

## Consultation response

### Revisions to the Standardised Approach for Credit Risk

27 March 2015

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The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the **BCBS's consultative document REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK**. 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.

#### Scope

The focus of this paper is exclusively on the treatment of **trade and commodity finance exposures** and is being submitted by AFME as a complement to the joint response of the GFMA and IIF which covers all aspects of the consultation on the new Standardised Approach for Credit Risk. It should be noted that other industry responses, such as those of the ICC, BAFT, FBF and NVB, also cover trade and commodity finance issues which should be read in conjunction with this paper.

Trade Finance is here defined as a product class stretching over several asset classes (SMEs, LCs, FIs, Sovereigns and even Public Sector Entities). Please note that, as a result, Trade Finance has historically never been fully recognised by the BCBS framework, but instead some special capital treatment has been allowed in particular for certain CCFs and for maturities shorter than one year.

Commodity Finance<sup>1</sup> is here defined as focusing on commodities, making use of Trade Finance products, and with a dedicated monitoring/collateral unit.

#### Introduction

We welcome the stated BCBS objectives to seek convergence and enhanced comparability in RWAs between SA banks and IRB banks and that this be achieved in a simple and risk sensitive manner. However, we would like to express our grave concerns regarding the potential unintended consequences that the current proposals will have on the Trade Finance and Commodity Finance sectors. While some general comments certainly apply to Trade Finance and Commodity Finance, we focus in this response on the asset class Specialised Lending (SL), and on Commodity Finance as a special case. Other comments apply more generally to Trade Finance, for which existing specific capital treatments should be at least kept and moreover some clarification under the BCBS framework is urgently needed. Finally, we also disclose aggregated high-level historical data in the area of Commodity

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<sup>1</sup> Please note that whether a bank has historically reported those exposures under Corporates or Corporates-SL was until now not so important, given similar capital treatments, but will become essential given the proposed risk weight for SL.

Finance (evidencing its low risk nature) and we propose simple alternatives recognising the specifics of Commodity Finance structures, which are far more risk sensitive than a simple two financial factors-approach and/or a single risk weight/floor for SL. These alternatives therefore more accurately reflect the true risks of Trade and Commodity Finance activities.

### **Ongoing dialogue after March 27<sup>th</sup>**

Given the consultative nature of the current proposals and their estimated huge impact, an ongoing dialogue, through a technical meeting between the BCBS Task Force and the industry, is deemed necessary to exchange knowledge on risk drivers and IRB modelling practices within the area of SL. This asset class often encompasses low risk businesses which on occasion are incorrectly perceived to carry a higher level of risk because they are somewhat more complex than standard corporate lending. A quantitative industry survey evidencing the low risk nature of Commodity Finance could also be conducted. This would be at a more granular level than the information presented in this response and hence more time would be needed to collect historical data in a consistent manner from the respective banks.

#### **1. General comments**

##### **Proposed capital floors are actually to the detriment of low risk businesses**

By flattening capital requirements the proposed capital floors actually have the undesirable effect of reducing risk sensitivity and ultimately making the banking sector less resilient. In particular, it demeans the value of structure and reduces the benefit of taking collateral and other forms of security. Furthermore, systemic risk is actually increased because capital outcomes will converge, and the cost of borrowing for Commodity Finance clients significantly raises thus ultimately reducing the availability of liquidity in the international trade finance market. Capital floors, if set at an artificially and unnecessarily high level<sup>2</sup> will thus give wrong incentives to banks that currently have higher quality Commodity Finance portfolios. Floors create the unintended opposite effect for banks to engage in higher margin business (read: higher risk), lending to weaker counterparties for which higher margins can be charged. This, in order to compensate for the higher capital charge required to meet the return on equity targets.

##### **Pursuing and refining industry initiatives for convergence and comparability is thus preferred**

We therefore recommend not introducing RSA floors for IRB banks, and instead to pursue and refine existing work aimed at creating more consistency and less variability in RWAs (such as the ongoing work undertaken by IIF on discount rates or downturn LGDs and also work by the ICC on CCFs for trade finance products). Furthermore, we believe it is important to maintain the risk sensitivity of internal risk management tools developed by Commodity Finance banks who have each made substantial investments in AIRB models and which play a crucial role in the banking sector as a whole. For Commodity Finance businesses in particular, we believe that detailed work still needs to be done in this area and would encourage knowledge exchange between the various stakeholders.

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<sup>2</sup> The final calibration of the BIS proposals is still uncertain, but the impact is likely to be significant for IRB banks, if current proposals become reality, while current IRB calibrations are based on own historical data and the process is approved by supervisors. The representativeness of the data used for the calibration, as well as the statistical methods used to determine risk drivers, are therefore questionable at this stage. Using QIS, EBA and other existing historical data is therefore strongly recommended.

## 2. Specialised Lending

### Lack of granularity for SL does not improve risk sensitivity

Specialised Lending includes a broad range of financing types, such as Commodity Finance, Project finance (including Mining and Reserves), Object Finance (such as Shipping and Aircraft), and Commercial Real Estate Finance, all with their specific characteristics and risk profile, hence the design of the AIRB framework distinguishes among these different types. The same granularity in the treatment of SL is certainly needed in the current consultative papers, in order to achieve and to maintain enhanced risk sensitivity. This holds in particular true for Commodity Finance. While we agree that SL might represent only a small part of the portfolio of SA banks, it is often significant for IRB banks, and certainly as a global financing sector across banks. We absolutely do not recognise the statement “*Empirical evidence shows that specialised lending generally exhibits higher risk and losses than other types of corporate lending*” and would be keen to learn about the sources of the empirical research leading to this conclusion. For several categories of SL, and certainly Commodity Finance, banks can indeed demonstrate a track record of low losses over time, including a full economic cycle. The historical evidence has in fact already been applied in annual reviews of internal models, where back-testing is an important part of the analysis, and for which regulatory approval has been obtained (although it is recognised that because only a few banks have invested in developing such Trade Finance and Commodity Finance models, industry practice might not be well spread as yet). Additionally, publically available statistics from the EBA also tend to indicate a lower risk profile for SL than for traditional Corporate Lending.

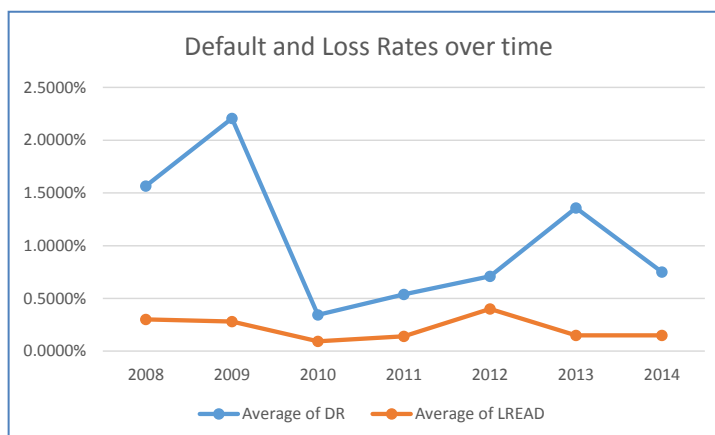
### The proposal dismisses the value of structure and collateral in Specialised Lending

The Standardised Approach is borrower specific and does not take into account the structure, collateral and other security types. This extremely narrow approach effectively penalises sound business models such as Commodity Finance (or Project Finance), which are all important for the real economy, even to the point that banks will have to consider carefully whether some of these businesses will remain economically viable under the new proposals. Also, for many banks, low defaults and low losses can be evidenced for those activities, with the bank’s proprietary data that are as a rule accessible to the competent supervisor, and in some cases through publications from data pooling initiatives.

## 3. Commodity Finance

### Low risk evidenced by historical data

Anonymously aggregated high-level historical data by six French- and Dutch banks actively involved in Trade and Commodity Finance clearly evidences the low-risk nature of Commodity Finance. These facts clearly reinforce the need for a more risk sensitive calibration for Commodity Finance, which would take into account the specific risk mitigants involved, and their proven historical effectiveness. In particular, observed default rates (ODFs) and loss rates (compared to EAD and exposures) have been collected over the period 2008-2014, see graph below.



The average default rate is estimated at 1.01% while the average loss rate is 0.21% on EAD (and even 0.14% when compared to exposures). Indicative and conservative estimates of implied risk weights, using this average default rate and the highest loss rate observed (2012), are much lower than the currently proposed 120% for Specialised Lending (55% with a maturity of one year, and 69% with a maturity of 2,5 years, while most commodity Finance exposures are even shorter than one year). A technical meeting where the observed loss data and resulting risk weights are discussed in more depth, will in our opinion provide a deeper understanding.

### **Leverage and revenue not risk sensitive for commodity traders and even lead to capital volatility**

Experience with developing internal rating models to establish counterparty ratings for corporates shows that models with sufficient discriminatory power are often based on qualitative as well as quantitative factors. While some leverage ratios (however different from the one currently proposed) and revenues (although not as an absolute figure among all borrowers) may sometimes be considered to be relevant drivers in the quantitative component of certain corporate models, this is certainly not true for counterparties active in commodities. Instead, gross margins, solvency and liquidity factors<sup>3</sup>, averaged over a multiyear period, are far more useful indicators. More importantly, leverage and revenues are even considered not risk sensitive for counterparties involved in commodity trade, since there is no risk differentiation through leverage (all are indeed rather similar) and the revenues are volatile as they mostly depend on (variations in) commodity price levels. Moreover, the qualitative component remains extremely important for a forward-looking view, e.g. for commodity traders the quality of management, risk management sophistication, trading practices and hedge methodology have proved to be important factors. Therefore, finding a simple and risk sensitive approach for commodity traders is challenging, but should at least revolve around the above mentioned financial factors instead of those currently proposed (or even a single risk weight/floor of 120%).

### **Alternatives for Commodity Finance structures**

No recognition is given in the current proposals for the short-term, uncommitted and trade-related nature of Trade Finance and Commodity Finance exposures. Trade financings are mostly self-liquidating in nature and truly short-term, i.e. 30 to 90 days. In addition, deals are typically secured by very good quality collateral, such as commodities for which liquid terminal markets exist, or Receivables. We recommend introducing alternatives to the current proposal, and in particular to consider for instance:

- Specific risk weights by subcategory within SL, taking into account structure/collateral specific elements. For example, in case that more than 100% commodity collateral is present;
- Recognition of non-financial collateral through the existing Credit Risk Mitigation framework. For example, liquid and exchange-tradable (hence with an objective valuation) commodities could be recognised in a similar way as gold;
- Define at least specific lower floors, when a strong structure/collateral is present.

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<sup>3</sup> Other examples include the current ratio and [Net debt adjusted with RMI/EBITDA], where RMI stands for Readily Marketable Inventories, as defined by the Moody's rating methodology for Commodity Merchandising and Processing companies. Moody's estimates adjustment for RMI to be typically between 20-50% of total inventory depending on the proportion of the company's revenue base and inventory that is tied to their trading operations.

#### **4. Trade Finance**

##### **ICC ongoing work on Trade Finance**

The International Chamber of Commerce (ICC) is considered a leading organisation to promote knowledge exchange between the BCBS Task Force and Trade Finance banks, and to propose alternatives to current proposals for the specific treatment of Trade Finance products. We therefore refer to the separate ICC response for more details on Trade Finance, and only highlight some topics in this response. We in particular share the urgent need for clarification of certain Trade Finance definitions such as commitments and unadvised limits, reporting rules on off-balance exposures, and a lower CCF calibration for both SA and IRB banks. Additionally, the issue of estimating/applying CCFs at a product level rather than at a facility level should be addressed explicitly. The current lack of clarity regarding these topics indeed lead to unwelcome variability in RWAs, as banks have used different own assumptions.

##### **Proposed increased CCFs and maturity treatment leads to high impact for Trade Products**

In terms of methodology, for trade-related bank exposures, mostly letters of credit and guarantees, short-term and uncommitted, we recommend to keep the current treatment of low CCFs (evidenced by data from ICC in particular) and maturity (e.g. the lifting of the one year floor for some products, and even for all Trade Finance products in some jurisdictions). Unfortunately, Trade Finance is more a product class than an asset class and therefore under the BCBS framework this group of exposures has only been partly recognised, despite obvious low historical defaults and losses. Its importance for the global economy as a form of risk diversification, shifting country- and counterparty risk, does not need to be proven anymore. Its resilience has once more been proven during the last crisis as acknowledged in the BIS research paper CGFS No 50 on the subject. There is moreover a risk of a shift towards shadow banking in case the proposals are not adjusted.

##### **AFME contact**

Jacqueline Mills, [jacqueline.mills@afme.eu](mailto:jacqueline.mills@afme.eu)

+44 (0)20 7743 9358