Association for Financial Markets in Europe

AFME Briefing Paper

Risk Reduction Measures Package: Issues for Trade Finance

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Introduction

This paper highlights the issues across the Risk Reduction Measures Package that might negatively impact trade finance. In particular, it sets out our comments on the impact of Net Stable Funding Ratio (NSFR) and the Leverage Ratio exposure measure of the proposed Capital Requirements Regulation 2 (CRR2), as well as of Article 55 of the Bank Recovery and Resolution Directive (BRRD).

About trade finance

Trade finance activities enable the financing of commercial transactions of exporting and importing firms via lending, issuing letters of credit or trade related guarantees[1].

From a technical perspective, trade finance tends to be a shorter-term asset class compared to other lending activities with the average tenor of most trade finance products ranging from 120 to 170 days according to the International Chamber of Commerce[2]. Trade finance products are generally secured against the traded goods, self-liquidating in nature and, even in crisis conditions, pose only limited risk to banks and overall financial stability. As a business line for banks, trade finance significantly helps to increase portfolio diversification and, from a macro-economic point of view, contributes to supporting trade flows across the world.

NSFR: more appropriate Required Stable Funding (RSF) for trade finance products

We support the objectives of the Net Stable Funding Ratio (NSFR) to promote greater funding stability in the financial system. However, we are concerned about rising costs for end-users if a too high degree of stable funding is required for both on-balance sheet and off-balance sheet trade finance items.

Alignment with the recommendations of the December 2015 EBA Report for the treatment of on-balance sheet trade finance items (including factoring/forfaiting)

We support the EC's CRR2 proposals that are in line with the December 2015 EBA Report[3] to assign RSFs based on buckets depending on maturity for on-balance sheet trade finance items.

In particular, we support the EC proposals to assign a 10% RSF to export/import loans with a maturity of less than six months instead of assigning a 50% RSF to these types of loans, as initially planned in the Basel III NSFR requirements for all export/import loans with a maturity of less than one year. This more granular approach better reflects the short-term maturity of trade finance products.

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[1] which can be either short-term or long-term.
[2] Per the ICC Registry Report from 2016: the average reported maturity by product for the period 2008-2014 is between 122 days for Import L/Cs, 133 days for Export L/Cs, 160 days for Loans for Import / Export and 582 days for performance guarantees, p.23.
[3] EBA report on Net Stable Funding Requirements under Article 510 of the CRR, 15 December 2015.

However, the CRR2 does not specify the treatment of factoring and forfaiting trade finance items. We would like to highlight that short-term trade receivables financing techniques (which are also used more broadly to finance EU corporates beyond the trade finance context), such as factoring and forfaiting, have the same characteristics as short-term trade finance export/import loans as far as liquidity risk is concerned: they are short-term and uncommitted financing, with a low funding risk profile.

We therefore suggest that factoring and forfaiting should be treated in the same way as other trade finance products and that the CRR2 text should include a specific reference to this effect.

RSF Factors proposed under CRR2[4]

Trade Products	Maturity		
	< 6 months	Between 6 months and 1 year	> 1 year
Letters of Credit (L/C)	5%	10%	15%
Guarantees (GTE)	5%	10%	15%
Export/Import Loans	10%	50%	85%
Factoring & Forfaiting Non-Financial Firms	-	-	-
Factoring & Forfaiting Financial Firms	-	-	-

Treatment of guarantees and letters of credit

Under the proposed CRR2, bank guarantees and letters of credit are assigned a 5% RSF when their residual maturity is less than six months, 10% when their maturity is between six months to one year and 15% when it is more than one year.

We believe that the RSF assignment for letters of credit and bank guarantees, which are off-balance sheet trade finance products, should be independent from maturity as off-balance sheet trade finance items, whether short-term or long-term[5], only require the bank to make a payment in the event that a beneficiary makes a claim. Moreover, this would be consistent with the treatment of other off-balance sheet items.

Claims occur in case of nonperformance of a contract, which is when one of the parties fails to fulfill its obligations under the contract. This might be the case if, for instance, a commercial dispute occurs between the importer and the exporter about how a product was delivered or if the delivery takes too long.

[4] Products listed under Articles 428 (s), 428 (u), 428 (w), 428 (ac) and 428 (af) are outlined in this table.
[5] According to ICC Trade Register Report from 2016, the weighted average contractual maturity (days) for bank guarantees is 582 days, with a minimum of 2.9 days and a maximum of 1153 days.

However, the likelihood for claims occurring on such products tends to be very low and the actual funding needed by banks for such transactions is also low because banks have access to the underlying client's account. Before issuing a letter of credit or a guarantee, banks ensure that the client has enough available funds on its account.

We therefore believe that considering the credit quality of a counterparty and the bank's exposure to the counterparty is more relevant than the underlying maturity. While assigning a stable funding requirement based on tenor is relevant for on-balance sheet trade finance items, it is not for off-balance sheet trade finance items.

Data from ICC trade finance register from 2016 shows that default and loss rates for off-balance sheet trade finance items are very low: between 2008 and 2015, the average default rate for issued letters of credit (import and export) was 0.06%, and 0.19% for bank guarantees, while loss rates were 0.02% for letters of credit and 0.01% for guarantees[6].

On the basis of these considerations, we also believe that assigning a minimum 5% RSF for these types of products is too high. In the initial Basel III NSFR requirement, the assignment of the RSF factor is at the national discretion of regulators for bank guarantees and letters of credit. We note that other regulators worldwide assigned funding requirements for these products, which are significantly lower than in the CRR2 proposals without taking their maturity into account: a 3% RSF is assigned in Hong-Kong, a 1% RSF in Singapore, a 3% RSF in Indonesia and a non-maturity based 5% RSF is assigned in India and in the U.S. [7]

A 5% RSF in the U.S can be justified by the fact that it is not a strong exporting country compared to some European countries, such as Germany, Benelux countries or Italy. A 5% RSF for off-balance sheet trade finance items in the EU could be a disadvantage to the EU banks and ultimately penalise the bank's end-user exporters, especially compared to other countries with strong export economies.

We therefore believe that higher and maturity based RSF for off-balance sheet trade finance items under the EU prudential framework could significantly disadvantage EU banks compared to other banks worldwide and potentially lead to a reduction in the provision of guarantees and letters of credit in the EU. Therefore, our recommendation is that they should be assigned a maximum 5% RSF regardless of maturity.

Proposed adjustments to the leverage ratio exposure measure and its impact on export credit activities

We welcome the proposed adjustment to the leverage ratio exposure measure included in the CRR2 for officially guaranteed export credits.

[6] Per the ICC Registry Report from 2016, p.45

[7] According to the proposed rule on the NSFR in the U.S by the Federal Deposit Insurance Corporation, the Federal Reserve, and the Office of the Comptroller of the Currency, a 5% RSF applies to any undrawn amount of committed credit and liquidity facilities. The following rationale is given in the preamble (p.75): *"Research conducted by Board staff found increases in drawdowns of as much as 10 percent of committed amounts over a 12-month period from 2006-2011. Given the proposed rule's application across all counterparties and economic environments, assignment of a 5 percent RSF factor would be appropriate based on the observed drawdowns during this period".*

We believe these adjustments are necessary to preserve export credit activities from being potentially negatively impacted by the Leverage Ratio. The explanatory memorandum of the amending Regulation (EU) No 575/2013 stresses that: *"Since a 3% leverage ratio would constrain certain business models and lines of business more than others, further adjustments are warranted. Institutions may reduce the leverage ratio exposure measure for public lending by public development banks (Article 429a(1)(d)), pass-through loans (Article 429(1)(e)) and officially guaranteed export credits (Article 429a(1)(f))"*[8].

In particular, Article 429a(1)(f) excludes the guaranteed parts of the exposures arising from export credits from the scope of the leverage ratio, when these exposures would receive 0 % risk weight under either Article114 (4) or 116 (4) of the CRR, that is when the Export Credit Agency (ECA) is incorporated within the EU and the loan is funded in the local currency of the country of the ECA.

It should be noted that less than 50% of export credits covered by an ECA established within the Eurozone are denominated in Euro, and the percentage of loans issued in domestic currency is much lower if the Export Credit Agency is not established in a Member State outside the Eurozone.

We therefore suggest that *all* ECA exposures be exempt from the leverage ratio exposure measure, irrespective of the currency of the loan as long as the loan has been covered by an ECA within the EU.

Furthermore, to avoid ambiguity in the interpretation of Article 116 (4) we recommend amending Article116 (a) by introducing the term "official" in line with the definition of ECA exposures under Article 4 (811) to distinguish between ECAs which are and which are not state backed.

The impact of Article 55 BRRD

Background and practical challenges

Article 55 of the Bank Recovery & Resolution Directive (BRRD) requires that a broad scope of liabilities governed by non-EU law entered into by in-scope institutions must include a clause recognising the effectiveness of a bail-in under the BRRD. While we support the objective of ensuring resolvability, Article 55 has given rise to a significant number of practical challenges, including for trade finance products. Our members have undertaken a thorough analysis of the contracts which are within the scope of Article 55 and identified the following categories as presenting particular challenges:

a) contracts where there is no realistic possibility of inserting the relevant provisions – and in some cases, it is not clear what these would achieve. Examples include trade finance products (see below) and membership of financial markets infrastructure; and

b) contracts where there is resistance from the local regulatory authorities to any change in the terms, for example uninsured corporate deposits of a branch of a bank outside the EEA, which are governed by local law.

[8] Extract from the explanatory memorandum of the amending Regulation (EU) No 575/2013, p.18.

Impact on trade finance products

Some examples of the types of agreement which cause the greatest difficulties include those within trade finance. Trade finance has, since 1933, been governed by protocols developed by the International Chamber of Commerce and not expressly by national laws. As highlighted by the UK Treasury: *"The use of international standard documentation and rules, the practice of having no express choice of governing law of contracts, the legal nature of certain finance liabilities and the inability to impose unilateral changes to a contract because of the dominant bargaining position of non-customers makes it practically impossible for banks to add contractual bail-in terms to some types of trade finance liabilities."*[9]

In order to avoid an unintended fall in the provision of trade finance by EU banks, we believe that the best way to address these practical difficulties, while not impeding resolvability, is to limit the scope of Article 55 to liabilities eligible for MREL, and any additional liabilities identified by the resolution authority where required for the resolvability of the group.

This approach would provide a clear and consistent scope of liabilities, creating clarity for the market and ensuring a consistent approach across the single market while maintaining the oversight of resolution authorities and ensuring that resolvability is not impeded. It would also be consistent with the FSB Principles for Cross-border Effectiveness of Resolution Actions[10].

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

[9] Extract from HM Treasury response to the European Commission Call for evidence on the EU regulatory framework for financial services, February 2016, available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/496887/PU1903_HMT_response_to_EU_consultation.pdf at p.42.

[10] http://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf