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INTERNATIONAL REGULATION AND TREATMENT OF TRADE FINANCE: WHAT ARE THE ISSUES?

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Abstract

The paper discusses a number of issues related to the treatment of trade credit internationally, a priori (treatment by banking regulators) and a posteriori (treatment by debtors and creditors in the case of default), which are currently of interest to the trade finance community, in particular the traditional providers of trade credit and guarantees, such as banks, export credit agencies, regional development banks, and multilateral agencies. The paper does not deal with the specific issue of regulation of official insured-export credit, under the OECD Arrangement, which is a specific matter left out of this analysis. Traditionally, trade finance has received preferred treatment on the part of national and international regulators, as well as by international financial agencies in the treatment of trade finance claims, on grounds that trade finance was one of the safest, most collateralized, and self-liquidating forms of trade finance. Preferred treatment of trade finance also reflects the systemic importance of trade, as in sovereign or private defaults a priority is to "treat" expeditiously trade lines of credits to allow for such credit to be restored and trade to flow again. It is not only a matter of urgency for essential imports to be financed, but also a pre-condition for economic recovery, as the resumption of trade is necessary for ailing countries to restore balance of payments equilibrium.

The relatively favourable treatment received by trade finance was reflected in the moderate rate of capitalization for cross-border trade credit in the form of letters of credit and similar securitized instruments under the Basel I regulatory framework, put in place in the late 1980s and early 1990s. However, as the banking and regulatory communities moved towards internal-rating based and risk-weighted assets systems under the successor Basel II framework, a number of complaints emerged with respect to the treatment of trade credit – particularly in periods of crisis. Issues of pro-cyclicality, maturity structure and country risk have been discussed at some length in various fora, including in the WTO at the initiative of Members. Part of the issue was that Basel II regulation was designed and implemented in a manner that, in periods of banking retrenchment, seemed to have affected the supply of trade credit more than other potentially more risky forms of lending. With the collapse of trade in late 2008 and early 2009, the regulatory treatment of trade credit under Basel II clearly became an issue and was discussed by professional banking organizations, regulators and international financial institutions. A sentence made its headway into the communiqué of G-20 Leaders in London in April 2009, calling upon regulators to exercise some flexibility in the application of Basel II rules, in support of trade finance. As the issue of removing the obstacles to the supply of trade finance spread became part of the public debate, discussions with respect to the regulatory treatment of trade finance in the context of the making of "Basel III" rules are now raising political attention.

Part of the underlying problem regarding the design of regulation of trade finance is that banking regulators may not have enough understanding of the way that trade and trade finance operate in practice. In turn, the banking community has made insufficient progress in explaining these issues to regulators and in providing evidence about the high level of safety and soundness of their activity, in collecting statistical information and even in defining clearly what comprises trade finance. This paper aims at clarifying such issues. The WTO, in its role as an "honest broker", is trying to help the parties concerned, and has been asked from time to time to act as a go-between between the two communities, in order to clarify issues. Section 1 looks at the overall Basel framework and its evolution over time, with particular emphasis on the regulation of trade finance. Section 2 looks at

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issues raised in the WTO context by the trading and trade finance communities, be it by WTO Members or by experts, and how this has helped to clarify some of the disputed issues. Section 3 raises a number of questions which need clarification from the trade finance community for regulators to be able to better capture the reality of trade finance operations, and allow them to regulate with full understanding of its implications.

Keywords: Trade financing, cooperation with international financial institutions, coherence, G-20, financial crisis.
***JEL* classification**: E44, F13, F34, F36, O19, G21,G32

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I. The Basel Framework and the Regulation of Trade Finance

A. Background: the Basel Committee on Banking Supervision

The Basel Committee of Banking Supervision (BCBS) was established by the central bank Governors of the Group of Ten Countries (G-10) at the Bank of International Settlements (*BIS*) at the end of 1974. The Committee was not aimed at exercising supranational authority nor at issuing conclusions having legal force. Rather, it aims at formulating broad regulatory standards, guidelines, and statements of best practices "in the expectation that individual authorities will take steps to implement them through detailed arrangements – statutory or otherwise – which are best suited to their own national systems".[2] The Committee meets mainly four times a year at the *BIS*, which also hosts its Secretariat, and reports to the G-10 Governors of central banks and heads of supervision. More information on the evolution of the mandate and composition of the BCBS is available on a specific page of the *BIS* website.

The need for stronger cooperation between national banking regulators and supervisors and for increased convergence of their approaches and standards arose with the internationalization of banking in the 1970's and afterwards. The development of the "Euromarkets" (off-shore dealing of national – in particular US-dollar based – assets) and the risks associated to cross-border banking, including through foreign branching or other forms of establishment, required a better delineation of host and home country control over banking activities of increasingly internationalized financial institutions. Already, previous episodes of banking failures had convinced the members of the Basel Committee (central banks and other authorities in charge of prudential supervision when it is not the central bank) that the internationalization of banking activities had raised the risk of international spill-overs when large domestic banks failed altogether. In other words, the systemic risk was no longer a national risk but was a matter of common interest.

This led the Committee to adopt in 1975 under the co-called "Concordat" a series of core principles of prudential supervision for foreign banking, clarifying the respective responsibilities of home and host countries regulators in supervising these institutions. Since then, the Concordat has been complemented by a long series of documents specifying standards and guidelines regarding the treatment of particular banking activities and establishments.

Capital adequacy requirements are one of the most important standards developed by the Basel Committee on Banking Supervision because it touches upon solvency issues. However, it is not the only one, the Basel Committee covering the whole spectrum of regulatory and supervisory issues such as liquidity standards, credit and market risk management, accounting standards and reporting issues, confidentiality and disclosure, deposit protection, liquidation, and on and off-site supervision of domestic and cross-border banking. This paper focuses primarily on capital adequacy requirements, which is the most debated regulatory aspect affecting trade credit supply.

B. From Basel "Basel I" to "Basel II"

1. The basic Basel I Regulatory Framework for Trade Finance (capital adequacy)

There is undoubtedly a relationship between the strengthening of international cooperation in the banking regulation and international banking crises. One of the first international banking crisis after the end of the Breton-Wood system and the subsequent oil shocks was the default in a number of Latin American and other countries of debtors to pay back loans essentially granted by westerns banks, primarily US and European-based banks. The intervention of the US Government, the IMF and other international institutions under the Brady Plan helped considerably alleviate the crisis, but also

[2] "History of the Basel Committee and its Membership", *BIS* website, at www.bis.org.

convinced the political authorities of creditor countries that regulatory agencies should establish a measurable fixed proportion of capital for any main category of lending in the banks' balance sheets. The establishment of such an international standard, to be shared by all members of the Basel Committee, had the considerable advantage of reducing the potential exposure of lenders of last resorts in the home country of the failing banks. It also aimed at avoiding potential "races to the bottom", i.e. forms of regulatory competition whereby lower capitalization requirements would be imposed by national regulators with a view to provide a competitive advantage to domestic banks against more stringently regulated banks abroad.

Hence in 1988 the Committee decided to introduce a capital measurement system for internationally active banks commonly referred to as the Basel Capital Accord (also called the Basel I framework). This system provided for the implementation of a credit-risk measurement framework with a minimum standard capital of 8% of total assets to be set aside by end-1992. The framework has not only been introduced in all of the 10 Members of the Basel Committee but also in virtually all other countries in the world with active banks internationally. In the Basel I framework, as in successor frameworks, assets are risk-weighted according to an evaluation of the risk of default of the borrower, ranging from the lowest risk-weightings (0% for the best Governments bonds in the world) to a 100%-risk weight (or more in successor arrangements) for standards corporate loans. A 100% risk-weight meant in effect that the capital to be "set-aside" for such loans ought to be no less than 8% of its notional value.

The overall logic of the system was to protect financial institutions against the risk of insolvency in case of default on their assets by accumulating sufficient amounts of capital (categorized as so-called Tier 1 capital, broadly representing equity, and Tier 2 capital - reserves, near-to-capital instruments such as subordinated debt) to cover possible losses in difficult times, each category of assets receiving a weight in relation to estimated, historical risk.

Under the Basel I framework, the treatment of short-term trade finance, the bulk of the trade credit market, is relatively favourable. The Text in Basel 1 indicates that "*Short-Term self-liquidating trade-related contingencies (such as documentary credits collateralized by the underlying shipments)*" would be subject to a credit conversion factor equal or superior to 20%, under the standard(ized) approach. This meant in effect that for an unrated trade credit to a corporation of US$ 1,000,000, carrying a normal risk-weight of 100% and hence a capital requirement of 8%, the application of a credit conversion factor (CCF) of 20% would "cost" the bank $16,000 in capital (Box 1).

Box 1: Simple Credit Conversion Factor Example under the Standardized Approach of Basel I

- Unrated trade loan to corporate: US$ 1,000,000
- Application of a risk-weight of 100%
- Capital requirement of 8%: US$ 1,000,000 * 8% = US$ 80,000
- CCF of 20%: US$ 80,000 * 20% = US$ 16,000 in total capital to set aside

Source: WTO Document WT/WGTDF/W/42

The use of CCF values of 20% was widely regarded by the banking community at the time as a recognition of the low risk of lending on trade and transactions related contingencies in comparison to other forms of lending products. Trade-related contingencies are contingent liabilities that arise from trade-related obligations underpinned by the movement of goods or the provision of services and evidenced by commercial contracts that documents the arrangement between the buyer and the seller. Hence, trade-related contingencies are hardly speculative in nature. In providing for such facilities, the banks are simple intermediaries between the parties, i.e. the buyer and the seller, and are offering a service providing for risk mitigation and transaction structuring for the counterparties. Documentary credit, predominantly import documentary letters of credit, are the prime trade-related contingency. A letter of credit provides an irrevocable guarantee to the exporter that, should the goods and/or services be delivered to the importer according to contractual terms, and in presence of compliant documents, that it will be paid by the bank that issued that letter of credit (the bank of the importer). The letter of credit also provides assurances to the importer, in particular that of receiving the goods and/or services ordered, in line with the compliant documentation, and under any contractual terms set out in the purchase agreement. The obligation of the issuing bank to pay the beneficiary of the letter of credit, most generally the exporter, is hence contingent on the exporter delivering the merchandise as detailed in the letter of credit, but also in accordance with all the other requirements specified in the documented credit.

The documentation required in a letter of credit depends on the level of complexity of the transaction and the degree of security that the two parties wish to have on the transaction: security of payment, security and transparency regarding the description of the goods, security regarding the clearance of customs, transportation process and delivery on time, and other kinds of risks related to the transactions. Document compliance has to be verified – one important feature of the acceptance/endorsement process for letters of credit, in particular by the bank of the exporter. While the amount of documentation varies according to the nature of the transaction, the legal clauses of basic letters of credit are subject to regular standardization by the banking commission of the international chamber of commerce, which also provides for arbitration services in the case of such contingencies. The existence of a strong and well identified collateral, and detailed documentation, concur to make documented letters of credit one of the safest forms of lending as such documentation and collateral are internationally recognized by commercial laws around the world and subject to arbitration in case of default or other problems affecting the transaction.

2. "Basel II"

The difficulties experienced by several banking systems in the early to mid-1990, including in Japan, France, Nordic European countries, and newly industrialized countries in Asia convinced regulators that the Basel I framework, which essentially dealt with traditional credit (default) risk, had to be adapted to reflect the increasing complexity of banking operations and the rapid innovation in financial markets, such as off-balance sheet operations, securitization of lending, derivatives and forward operations, as well other features of modern banking which had appeared in the context of cross-border transactions. Basel II was deemed in particular to provide a stronger link between risk, risk management and capital.

The relatively "simple" risk-weight benchmarks developed under the Basel I framework no longer reflected the wide variety of banking and other financial transactions, and did neither offer a sufficient spectrum of risk-weighting in relation to the type of lending operation nor allowed for a proper identification of the end-user/borrower. Hence, the capital allocation could be similar for different risk exposures, be it domestically or internationally. This difference between the "economic" and regulatory risks led financial institutions to engage in regulatory arbitrage, shifting away from less risky assets towards risky ones within a given risk-weight category to seek higher yields. To avoid in-balance sheet capitalization, they also had recourse to securitization in off-balance sheet vehicles and at times increased lending exposure from overseas' subsidiaries in countries in which transparency and disclosure requirements were lower. These practices allowed capital ratios in consolidated accounts of global bank to fall albeit at the risk of blurring the evaluation of value at risk.

The first proposals for a reform of the Basel Accord came from the BCBS then years after its inception. The reform was articulated around three pillars: minimum capital requirements (Pillar 1), supervisory review process (Pillar 2) and disclosure requirements (Pillar 3). Under Pillar 1, one of the key reform's objective was to specify capital requirements in much greater detail according to the type of economic risk, with a view to bridging the gap between the underlying economic risk and regulatory risk (and hence limiting the scope for regulatory arbitrage).

One the one hand, the minimum ratio of capital to total balance-sheet commitments remained at 8%, and, at least in the early years of Basel II, the definition of capital was maintained relative to Basel I. On the other hand, capital requirements were revised and detailed for "credit risk", new ones were introduced for "operational risk", and slightly changed for "market risks". Another innovation under Pillar 1 was the use of ratings to weight-risk by economic category of banking as well as by final counterparty/borrower. For financial institutions that did not have the resources to operate their own "models" of credit risk estimation, the "standardized" approach would provide guidelines on how to manage risk and allocate capital according to the wider proposed set of categories of economic risks. External credit ratings for cross-border lending operations would be based on benchmarks (ratings of counterparty institutions, countries, and financial instruments issued by them) provided by international commercial rating agencies. More "sophisticated" financial institutions would rely on an "advanced internal-ratings based approach" to make their own estimation of such credit risk, taking into account in their models a number of compulsory criteria such as the probability of default, loss given default, exposure at default, and maturity. The most advanced models would provide estimates of the incidence of changes in market conditions (including prices and interest rates) on existing (or new) in and out-of balance sheet commitments, using the concept of value-at-risk.

Under Pillar 2, the supervisory review process was given more attention, as it established a three stage process of: (a) banks' own assessment of capital adequacy (b) a supervisors' review of banks' capital adequacy assessment (c) an a supervisory response in case of a discrepancy between the two.

Overall, the new framework designed between 1999 and 2004 relied on extensive consultations between regulators and the financial services industry, and was to be implemented by January 1, 2008 by not only BSBC members, but a wide number of associates and voluntary countries – more than 100 "jurisdictions" overall. Basel II requirements were not yet fully in place in several important countries when the financial crisis started.

As for the banks' capital adequacy regime of trade credit under Basel II, the text for the standardized approach (Article 85) looks as relatively unchanged compared to that of Basel I (Box 2)

Box 2: Capital Treatment of Trade Credit under the Basel I and Basel II framework – comparison of texts

- Basel I: "Short-term self-liquidating trade-related contingencies (such as documentary credits collateralized by the under the underlying shipments" are subject to a 20% credit conversion factor.

- Basel II: (under the standardized approach, paragraph 85) "For short-term self liquidating letters of credit arising from the movement of goods (e.g. documentary credits collateralized by the underlying shipment), a 20% credit conversion factor will be applied to both issuing band confirming banks". Paragraph 311 under the internal-rating based approach refers explicitly to paragraph 85 language.

Source: WTO Document WT/WGTDF/W/42

Some regulatory requirements particularly relevant for trade credit transactions in emerging markets are also to be noted:

- Inter-bank claims, including trade bills, denominated and funded in local currency could be risk-weighted at 20% when the original maturity was three months or less,

- and the risk weighting of certain multilateral development banks had been reduced from 20% under the 1988 Basel Accord to 0% under the Basel II framework.

While the international banking community had been generally in demand of a strengthened approach to banking regulation and supervision, the trade finance community rapidly felt that in an internal-ratings based system the regulatory treatment of its own activity – although in appearance comparable to Basel I, was this time worsened relative to other forms and segments of credit, for the following reasons:

- Pro-cyclicality: Capital requirements under Basel II vary according to the nature and structure of the transaction, but also according to counterparty and country risk. Under Basel II, the country risk cannot be worse than any individual counterparty risk in that country, so any deterioration of the country risk in, say, a period of recession, will automatically and negatively affect the counterparty risk – regardless of the underlying creditworthiness of that counterparty. A deterioration of the counterparty's risk-weight requires more capital for such a transaction.

- Disproportionate capital requirements for trade finance in periods of crisis: this argument follows the previous one. If the Basel II system was inherently pro-cyclical in its design (with capital requirements increasing in low cycles), trade finance professionals consider that banks face higher capital requirements for their trade assets in comparison to other forms of potentially more economically risky, notably in periods of crisis. The reason is the high intensity of lending of the banks' trade credit departments to mid-market companies and customers in developing countries. As indicated by the International Chamber of Commerce (ICC, 2009b), "the capital intensity of lending to mid-market companies under Basel II is four to five times higher than for equivalent transactions under Basel I".[3]

- Rigidity in the maturity cycle applied to short-term trade lending: while trade finance lending is usually short-term in nature, generally between 0 and 180 days maturity, the Basel II framework applies de facto a one-year maturity floor for all lending facilities. as capital requirements increase with maturity length, the capital costs of trade finance have been felt to be artificially inflated. While national regulators have the flexibility to waive this floor, at least on a temporary basis, only the United Kingdom's Financial Services Authorities (FSA) chose to do it. Other regulators remained on the "safer" side, e.g. they requested the trade finance industry to provide data about the average maturity structure of trade credit deals, as well as data on the history of default on such deals.

- In relation to the above, the industry has been complaining about data requirements, in particular the lack of historical and performance data to assist in validating risk attributes. Apparently, most banks (even global ones) face difficulties identifying and isolating sufficient data to produce validatable estimates of risk attributes for trade lending. According to the ICC (2009b), "this tends to translate into overly conservative risk weightings for trade finance products – in particular, where banks are required to rely on the standardized approach".

[3] International Chamber of Commerce (2009), Banking Commission Recommendations on the Impact of Basel II on Trade Finance, Document 470/1119, Paris, available at www.iccwbo.org .

In a capital constrained environment such as the one prevailing in 2008 and 2009, lending departments of banks have been competing internally for each unit of the bank's scarce capital (and still are, to a large extent). Professional associations such as the ICC Banking Commission and the Bankers Association on Finance and Trade (BAFT) are of the view that the above factors have been restricting the ability of banks to lend short-term trade credit to business or to support international trade in developing countries, in particular the poorest (and not necessarily the most risky).

II. The WTO's role: improving the understanding between the trade and regulatory communities

A. Improving understanding around the regulatory environment for trade credit

1. Discussions in the context of the Working Group on Trade, Debt and Finance

The interest of the WTO in such regulatory matters is only in relation to the systemic impact of potential shortage of trade finance on trade flows, particularly in period of crisis, and hence in trying to understand how regulation may affect the cost of supply of trade finance, a financial activity that finds its origin in the ages of times – at the very origin of banking and international trade.

WTO Members raised prudential issues as a potential area for concern in the context of the WTO Working Group on Trade, Debt and Finance (WGTDF). Brazil provided in particular a written submission in this respect, indicating that the prudential treatment of trade credit under Basel II could be one factor hindering the supply of credit towards developing countries (WT/WGTDF/W/39). At its meeting on 26 November 2008, the Chairman of the Working Group invited the Deputy-Secretary General of the BCBS to look at the various issues related to that treatment, in particular that of cyclicality and maturities, which dominated the discussion. This dialogue between WTO Members and a representative of the Basel Committee was more than useful in initiating a dialogue that eventually reached the G-20 and the Committee of Governors of the Bank of International Settlement for review. [4]

After a factual presentation of the Basel II rules for trade credit, the representative of the BCBS engaged with WTO Members into a discussion on the various aspects of Basel II, and answered questions and remarks by the delegations of, *inter alia*, Brazil, India, Singapore, Hong Kong SAR, the European Union, and Korea. Several developing countries pointed out that they neither had been involved in the elaboration of recommendations of Basel II rules by the Basel Committee on Banking Supervision, nor had any control over ratings by international rating agencies. Some delegations indicated trade finance was dis-proportionally and negatively affected by the re-assessment of risk during the financial crisis; according to them, the Basel II framework had encouraged a confusion between the systemic risk and customer's risk. Other delegations complained about the role of commercial credit rating agencies and lack of supervision on them. The issue of cyclicality was also addressed, with several delegations noting that when market conditions tightened, capital requirements for trade finance instruments increased more than proportionally to the risk when the counterparty was in a developing country. There were also views that ratings from international rating agencies maintained a bias against developing countries' risk.

The representative of the BCBS Secretariat focused his remarks in three areas: (i) the supervision of rating agencies; (ii) whether Basel II was treating trade finance in the same way as Basel I; and (iii) pro-cyclicality. On rating agencies, he said that the Basel Committee did not intend to supervise them *per se*. What was under consideration under the G-20 work stream was to review the treatment of ratings under Basel II which would only be relevant for the standardized approach

[4] A full report of the discussion can be found in WTO Document WT/WGTDF/M/17. The following paragraphs are a crude summary of the discussion for the purpose of this paper.

and under the securitization framework. While the Basel Committee had been aware for some time of the problems posed by using external assessments of the riskiness of banks, there was for the time being no real alternative to it (no public institution seriously intended to do the job comprehensively) – although he was aware of some views about imposing stricter regulation on rating agencies.

However, the Basel II framework tried to incorporate a number of safeguards, for example a set of eligibility criteria for rating agencies to be recognized, and it imposed several disclosure requirements on the methodologies used by them. Regarding trade finance, he said that the basic requirements of Basel I and Basel II were unchanged, e.g., the 20 per cent credit conversion factor. He did not know whether trade finance was any riskier than other finance – since there was hardly any evidence – but he reiterated that Basel II, being based on risk-sensitivity, to the extent that a loan was more risky than another one, the bank had to hold more capital. Some measures had been taken to dampen this effect, in particular the preferential treatment given to small- and medium-sized enterprises – which resulted probably in such treatment being more favourable than under Basel I. On pro-cyclicality, cyclical elements were unavoidable under a risk-sensitive, capital-based system. Inversely, no one was advocating a return to the Basel I approach. So, the issue was to avoid pro-cyclicality. He believed that much had been done to avoid this shortcoming. He mentioned that "probability of default" assessment had to be done on the basis of long-term data. Banks were required to engage into stress-testing and had been encouraged to maintain buffers for capital adequacy purposes.

Overall, while the Working Group had made some headways into some of the key constraints to trade finance, it has been well understood by the Working Group, as concluded several times by the Chairman, that some of the issues raised in the context of trade finance could not be solved by the WTO, nor would they be even within the remit of the institution.[5] The discussion had contributed, though, at a better understanding of issues between the trade and the financial regulators' communities, leaving Government to take up unresolved issues in proper circles.

2. Follow-up discussion in the context of the preparation of the G-20 Summit in London.

One key development in the G-20 process was the agreement that all G20 countries would become members of the Financial Stability Forum (now Financial Stability Board) and its associated bodies, including the Basel Committee on Banking Supervision and various other coordinating bodies on financial regulation. Therefore, they would be able to participate in the scheduled review of Basel II rules.

In the run-up to the G-20 Summit in London (2 April 2008), the WTO has been focusing its efforts in favour of mobilizing public-sector institutions to shoulder some of the risk with private sector banks. The idea was to design a trade finance "package" responding largely to the criteria developed by the WTO Expert Group on Trade Finance, namely strengthening trade finance facilitation programmes (both on the insurance and liquidity sides); the creation by the IFC of a global trade liquidity pool, allowing to finance with commercial banks, on a 40-60% co-lending agreement, up to $50 billion of trade transactions in the two years; and the intervention by export credit agencies in favour of short-term trade, through the provisions of insurance, guarantees and working capital, in particular to small and medium-sized firms.

The above mentioned elements were reflected in the trade finance "package" of the G20 Summit's communiqué, on April 2, 2009. Under the heading "Resisting Protectionism and Promoting Global Trade and Investment", the last two bullets points of paragraph 22 of the communiqué say:

"we will take, at the same time, whatever steps we can promote to facilitate trade and investment, and, we will ensure availability of at least $250 billion over the next two years to support

[5] WTO Document WT/WGTDF/M/18.

trade finance through our export credit and investment agencies and through the MDBs (multilateral development banks).

Regulatory concerns were not forgotten. According to the joint IMF-BAFT (Banker's Association for Trade and Finance) survey of trade finance bankers around the work, presented at the WTO Expert Group Meeting on Trade Finance on March 18, 2009[6] – more than 70% of the respondents attributed this further decline in the value of transactions to the fall in demand for trade activities, six-in-ten respondents attributed it to restrained credit availability, thereby also describing an increase in the banks' own difficulties to supply trade credit due to the general liquidity squeeze faced by them and the increased risk aversion to finance cross-border trade operations.[7] About half of the banks had confirmed a decrease in volume and value in letters of credit volume and value of aggregate transactions – a trend that was particularly clear looking at 4th quarter 2007 to 4th quarter 2008 data. This was particularly true for developed countries' market (even more so for least developing countries'), with large scale financing projects being deferred or difficult to finance.[8] The main reasons provided by banks for the decrease in credit lines, and increase in spreads[9] – apart for the reduction in the demand for trade – were the application of more stringent credit criteria, capital allocation restrictions, and reduced inter-bank lending.

The ICC own survey also pointed out that intense scrutiny of documents (within a general movement of re-intermediation of trade finance, away from open account transactions and in favour of letters of credit) by some banks were leading to higher rates of rejection of letters of credit. Prospects for trade financing were negative in 2009, with the general view that "tight credit conditions may further reduce access to trade finance".[10] In presenting its conclusions of the survey, the ICC Banking Commission issued a small but influential paper, laying down the recommendations of the industry on possible changes to be recommended to Governments and regulators (Box 3). The BAFT and ICC arguments have not remained unheard by G-20 leaders as the communiqué in London contained one sentence immediately following the above paragraph in italics:

"we ask our regulator to make use of available flexibility in capital requirements for trade finance".

The sentence aimed particularly at: (1) encouraging regulators to imitate the UK's FSA in waiving the one-year maturity floor for short-term trade finance, at least temporarily (2) encourage regulators act rapidly and avoid the "wait-and-see" stance, either for a global revision of Basel II rules or for hypothetic collection of historical credit default data by the industry. The call by G-20 Leaders was not followed by actions by regulators.

<u>Box 3</u>: ICC Banking Commission Recommendation on the Impact of Basel II on Trade Finance

According to the ICC, "the case for revised treatment of trade finance in the allocation of banks capital rests on the historically low risk profile of the activity. Many banks will attest that they have experienced relatively few losses on trade lending over the past few decades. This primarily reflect the fixed, short-term maturity of trade finance products, and the fact that exposures are liquidated by cash upon maturity. In addition, the transactional nature of trade financing allows banks to carefully manage exposures. Unlike products such as term loans or overdrafts, which may be granted on a

[6] See in particular WTO Document WT/WGTDF/W/44, available on www.wto.org

[7] IMF and BAFT Trade Finance Survey (2009), <u>Survey Among Banks Assessing Current Trade Finance Environment</u>, available at www.baft.org

[8] SWIFT data pointed to a deterioration particularly visible in the Asian Pacific Area.

[9] Some 40% of the respondent banks indicated that spreads had increased significantly over the past year, and were not expected to fall anytime soon.

[10] ICC Banking Commission (2009), Rethinking Trade Finance, Survey sponsored by the Asian Development Bank, the EBRD, the Inter-American Development Bank, the International Financial Corporation, and the International Financial Services Association.

revolving or ongoing basis, trade financing is not automatically renewed or rolled over on maturity. Moreover, each drawdown by the obligor requires submission of the underlying documentation – often based upon standardized codes of practices – for the bank for review. The bank can refuse a new drawdown if it is not comfortable with the credit worthiness of the transaction, or the documentation submitted. What is more, even in times of severe difficulty companies will generally try to avoid defaulting on trade obligations, as continual access to finance is a lifeline for most firms. It should be noted that trade-related instruments are generally the last forms of credit to be cut, and the first to be re-established, in debt-distressed economies".

"In the context of the above, we would urge policy-makers to give consideration to how changes to international adequacy requirement might complement other public interventions to boost trade finance flows. Based on our consultations with major trade finance banks, we firmly believe that such changes would have a significant impact on the ability of banks to lend trade credit at the current time. The measures we propose do not require amendments to the fabric of the Basel II framework; rather, the introduction of mall, 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 (...). Specifically, we recommend that the G-20 London Summit mandate national regulators to:

- Exempt trade finance products from the one-year maturity floor applied for "short-term self-liquidating trade transactions. This is because the contractual maturity of trade finance products is reflective of the time horizon over which banks are exposed to a credit risk. Such discretion has already been exercised by a small number of national regulators. Our initial analysis suggest that removal of the maturity floor has the potential to cut capital requirements for trade finance obligations of 90 days-maturity by around 20 to 30%. We believe that the G-20 London Summit should used to encourage all national regulators to replicate this regulatory "best practice".

- Allow key risk attributes to be determined on the basis of industry benchmarking: As noted above, many banks face difficulties in identifying sufficient data to produce estimate of risk attributes for trade lending. These problems are particularly pronounced in the relation to the calculation of "loss given default" and credit conversion factor" inputs in modelling to determine capital requirements under Basel II. To assist in ensuring more realistic capital weightings for trade finance products, we suggest that national regulators are encouraged to utilize their discretion to allow these inputs to be determined on the basis of expert judgement".

Source: ICC Banking Commission (2009), Document 470/1119 of 24 March 2009.

In the difficult financial landscape of 2009, it was acknowledged that many regulators could be unwilling to allow risk attributes to be determined on the basis of expert judgement in the absence of comprehensive empirical evidence base. This is at least the way the relative inaction of regulators in view of the G-20 "regulatory" sentence was interpreted.

This is why, at recent meetings of the WTO Expert Group on Trade Finance, suggestions were made by participants to ICC to collect historical and performance data for trade finance facilities. At the end of the last meeting of that Group, the Director-General of the WTO, *inter alia*, "had urged all implicated institutions to continue to act together and cooperatively to shoulder risk, which had not disappeared from the current banking environment. The WTO would continue to act by way of persuasion and awareness-building, and eventually by trying to leverage political energy to address the challenges of trade finance. However, the group should continue to work for tangible results by way of cooperation and common projects. This should be visible in a number of fields at the next meeting, such as utilization rates of extra capacity put in place by multilateral institutions, improved data collection systems for banks and ECAs, a register organized by the ICC, and continued work at the technical level with the BCBS on increasing the flexibility of the Basel II rules."[11]

On November 23, 2009, key international banks (12 of them) and representatives of professional associations of trade finance providers agreed to establish a Working Group under the common auspices of the ICC and the Asian Development Bank to set up a Trade Credit (Default) Register, with data collected from the main market makers. The pilot project is expected to deliver its first outcomes in the Spring of 2010.

In the meantime, some political leaders continued to criticize the "unfair restrictions" placed by the Basel II framework over trade finance.[12] The issue captured some press attention ahead of the 2010 World Economic Forum's meeting in Davos.[13]

B. Maintaining the Preferred Status of Trade Claims

As quoted from the ICC Banking Commission in Box 3, "even in times of severe difficulty companies will generally try to avoid defaulting on trade obligations, as continual access to finance is a lifeline for most firms. It should be noted that trade-related instruments are generally the last forms of credit to be cut, and the first to be re-established, in debt-distressed economies". What holds for firms holds for States as well. States in situations of sovereign default are generally in need of foreign exchange resources to pay for balance-of-payments obligations falling due, be it essential imports or external debt payments. Countries requesting balance-of-payments' support from the International Monetary Fund (IMF) will typically seek to honour their commitments, precisely to avoid any disruption in its relations with creditors, while asking them to reschedule payments immediately falling due. The rescheduling of countries' external debt would typically take place in the early stages of an IMF supported-program, contingent on the country taking commitments to redress its balance of payments under the program.

The importance of trade finance in these circumstances is two-fold: keeping trade credit lines open allows the country in question to finance essential imports during the balance of payments crisis, while hoping to count on a turnaround of export demand, which would also necessitate trade credit lines. Besides, the rescheduling in itself would represent a relief for the country, in the form of lower immediate payments.[14] For both reasons, international trade credit lines are being rescheduled as a matter of priority, and benefit from "preferential treatment" in the case of default: preferential treatment in that case means that, according to international practice, at least for private sector claims, trade finance would not be subject to significant discount in restructuring plans and that outstanding debt be paid as a matter of priority to allow the roll-over or resumption of credit lines.

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[11] See WTO Document WT/WGTDF/W/46.

[12] Reuters, 19 November 2009: "Lord Davies slams Basel II" – The UK Trade Minister, Lord Davies, says that Basel II has placed unfair restrictions for trade finance and needs to change (...) The former bankers and chief executive of Standard Chartered asked trade financiers to have a louder voice in getting regulators to pay attention to the issue: "I think we need to do this together, the industry, the ICC, and the Government. We need to be positioned as one. We need to look in a different way at the amount of capital that is portioned and liquidity to trade activity. That is what the bank is there for. It is there to support businesses and consumers. I think Basel got it wrong and it needs to change (...). Bankers attending the conference welcomes Lord Davies words but some warned that the fact gathering exercises presently underway to achieve the granular data regulators demand to make any changes may arrive only after the recession has finished (...). The trade finance loss register is the first scheme of its kind to provide accurate numbers surrounding trade finance default. An ICC Working group is due to meet in Brussels next week to discuss the future direction of this project".

[13] See in particular the Article by Jonathan Lynn, from Reuters, on January 14, 2009: "Banks to show regulators trade credit less risky".

[14] While the rescheduling of claims may reduce the amount of payment immediately falling due, a rescheduling does not mean a reduction in the net present value of claims.

There is well established in the international methodology for treating trade claims under sovereign default situations. For outstanding government-guaranteed trade credit, the Paris Club is competent to reschedule such claims. Rescheduling terms are granted according to established "terms", which ensures consistency in the consideration of similar claims of different countries. These terms are contingent on the commitments of the country taken in the context of an IMF-World Bank supported program, the country's "track-record" *vis-à-vis* such and earlier commitments, and its level of development.

During the Asian financial crisis, the double occurrence of sovereign and private sector default – the banking and state sectors collapsing at the same time – led to the interruption of all credit lines by private creditors, including trade credit (a rare occurrence). In the case of Indonesia, in which the import content of exports was over 40%, the endorsement of letters of credit issued by badly-hit domestic bankers on behalf of importers and the resumption of credit lines by international banks by a key pre-condition for the restoration of trade flows – and hence the turnaround of the balance of payments. That is why, under the sponsorship of the IMF, the World Bank and Japan, a vast rescheduling exercise was undertaken by both official creditors, in the context of the Paris Club, and by private creditors, in the context of the London Club. In the fall of 1997, roughly three months after the collapse of the exchange rate of the Rupiah against the US dollar, an agreement was found, allowing for normal trade relations between Indonesia and the rest of the world to resume.[15]

Other situations may be less straightforward, though. In cases, local banks may be defaulting on claims *vis-à-vis* foreign creditors, without the official sector being subject to default. In other words, while the banking sector would experience bankruptcy, the balance of payments may nevertheless remained financed. As unusual as it may be, such situations could be experienced in oil-rich countries. The balance-of-payments may remain financed thanks to the export revenues stemming from oil and income revenues generated by sovereign wealth funds. At the same time, local banks having borrowed overseas in foreign currency may be cash-trapped by a reduction of non-oil domestic activity or by the depreciation of the local currency. The peculiarity of such rare cases is that the State may not have extended its guarantee to any of the borrowing by the local banking sector. Hence, without official default and government guarantees, the IMF and the Paris Club are not mandated to intervene. In principle, private trade claims are to be treated bilaterally by the club of private creditors and the ailing financial institutions. As raised in a recent case, concerns that trade finance could be subject "to significant discounting under restructuring plans would be unprecedented in the global market for bank with overall systemic national importance. The group (of creditors) urged that (...) all measures necessary to ensure that prior international practice is followed with reference with full and timely payment of trade finance obligations." In this case, a mutually acceptable solution was eventually found between creditors and debtors, in full respect of the preferred status of trade credit.[16]

An important pre-requisite for successful restructuring plans is for trade claims to be recognized as to be effectively linked to trade-related transactions. The issue of clarification of trade finance is important in this respect, and discussed in Chapter III (B).

III. Looking into the future: what are the important trade finance issues for "Basel III"?

A. Acknowledging the safe character of trade credit and finance

1. Efforts to collect appropriate data for regulators

As indicated in Chapter I.(B)(2), the Basel II framework requires a minimum of historical data to establish the maturity structure and safe character of specific instruments, but it has not always

[15] Details are available in WTO (1998), Trade Policy Review of Indonesia, Chapter 3 and 4, Geneva.

[16] See in particular the BAFT website, at www.baft.org, in particular the News Releases of September 28, 2009 and of 20 October, 2009.

been easy for banks to isolate trade finance data from other credit exposure. To replace historical data, the trade finance industry has been requesting that estimates be based on available data (Probability of Default, Loss Given Default, and Exposure at Default). As a result, under the sponsorship of the WTO Expert Group on Trade Finance, the ICC and the Asian Development Bank have launched in November 2009 a pilot project to create an International Trade Finance Loan Default Registry, aimed at collecting individual data on trade finance operations and showing that the default rate on such business is one of the lowest in the industry. At the ICC Banking Commission meeting of November 2009, the main international banks active in trade finance agreed to surrender the necessary data to establish the registry, with the objective of having a data base functioning in the Spring of 2010. Once data is available, bankers and professional associations are expected to approach regulators – and generally the Basel Committee on Banking Supervision, the competent body at the international level, for re-consideration of the way the regulation should be interpreted.

As concluded by WTO Director-General Pascal Lamy at the WTO Expert Group Meeting on September 15, 2009, the banks should continue to work with the Basel Committee on Banking Supervision on increasing the flexibility of the Basel II rules, with the aim of coming up with tangible solutions at its next meeting (the Basel Committee is the body of central bankers and regulators responsible for setting up the Basel II accord). The survey of banks prepared by the Bankers' Association for Finance and Trade (BAFT) for that meeting had showed that 43 percent of respondent banks said Basel II had a negative impact on their ability to provide trade finance, with banks in industrialized countries more likely to cite the negative implications of Basel II, with 60 percent of respondent citing it as a hindrance. The BAFT (2009) said a "more rational treatment under Basel II of trade finance, given its fixed, short-term, self-liquidating nature, will ultimately have a positive effect on the trade finance markets." In specific, the association called for clarification of trade finance treatment under Basel II's maturity floor for lending facilities.

2. Understanding the changes proposed under the revised Basel II framework

Notwithstanding the treatment of trade finance in the Basel II framework, new proposals have been made by the Basel Committee on Banking Supervision to the Committee of Governors of Central Banks and Heads of Supervision of the *BIS* on January 10, 2010. These proposals, contained in a Consultative Document ("Strengthening the Resilience of the Banking Sector"), are open for public comments through the Spring of 2010.

These proposals aim at improving the Basel II framework in general. Many of the criticisms described in the above chapters are being addressed by regulators. In particular, efforts have being made to raise the quality, consistency and transparency of the capital base, and to strengthen capital requirements for counterparty credit exposures arising from bank's credit derivatives and securities financing activities. These reforms are aimed at raising the capital buffers backing these exposures, reducing pro-cyclicality, and hence in principle reducing systemic risk across the financial system, a drive that can only benefit the trade and trade finance communities.

(a) Proposals to introduce a leverage ratio on off-balance sheet trade credit instruments

One of the key measures to reduce systemic risk is to supplement risk-based capital requirements with a leverage ratio, to reduce incentives for "leveraging". The intention of reducing such incentives are relatively consensual, and can be shared by both economists, regulators and bankers. The features of this new mechanism are explained in Paragraph 24 to 27 of the *BIS* draft proposals, which are drafted as such:

"Supplementing the risk-based capital requirement with a leverage ratio

24. One of the underlying features of the crisis was the build up of excessive on- and off-balance sheet leverage in the banking system. The build up of leverage also has been a feature of *previous financial crises, for example leading up to September 1998. During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses, declines in bank capital, and the contraction in credit availability. The (Basel) Committee therefore is introducing a leverage ratio requirement that is intended to achieve the following objectives:*

• put a floor under the build-up of leverage in the banking sector, thus helping to mitigate the risk of the destabilising de-leveraging processes which can damage the financial system and the economy; and

• introduce additional safeguards against model risk and measurement error by supplementing the risk based measure with a simple, transparent, independent measure of risk that is based on gross exposures.

25. The leverage ratio will be calculated in a comparable manner across jurisdictions, adjusting for any remaining differences in accounting standards. Certain off-balance sheet items would be included using a flat 100% credit conversion factor. There will be appropriate testing of its interaction with the risk-based measure. The Committee has designed the leverage ratio to be a credible supplementary measure to the risk-based requirement with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration.

26. Section II.3. of the consultative document presents the Committee's proposals on the leverage ratio.

27. The Committee welcomes comments on the design of the leverage ratio, how to ensure an appropriate calibration relative to the risk-weighted requirement, and how best to adjust for remaining differences in accounting framework."

As set out in Paragraph 26 of the Consultative document, proposals on the leverage ratio are presented in Section II.3, which makes a distinction between on-balance sheet and off-balance sheet items (assets). Trade credit are nowhere in particular mentioned in the sub-section on on-balance sheet items. However, it is specifically mentioned under off-balance sheet items, in Paragraph 232 and 233 of the Consultative Document. These paragraphs propose the following treatment with respect to capital adequacy (which is what referred to in the Paragraphs 82 to 89 of the Consultative Document):

" 232. This discussion relates to off-balance sheet (OBS) items in paragraphs 82-83, (including 83(i)), 84(i-iii), 85-86, and 88-89) of the Basel II framework. These include commitments (including liquidity facilities), unconditionally cancellable commitments, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities. The treatment of the items included in 83(ii) and 84, i.e. "repos" (repurchase agreements) and securities financing transactions is addressed above.

" 233. OBS items are a source of potentially significant leverage. The failure to include OBS items in the measure of exposure creates an incentive to shift items off the balance sheet to avoid the leverage ratio constraint. The Committee therefore proposes to include the above OBS items using a 100% credit conversion factor. This approach is simple and consistent with the view that OBS items are a significant source of leverage.

(b) Potential impact of such proposals, viewed by the industry[17]

As part of the mutually beneficial dialogue that the WTO keeps with the trade finance industry in the context of the WTO Expert Group on Trade Finance, it has been understood that, while the philosophy of the new regulatory framework seems to be accepted by an activity that can be considered as promoting the development of long-term "real economy" activity – hence supporting the expansion of international trade", paragraphs 232 and 233 of the Consultative Paper seems to be fuelling the high fears in the trade finance industry regarding its future.

While the in-balance sheet treatment of trade credit seems not to have changed capital-wise, the credit conversion factor (CCF) for off-balance sheet operations raised to 100% (a five time increase relative to the 20% credit conversion factor used under Basel II) for stand-by letters of credit and similar trade bills, as for other any other kind of off-balance sheet assets. The bottom line position of the profession is that while understanding the logic of tightening the treatment of some toxic, off balance-sheet financial instruments, letters of credit and the like could hardly qualify as such. There is no evidence either historically or recently that these exposures have ever been used as “a source of leverage”, in particular given that they are supported by an underlying transaction that involves either movement of goods or the provision of a service.

The proposed change increase the credit conversion factor would also impact other exposures primarily used in trade finance, namely, trade related contingencies and transaction related contingencies. Again, at the present moment trade and transaction related contingencies are subject to generally low CCF values, 20% for trade related contingencies and 50% for transaction related guarantees (open account guarantees). According to some in the industry, increasing the CCF to 100% for trade related and transaction related contingencies for the purposes of calculating a leverage ratio may encourage banks to divert capital to higher risk/higher return products, cease to provide off-balance sheet trade/transaction lending, and increase the cost of providing these trade products to customers.

The question is hence why are off-balance sheet trade exposures not being automatically incorporated into the balance sheet (to avoid the leverage ratio), and why would they not automatically result in any liability to the bank, even in the case of customer defaults?

The answer of the industry to the first question is that the processing of letters of credit, which are highly documented for the financial transactions' own security, are involving off-balance sheet treatment at least until such time as the verification of the documentation is finalized – a process that has been existing for a long time. As mentioned in Chapter II, the financial crisis has even resulted in greater scrutiny of such documentation. The rigor of the process of document verification is at the very heart of what a letter of credit is, and it concurs to its safety. Given the high rejection rate of poorly documented letters of credit, and the fact if definitively rejected the letter of credit might not even enter the balance sheet, it is argued that the off-balance sheet management of these exposure is necessary and in most cases only a temporary treatment of what would eventually become an on balance-sheet commitment (Box 4). It remains that, requiring a 100% CCF during period, five times higher than when the same instrument reaches the balance-sheet, is likely to have more than a chilling effect on the opening of any new letter of credit.

Part of the answer to the second question is addressed in Box 4, in particular with the specific example of the legal implications of a default on stand-by letters of credit.

[17] The following section is a summary of various draft position papers prepared by the trade finance industry, in the process of consolidating it into one or two position papers to be presented to the *BIS*. The summary reflects my understanding of the views expressed, which are not mine, but the errors related to that understanding are definitively mine.

Box 4: Off Balance-Sheet (OBS) Exposures used in Trade

1. Trade Related Contingencies – Documentary letters of credit issued (L/Cs), shipping guarantees issued, confirmations and any other trade-related contingencies

Trade related contingencies ("TRC") are contingent liabilities arising from trade-related obligations underpinned by the movement of goods or the provision of services and evidenced by commercial contracts that document the arrangement between buyer and seller. In providing TRC facilities, the bank acts as an intermediary between the buyer and seller to provide risk mitigation and structure for the counterparties. The risk mitigation provided by TRCs was proven during the global financial crisis where banks witnessed a reduction in open account trading and a shift towards financing international trade via TRCs (predominantly import documentary letters of credit) as the level of risk perceived by the market increased.

a) Import Documentary Letters of Credit (L/C)

L/Cs are the primary TRC used to facilitate trade and provide assurance to the exporter that if delivering the goods/services requested by the importer and present compliant documents, the issuing bank irrevocably undertakes to pay the exporter. The L/C also provides confidence to the importer the goods ordered will be delivered in accordance to documentation and any additional terms/conditions that is part of the purchase agreement. To this extent, the obligation of the issuing bank to pay the beneficiary of the L/C (typically the exporter) is highly contingent on the exporter not only delivering the correct goods/service as detailed in the L/C, but also that all requirements of the L/C have been complied with. As such, a L/C typically remains an off-balance sheet exposure until the documents are presented and accepted in accordance with the terms of the L/C. Until this event occurs, there is a probability that the L/C might never convert to an on balance sheet exposure even in the event that the importer (the L/C applicant) defaults. According to the vast experience of banking institutions, a large majority of documents presented to issuing banks are discrepant. Hence the issuing bank is not obligated to make payment. When this occurs, there is no liability to the issuing bank and the obligation of the issuing bank to pay under the L/C is cancelled. It is estimated that 70 - 85% of documents are discrepant on first presentation. Part of service provided by issuing banks is to make sure that the documents are no longer discrepant and that the transaction and related payments can take place as desired by the importer and the exporter.

b) Confirmation of L/Cs issued by other banks

In cases an exporter may not be comfortable with the credit worthiness of the bank that issues the L/C. In this case, the exporter may request its bank to "confirm" the L/C. When a bank adds its confirmation it provides a commitment to pay the exporter once compliant documents are presented and all terms and conditions of the L/C are met, thus substituting the credit risk of the issuing bank with that of the confirming bank. From the perspective of the confirming bank, the risk of loss becomes contingent on compliant documents being presented, any additional terms and conditions of the L/C being met and the issuing bank failing to honour its commitment to pay.

c) Shipping Guarantees

Shipping guarantees are issued by banks in favour of the shipping company where the goods have arrived before the documentation. In such circumstances it is in the importers interests to clear the goods as quickly as possible to:

1. Avoid paying storage costs
2. Release the goods to the market before competitors
3. Reduce any obsolescence/perishability risk
4. Free cash flow by reducing the trade cycle.

The primary purpose of the guarantee is not to guarantee the importer will pay the exporter and shipping company, but rather to guarantee that the person receiving the goods from the shipping company is the legal title holder of the goods, as the bills of lading and other documentation that evidences this have not yet arrived. In the event that it is proven that the person claiming the goods was not the legal title holder of the goods, the shipping company can call the guarantee to pay damages to the actual title holder of the goods. Again, the calling of the guarantee is not triggered by an event of default; instead it is initiated by a dispute in legal ownership. Trade practitioners advise that it is very rare for shipping guarantees to be called, even where the importer may default.

<u>2. Transaction Related Contingencies – Performance Standby Letters of Credit or Performance Guarantees (TRCP)</u>

Proposals under Article 232 and 233 are specific in stating that bank guarantees ("BG") or standby letters of credit ("SBLC") that are direct credit substitutes (i.e. financial in nature) must have a CCF of 100% and therefore the proposed changes in the CD will only change the CCF for TRCPs. TRCPs are guarantees that support certain performance obligations of a borrower, with the calling of these guarantees being contingent on the overall performance of the borrower rather than the financial soundness of the borrower. Examples of these types of exposures are performance bonds, bid bonds, tender bonds, advance payment guarantees. Prior to providing a TRCP, the bank will ensure that there is an underlying transaction and that the calling of the TRCP is triggered by a performance event and not the customer failing to pay monies. As such, even in the event of default, a contingent SBLC or BG will not necessarily result in an on balance sheet exposure. For example, a performance SBLC where drawings under the guarantee are conditional upon the applicant not fulfilling its obligations to the agreed standard specified in the contract; in most cases, a bankruptcy filing on the part of the applicant will not impact performance under existing commercial contracts - therefore providing no justification for a drawing under a performance SLC.

In conclusion, it is argued by the industry that the five-fold increase of capital requirements for OBS L/Cs would increase the cost of banks in offering such risk mitigation products, and that either that cost will be passed on customers, hence making even more difficult to smaller businesses to trade internationally; or, in absence of incentive to issuing L/Cs, customers may simply choose to use on-balance sheet products such as overdrafts to import goods (as these carry less stringent documentary requirements) that prove to be potentially far more risky for the banking sector in general.

Another argument, a process one, is about bank's incentive to actually supply L/Cs relative to unsecured lending (overdraft, open account rediscounting of trade bills). TRCs (in particular L/Cs) are very labour intensive given the required amount of document checking and handling. To meet this need, banks employ large back offices. A significant decline in the number of L/Cs issued may see banks review the need to retain large back offices if there are insufficient economies of scale to do so.

(c) Keeping a balance between the need to regulate and what to regulate

In the economics of regulation, there can be doubts about the ability of public authorities to adopt fully independent points of view. A recent paper argues that the Basel II framework did not fail because it was too ambitious, rather on the contrary because creators fell short of their aim of improving the safety of the international banking system. Intense and successful lobbying by the banking sector was, according to the paper, largely responsible for the failure of regulators and supervisors to impose sufficiently stringent standards. For the same reason, the author believe that recent proposals to re-regulate the international banking system are likely to meet a similar fate (R.

Lall, 2009). Drawing on recent work on global regulatory capture, the authors presents an interesting theoretical framework emphasizing the importance of timing and sequencing in determining the outcome of rule-making for international finance.

As attractive as the argument may be, the matters involved in financial regulation are inherently complex and require the understanding of all sides. In matters that are at the cross-roads of trade and financial regulation, there should be a thorough examination of both cultures and instruments. Having this in mind, there should certainly be some middle ground in attempting, on the one hand, to prevent toxic assets to spread out through the financial system and harm its transparency through off-balance sheet vehicles, and on the other hand disrupting seriously a process for securing trade credit instruments that have long been used. For this, the trade finance and the regulators communities should understand one another processes and objectives; they are not necessarily at odds with one another. The trade finance community believes that it promotes a cautious model of banking that has clearly be financing the sustained expansion of international trade without major hurdles until the recent crisis. That is why this paper can only encourage to develop mutual understanding and the two communities' representatives to meet regularly during the comment period, with a view to achieve understanding on processes and hence on a regulation that could certainly be right and fair.

B. Clarifying the concept of trade finance

Forms by which financial intermediaries are providing lending, working capital or liquidity for the purpose of financing trade have changed in the past couple of decades, in particular to accommodate the expansion of international supply chains. As explained in Auboin (2007 and 2009), new forms of unsecured forms of financing have appeared to maximize the importers and exporters' cash flow while minimizing the cost of trade finance (open account financing, forfeiting, etc). These forms of financing have become dominant in North-North trade, and spread out in global supply-chains producing mass, global products. Hence, in the 2000's the share of traditional forms of trade credit such as letters of credit have receded. In the recent period of crisis, though, both the ICC and BAFT 2009 surveys provided indications of a "re-securitization" of lending, as payment defaults increased, liquidity became scarcer, and the counterparty risk was reappraised (Auboin, 2009). The relative shares of open account financing versus letters of credit seem to have been reversed again, to the benefit of letters of credit. The lack of a comprehensive set of statistics on trade finance does not allow for a firm confirmation of this trend, revealed by market intelligence surveys. It can be envisaged, though, that letters of credit will continue to account for a significant – if not growing – part of trade finance, as the most dynamic segments of trade id expected to be in South-South trade. In such trade, letters of credit are prevalent – for a variety of reasons, technological, security-related, user friendliness and enforceability, standardization and other factors.

As international trade evolves, it is important, through, to engage into a better definitional work for trade finance, and establish a clear typology of the instruments used, including the latest technology-based innovations. This is not only necessary to maintain the preferential status of trade finance (in reconciliation exercises during restructuring phases, creditors and debtors should be able to understand one another as to what constitutes a trade claims), but also to allow for a fair allocation of capital per instrument. As demonstrated by attempts to allocate fair shares of capital to traditional forms of trade credit, the characteristics of trade must be better understood by the regulators. Likewise, the relative riskiness of each of the various financing instruments must be specified; the professionals of trade finance have a responsibility in sharing their experience with regulators on new forms of financing. The relative risk-weights must hence be examined very carefully: should letters of credit be over-regulated relative to open account transactions (for example overdrafts), a discrepancy can be re-opened between the economic and regulatory risk. For this reason, professional organizations – which have made already a lot of progress in designing international standards for letters of credit – must engage into a wide reflection over the limits of trade financing, and present their own criteria and typology of instruments used, at least for an open, transparent discussion with the regulators. This entails non only a definitional but also a data-gathering process, which would support such typology, and hence allow proper weights to each kind of trade-related risks. This means in practice that more needs to be done by way of investing in data gathering, methodology design, and impact studies, if trade finance is continue to benefit, like under the Basel I framework, from the presumption of being a safe form of finance.

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