Partners working to a solution, at last?

Alexander Malaket provides opinion to the recent Basel Committee rulings and assesses the impact within the international trade finance community.

The maturity and cohesiveness of the message communicated by trade financiers to key stakeholders around the business of capital adequacy and more broadly, the Basel regulations, is clearly far advanced from where it was two or three years ago.

No one could credibly or justifiably argue against the need for prudent and effective regulation of the financial sector – globally – given the crisis which we continue to endure. Philosophy aside, it appears that our industry has developed clarity on a message and an approach to the whole issue of the Basel regulations, and has internalised the necessity to engage in an organised, coherent and most importantly, proactive manner.

These efforts, and the evolution of the approach, have been rewarded with the publication of a paper by the Basel Committee on Banking Supervision, entitled *The Treatment of Trade Finance* under the Basel Framework, in late October of this year.

The very fact that such a paper has been published – almost irrespective of its content – is representative of useful progress. The Basel Committee demonstrates that they have been listening to political leaders, international institutions, and senior industry specialists.

Low-income countries in focus

As noted by the Basel Committee, a primary driver underpinning discussions with industry, with the ICC, WTO and others, was the explicit direction from the G20 meeting in Seoul, related to the impact of regulatory requirements on trade involving low-income countries.

This is a fundamentally important dimension of the dialogue, and one that is fully in need of priority attention and resolution – there can be no doubt on this. The Bank for International Settlements (BIS) is to be commended for taking a considered and careful look at the issues and concerns raised by various stakeholders and interested parties.

No one would justifiably argue against adjustments to BIS regulations which remain consistent with the BIS' overall mandate, while redressing the unintended negative impact on low-income countries and the globally important small and medium-sized enterprises (SME) segment.

Now the key question is, how do we as partners in working toward the appropriate overall solution, ensure that trade finance more generally, achieves the equitable and differentiated treatment justified by its own unique characteristics within the business of banking and financial services?

Some industry leaders have opted to remain silent for the moment on the implications of the BIS paper. However, let there be no doubt that there is careful consideration of a reaction to this refinement of the BIS position.

Gilles Thieffry at GT Law in Geneva observes: "While our focus is most commonly on commodity➤

➤trade finance, typically involving export flows from developing economies, we welcome the announcement by the Basel Committee on Banking Supervision, as a step in the right direction. The publishing of a paper which specifically addresses the treatment of trade finance under the Basel capital framework is, perhaps, an appropriate symbolic recognition of the uniqueness of trade finance as a business and as an asset class. However, in practical terms, this appears to be a rather timid step ahead, and one which addresses only a subset of the legitimate issues related to equitable regulation of trade finance."

The maturing of the dialogue, and the clarity of the message communicated by trade financiers, has been an all-important contributor to advancing the legitimate interests of the industry and the broader interest of financial stability and global economic recovery. However, it must be clear – and it is clear to leaders in key positions – that the process is still evolving, and there is work yet to be done.

Providing a clearer picture of trade

Initial efforts to address the absence of credible, objective data around trade-related defaults, championed by the Asian Development Bank (ADB) and now led by the ICC, were a crucial, long overdue step ahead. The communication and use of that data in a well-crafted message is the second step forward, and the engagement of more than just two or three industry leaders in communicating the key messages, is another, concurrent element of the overall evolution of the dialogue.

The BIS paper acknowledges the creation of the trade finance default register, while noting that default probabilities represent one level of the necessary analysis. This needs to be complemented with an assessment of the likelihood of trade finance assets shifting from off-balance sheet to on-balance sheet, the latter having direct implications for capital adequacy.

As the Basel Committee notes: "The Committee is of the view that the credit register does not provide sufficient analytical evidence for reducing the CCF (Credit Conversion Factor) in the risk-based approach below the currently applied 20%. In addition, the data presented is more relevant for the probability of default of a trade finance instrument rather than its likelihood of becoming on-balance sheet. The Committee, however, supports further work by the ICC, as well as the WTO and the World Bank, to strengthen data on trade finance. It has been informed that the ICC has considerably expanded its database of defaults on trade finance transactions and intends to publish a report based on new data."

Herein lies the promise of further constructive, well-informed and solution-oriented dialogue.

We have progressed significantly from Sibos in Amsterdam, where one global trade head was heard to say: "The [Basel II] regulations will be what they will be: all we can do as an industry is react", to witnessing a vigorous dialogue at Sibos in Toronto between industry leaders such as Kah Chye Tan, chairman of the ICC Banking Commission and head of global trade finance and working capital, Barclays Corporate, together with Howard Bascom, BAFT-IFSA board member and global head at BNY Mellon, Adnan Ghani, global head GTS at RBS and Steven Beck, head of trade finance at the ADB. The Sibos panel and the broader dialogue around trade-related regulation rightly acknowledges the importance and appropriateness of regulation, while distinguishing the unintended consequences of the latest Basel regulations – the set of consequences which ignore the unique characteristics and risk profile of trade finance, and as a result, penalize the business incorrectly.

Perhaps more importantly in the long term, our leaders, following a path set by BAFT-IFSA, the ICC and others over the last couple of years, have understood – perhaps more accurately, taken aim at – the political context around financial sector regulation.

A level of urgency

Industry leaders have taken steps to invite engagement from risk insurers, international institutions, OECD and non-OECD financial sector regulators, as well as corporate executives whose business will be directly impacted by the regulation of trade finance. They recognise that the group of stakeholders affected by Basel regulations is much larger than just the banks.

There remains a level of urgency around the importance of international trade to global recovery – and by extension, the importance of trade finance. Likewise, the key roles of small businesses and of emerging market economies continue to garner attention. This comes at the very same moment as the unintended consequences of inappropriate regulation on trade finance threaten to stifle the very trade flows – and the trade activities of SMEs and emerging economies – so widely recognised as critical to global recovery.

Some commentators have suggested that trade financiers are now overstating the urgency and the adverse impact of misapplied regulation on trade and trade finance. One example of this is the estimate that capital reserve requirements related to certain types of transactions may increase by a factor of five, driving

the cost of trade finance upward by the same factor. The banks, say such observers, need not actually pass on all of these added costs to their clients.

In theory, perhaps, but banks remain – despite the quasi-nationalised state in which several found themselves recently – commercial ventures with profitability and returns targets and an obligation to generate value for shareholders. Like most businesses, banks will tend to pass on increases in the cost of production to the end-client. In any case, individual banks may choose different responses and strategies, but as an industry, the potential adverse impacts must be communicated to decision-makers. Sometimes, that means painting the worse-case scenario to attract the necessary attention to the issue under debate.

Broadening the dialogue

As the message takes shape, certain industry leaders are taking a conciliatory tone with the Basel Committee and working to a solution through communication and agreement. Others are taking decidedly more aggressive positions and referring to the BIS as having 'dug in its heels' on the treatment of trade finance.

The publication of this latest paper by the Basel Committee lends great credence to the more collaborative and partnership-oriented approach, and hopefully removes the need for posturing and inflammatory language going forward. The time for such aggressive tactics has passed, and the BIS is to be acknowledged for taking this important first step in resolving the broader issues around equitable regulatory treatment of trade finance.

There is no doubt that the BIS faces a gargantuan challenge, and even less doubt that the trade finance industry has been late 'arriving to the ball' for a dance with the Basel Committee. The industry is here now, and the urgency in assuring a healthy and vibrant trade environment is undisputed. Those in positions of authority and decision-making must therefore come to an equitable agreement, leading to fair treatment of what is, in the end, a very safe business as evidenced by trade finance default data.

Equally importantly for the overall health of the financial system, it must be acknowledged that the interdependence and high levels of integration of the global financial system require – probably demand – a solution which addresses issues on a global basis. Unilateral action, narrow self-interest and the imposition of will through economic power will not be effective over the long-term. Organisations and nations with influence must use their influence wisely and with an eye to equitable long-term settlement of the issues, sometimes quietly and diplomatically, rather than loudly and combatively.

In the current context, financial stability and more broadly, economic recovery and stability have been directly linked to healthy trade flows – and thereby, indirectly linked to the health and vibrancy of the trade and supply chain finance market globally.

Trade finance specialists have engaged successfully with certain key financial regulators such as the UK's Financial Services Authority, and must continue the process of engaging with, informing and gently influencing other major national regulators. This should ensure that the 'soft law' promulgated by the BIS, however unjustly it may apply to trade finance in the first instance, is interpreted and applied with due consideration at the level of the national regulators.

Recent remarks by industry leaders have included suggestions for business leaders to engage their political representatives as an additional layer in the discussion. In the end, if the influence of trade is so critical to the global recovery, as most will acknowledge, then the full adverse impact of inequitable treatment of trade finance should be captured, reflected and communicated – vigorously.

The next step

In the end, posturing and politics aside, we probably all agree that effective regulation is necessary, must be fact-based and equitable, and must allow for the efficient conduct of legitimate – and commercially sound – business. Given that fundamental agreement, it should follow that a well-informed, data-driven discussion between well-intentioned partners will lead eventually to the right balance between regulation and the successful conduct of business on a global basis.

At the same time, the urgency of the discussion must not be allowed to fade, and the dialogue needs to be broadened to include a wider set of informed stakeholders. The world continues to face serious systemic challenges in the financial sector, and more broadly in terms of the robustness of the global economy. Trade remains one of the only truly cross-cutting solutions to the challenges of recovery. As such, trade finance must maintain a vigorous expression of its value proposition and an energetic, well-informed defence of its business model and practices in the face of continued pressure to regulate financial activity.

The Basel Committee must, in parallel, maintain an openness to dialogue and a receptiveness to better understanding the nature of trade finance, in order to achieve its objectives as a prudent and effective regulatory body, without unduly stifling one of the critical enablers of trade – and by extension, one of the core elements of a sustained global recovery.

Congratulations to all for achieving notable progress, but now, back to work please: there are still big issues to be resolved. ■