INSTITUTE OF INTERNATIONAL FINANCE | ICC

February 2024

IIF/ICC White Paper: Empirical Evidence Concerning the Risk Profile of Trade Finance Under the Basel Framework

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Executive Summary:

The review of the post-financial crisis regulatory reforms will benefit from continuing analysis in light of evolving empirical evidence reflecting the risk profile of financial instruments covered by the Basel prudential framework. In that vein, this joint Institute of International Finance (IIF) and International Chamber of Commerce (ICC) White Paper outlines evidence collected in relation to the risk profile of trade finance - a form of financial intermediation critical to the growth of the global economy – and discusses its current prudential risk treatment versus the observed data sets available since the finalization of the Basel III reforms in 2017.

1. Background

Global trade relies upon accessible financing for both cross-border and in-country trade transactions. Trade finance assists customers with their import and export requirements by providing essential financial intermediation and risk mitigation. It is a core banking business serving the real economy with exposures that are diverse in nature, smaller in value, shorter in tenor, self-liquidating and which exhibit different behavior and payment patterns from other corporate banking products.[1] Within this sub-set of trade finance products, performance guarantees work as enablers of important infrastructure and sustainability-driven projects which are essential to building a more resilient global economy.

Ensuring the appropriate treatment of trade finance in line with its risk profile, from both a capital and liquidity risk management perspective, has been well recognized as essential in maintaining adequate access by businesses and consumers to financing which supports global commercial flows. In this regard, prudential regulatory standards for trade finance have been considered throughout the Basel III reform process following the global financial crisis.[2]

However, issues continue to exist within Basel III (and specifically, the Basel requirements which were finalized in 2017, hereafter referred to as B3.1) which can potentially lead to unintended consequences for the provision of trade financing across global markets. At a time when the world is recovering from the Covid-19 pandemic at different rates of speed - and when ongoing geopolitical tensions can exacerbate issues for cross-border businesses and supply chains - it is essential for the regulatory treatment of trade finance instruments to be commensurate with their risk profile in order to meet global demand and support economic growth.

[1] https://iccwbo.org/publication/icc-trade-register-report/ (select a language to download the report)
[2] https://www.bis.org/publ/bcbs205.pdf

2. Key Issues

Aspects of the finalization of B3.1 give rise to issues which could lead to higher financing costs for trade financing products and/or a commensurate retraction of such activity, exacerbating already well-known issues for trade finance availability globally.[3] However, there is an increasing industry focus on collating new empirical data sets which should be taken into account when considering the risk profile attached to such financing.

Specifically, the 2013 Capital Requirements Regulations (CRR) of the European Union (EU) had allowed the use of a 20% credit conversion factor (CCF) for all Performance Guarantees (Bid bond, Advance Payment, Performance and Retention Guarantees) which was subsequently validated by the data collected by the International Chamber of Commerce (ICC) sponsored Trade Register (TR). As this was a deviation from international standards, the European Commission (EC) was recommending removing the deviation and moving to a 50% CCF for Performance Guarantees. In 2022[4], with the help of data collected and analyzed over a twenty-year period by banks of the ICC TR and Global Credit Data (GCD) consortium, the European Council and the European Parliament agreed to keep the 20% CCF for performance guarantees. The data shows an average CCF of 10% for defaulted customers with a portfolio of performance guarantees. This also indicates the low conversion rate from off-balance sheet to on-balance sheet exposures for these products which only pay out when there are failures in the underlying contract/agreement even after a customer default has occurred.

This exercise was updated in 2023, with additional data of defaulted performance guarantees collected over a twenty-year period by a cross-section of banks. This data continues to prove the case that a 20% CCF is appropriate, as the empirical CCF derived from the claim pay-out ratio remains at 10%.[5] This empirical exercise was also done for financial guarantees, and it indicates a lower claim pay-out ratio of 8%.[6]

As such, it is clear that a 50% CCF for performance guarantees and 100% CCF for financial guarantees is not commensurate with the low empirical claim payout rates (even when adjusted for economic downturn scenarios). Banks have historically been pricing such risks at much lower rates compared to a funded product. For example, financial guarantees will have much lower fee incomes compared to a loan's pricing (net of cost of funds and liquidity premium), even though they attract the same CCFs and hence the same RWAs. However, product pricing at levels that do not generate returns commensurate with their cost of capital is not tenable in the long run and may result in banks withdrawing from the guarantees market in general.

Given the cross-border character of trade finance, there also remains a real concern for jurisdictional disparities and level playing field issues in the treatment of trade finance products without a consistent view taken on the new evidence by the international standard setting bodies, and the Basel Committee in particular.

3. Conclusion

The dynamic evaluation of prudential regulatory reforms put in place after the global financial crisis is a critical component of ensuring risk management frameworks operate consistently and effectively across jurisdictions. Though

[3] https://www.adb.org/publications/2021-trade-finance-gaps-growth-jobs-survey

[4] https://iccwbo.org/news-publications/policies-reports/icc-gcd-performance-guarantee-paper/ (select a language to download the report)

[5] ICC GCD 2023 Paper on performance guarantee CCF :-
https://cdn.shopify.com/s/files/1/2992/1976/files/ICC_GCD_Performance_Guarantee_Update.pdf?v=1680259205
ICC paper to PRA on B3.1 regulations - https://www.baft.org/wp-content/uploads/2023/04/ICC-PRA-Proposals-on-Basel-3-Regulations.pdf
The above ICC paper was endorsed by other industry forums including the Association of Corporate Treasurers (ACT), Association of Foreign Banks (AFB), Bankers Association for Finance & Trade (BAFT), International Trade & Forfaiting Association (ITFA), UK Finance (UKF) and provided to the Prudential Regulation Authority (PRA) where the performance guarantee CCF point is based on the ICC GCD 2023 paper.

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the Basel Committee Taskforce on Evaluations (TFE) is thus far focused on fully implemented aspects of Basel III, its mandate in considering the functioning of the reforms in light of the test provided by the Covid-19 pandemic – along with the wider and more holistic review of the impact of the reforms on bank resilience and bank behavior which are underway - will ultimately benefit from consideration of the evolving data on the risk profiles of financial instruments more broadly.

In a similar vein, the Financial Stability Board (FSB) undertook evaluations in 2018 and 2019 of the impact of regulatory reforms on infrastructure finance and Small and Medium Size Enterprise (SME) finance. In both instances, concerns for the treatment of trade financing were raised in connection with the needs of infrastructure projects and the import/export business undertaken by SMEs. Though these evaluations were among the first under the FSB framework for the post-implementation evaluation of the effects of the G20 financial regulatory reforms, the conclusions remain a snapshot in time that would benefit from continuing analysis in light evolving empirical evidence.

As such, we encourage the Basel Committee and the FSB to examine new data sets available for risk profiles across banking portfolios where relevant and to specifically review that data available herein for products linked to the financing of international trade. This, along with a review of the effect of fixed trade finance maturity calculations, should consider potential unintended consequences emanating from the standards if they do not appropriately reflect risk-sensitive management objectives in line with empirical data.

An *ex-ante* rather than *ex post* review of new data on banking product risk considering the final B3.1 package would ensure a full, global picture of observed trends in prudential risk. This would also assist in ensuring international coherence in implementation across jurisdictions through globally consistent updates to the Basel framework if warranted based on observed data and on the need for mitigation of potential negative downside effects to lending in specific areas. We believe this is especially critical and timely in areas concerning the financing of international trade, given the unique geopolitical circumstances and potential deleterious market consequences if financial intermediation for trade is either unavailable or unaffordable.

About the Institute of International Finance (IIF)

The Institute of International Finance (IIF) is the global association of the financial industry, with more than 400 members from more than 70 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks and development banks.

About the International Chamber of Commerce (ICC)

As the institutional representative of over 45 million businesses, reaching more than 170 countries, the International Chamber of Commerce (ICC) operates with a mission to make business work for everyone, every day, everywhere. The ICC is the primary voice of the real economy in a range of intergovernmental organizations—from the World Trade Organization to the UN climate process—championing the needs of local business in global decision making.
The convening power of its global network enables it to set rules and standards that facilitate over US$10 trillion dollars in trade each year—in addition to providing tailored products and digital services that directly address the real challenges faced by businesses operating internationally. The ICC also provides the world's premier private global dispute resolution services, leveraging its unique independence, integrity and expertise.