In our estimation the trade finance community globally must continue to mobilize with BAFT, the ICC and others to carry forward the arguments with BIS and with national regulators, relative to the appropriate treatment of trade finance under the Basel II Accord."

Transparency: the double-edged sword?

A recurring theme related to Basel II in trade finance revolves around the accessibility and availability of historical data. The more a bank can demonstrate an understanding of its loan-loss experience in trade finance over time, the more favourable its treatment under Basel II should be, in principle. While some argue that this provides the opportunity for competitive advantage for banks with the appropriate technology and data mining capabilities, others suggest that the issue is much broader. Loan-loss experience, they argue, is not only difficult to document, but in fact, often non-existent in trade finance, and as such, Basel II causes trade finance to suffer from its own success.

Robert Piller at Aupres Consult in Geneva


Jean-Francois Lambert at HSBC in London

Robert Piller, principal of Auprès Consult in Geneva remarks: "There are very few credible sources of data and statistics about trade finance transactions in the industry. There is no publicly available database or rating methodology to benchmark trade's performance. By contrast, project finance banks pooled their experience to help satisfy requirements, and Standard & Poor's rated the initial pool, which eventually grew to encompass more than 30 banks and over 3000 project financings. Through the engagement of the rating agencies, project finance benefits from an independent/external rating methodology, which is lacking in trade finance. Project finance banks have thus been able to demonstrate that this line of business has a higher rating at the portfolio level than corporate lending."

National regulators: the equalizers?

By all accounts, national regulatory authorities have significant leeway in their interpretation, implementation and enforcement of Basel II requirements, and may hold the key to an eventual equilibrium in the global treatment of trade finance. Under current conditions, regulators in many key jurisdictions will be nervous, defensive and gun-shy, especially in undertaking new, potentially risky responsibilities.

If the BIS fails to react – promptly – to concerns raised around their treatment of trade finance, responding to the call of the G-20 and others, it may be necessary to actively position national regulators as a counterweight to the treatment of trade finance under Basel II. The challenge will be, that national regulators will be nervous about such an approach, and will require political support in offsetting inequitable Basel II provisions.

This can work however, as the Financial Services Authority in the UK has demonstrated through its treatment of the maturity floor and other provisions – to the great satisfaction of numerous observers of this debacle. By contrast, the US Fed is being politely asked to explicitly support the notion that the US Export Import Bank ought to qualify as a sovereign entity under Basel II despite some ambiguity on the issue, engendered by the language used by the BIS.

Conclusion

There is a clear and urgent imperative to improve the treatment of trade finance under Basel II, given the critical importance of trade in the global recovery. While the industry has missed opportunities to influence the development of Basel II, the unprecedented profile of trade finance offers an opportunity: the chance to translate that profile into political capital, and to fairly and forcefully represent the interests of trade finance, both within financial institutions, and more widely, within the context of the global financial system.

As a recent paper from the ICC puts it: "The measures we propose do not require amendments to the fabric of the Basel II framework; rather, the introduction of small, yet significant, changes to the way in which the existing rules are implemented-making use of the discretion afforded to national regulators under the charter..."

Asked what HSBC would recommend to the BIS in terms of making Basel II more correct and equitable in relation to trade finance, Jean-Francois Lambert, global head of sales and risk management, structured trade finance at HSBC notes: "BIS guidelines allow for certain flexibility and it will be up to each country's regulators to implement locally if they deem fit. There are of course areas for improvement especially when endeavouring to recover from the crisis.

Lambert adds: "Trade movements are usually stronger than GDP movements – in both directions; trade will therefore play a key role in getting the world economy back on its tracks and the way it is appraised from a capital requirement perspective could amplify the recovery. In that respect we would welcome a better coordination of all regulators under stronger BIS guidance, a broader implementation of the one year maturity waiver for trade transactions and less reliance on historic data for favourable treatment of trade finance products to favour attractive default value which would then be tested against actual default history."

Longer-term, the level of knowledge and understanding of trade finance, by all concerned, must be elevated, enabled and supported. Riolacci at BNP Paribas considers that "...there is a need to start a serious pedagogy around trade finance, highlighting how it differs from other lines of business, and how it ought to be managed within a financial institution – including from a risk management point of view. We need to develop a stronger culture around trade finance."

Is anybody out there listening? ■