BAFT-IFSA

October 22, 2012

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Notices of Proposed Rulemaking: Enhancements to Regulatory Capital Requirements

Ladies and Gentlemen:

BAFT-IFSA is an international financial services trade association whose membership includes a broad range of financial institutions throughout the global financial community. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT-IFSA member banks have a high interest in preserving the safety and soundness of the global financial system.

BAFT-IFSA appreciates the opportunity to comment on the notices of proposed rulemaking issued by the US Banking Agencies[1] on enhancements to regulatory capital requirements implementing the Basel III global standards in the United States[2]. BAFT-IFSA supports the goals of the US Banking Agencies, and the wider Basel Committee, in promoting a more resilient banking sector and agrees that a strong banking system is the foundation for sustainable economic growth. BAFT-IFSA believes, however, that certain recommendations in the proposed rulemakings, and the wider Basel framework, could have an adverse effect on the availability and affordability of trade finance and could result in reduced trade flows at a time when they are essential to support economic recovery.

President Obama, and the other leaders of the G-20, recently emphasized the need to "*...work collectively to strengthen global demand and restore confidence with a view to support growth and foster financial stability in order to create high quality jobs and opportunities for all of our citizens*"[3]. Ensuring the appropriate regulatory treatment for trade finance under implementation of the Basel Framework in the United States, and around the world, will support the accomplishment of these goals.

Background:

At their November 2010 Summit in Seoul, the G-20 decided "*to evaluate the impact of regulatory regimes on trade finance.*"[4] The Basel Committee completed this assessment in relation to Basel III in October 2011 and made two changes to the Basel capital framework that were intended to alleviate the regulatory

[1] The Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Federal Deposit Insurance Corporation. Collectively, these are referred to in this letter as the "Banking Agencies" or "Agencies"

[2] The three proposals are (i) Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action ("Basel III Numerator NPR"), 77 Fed. Reg. 52,792 (Aug. 30, 2012); (ii) Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements ("Standardized Approach NPR"), 77 Fed. Reg. 52,888 (Aug. 30, 2012); and (iii) Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule ("Advanced Approaches NPR"), 77 Fed. Reg. 52,978 (Aug. 30, 2012). Collectively, these are referred to in this letter as the "Capital Proposals" or "proposals."

[3] G-20 Los Cabos Summit Communiqué; June 19, 2012

[4] G-20 Seoul Summit Document; November 12, 2012

burden for trade finance.[5] These changes were incorporated into the Banking Agencies' proposals[6]. While we applaud the G-20, the Basel Committee and the Federal Banking Agencies for recognizing the importance of trade finance to the international economy, we emphasize that these changes do not go far enough nor will they provide significant relief from the increase in capital costs impacting trade lending.[7] We stress through our comments herein that there is significant opportunity to mitigate the unintended consequence of the Basel Framework by further distinguishing the criticality of trade finance to global economic growth through national implementation of Basel III, and through further discussion at Basel Committee level in order to achieve coordinated change.

To that end, and in order to ensure the continued availability of trade finance for the end-user exporter and importer going forward, BAFT-IFSA would like to comment in detail on two aspects of the Agencies' proposals that we believe will adversely impact the crucial financing of international trade: the inclusion of off-balance sheet exposures in the calculation of the supplementary leverage ratio[8] and the calculation of the Asset Value Correlation[9]. We also provide comments on the need for further clarity of the waiver of the one year maturity floor for trade finance products[10]. Changes in these key areas by the Banking Agencies during the implementation process of Basel III will help contribute to sustained economic growth through trade[11].

Key Issues for Trade Finance in the Notices of Proposed Rulemaking:

To ensure that US firms have adequate and affordable trade finance to support growth in US business, BAFT-IFSA submits the following points for consideration by the Banking Agencies regarding implementation of the capital framework:

1. **Clarification for Treatment of Off-Balance Sheet Trade Finance Exposures under Supplementary Leverage Ratio**

The United States uses a non-risk-based leverage ratio as a backstop to risk-based capital ratios. US banking organizations normally must maintain a minimum ratio of Tier 1 capital to average consolidated assets of at least 3 or 4 percent, while bank subsidiaries of financial holding companies must maintain a leverage ratio of at least 5 percent to be deemed well-capitalized.

In addition to the existing leverage ratio, the Capital Proposals would require advanced approaches banking organizations to fulfill a supplementary leverage ratio of tier 1 capital to total leverage exposure of at least 3%. The denominator of this new measure of total leverage exposure is designed to capture off-balance sheet (OBS) exposures not included in the existing leverage ratio. The Banking Agencies do not specifically state the regulatory purpose of the supplementary leverage ratio, particularly as it relates to trade finance, and we respectfully request clarity as to what the Agencies expect such a broad-brush measure to achieve in creating a stronger US banking system. As the US will likely be the only country

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[5] Basel Committee, *Treatment of Trade Finance under the Basel Capital Framework* (Oct. 2011) http://www.bis.org/publ/bcbs205.pdf

[6] These proposals relate specifically to the waiver of the Sovereign Floor for Trade Finance and the waiver of the Maturity Floor for trade related letters of credit. BAFT-IFSA supports both proposals but details in the comments herein why a clarification to broaden the Maturity Floor waiver is needed in the Banking Agencies' Final Rule: Basel III Standardized Approach NPR at 52,896 and Basel III Advanced Approaches NPR at 52,994

[7] Joint Industry Communication on Trade Finance and the Basel Framework, December 1, 2011: http://www.baft-ifsa.com/eweb/docs/JointTFLetter.pdf

[8] Basel III Numerator NPR at 52,802

[99] Advanced Approaches NPR http://www.federalreserve.gov/aboutthefed/boardmeetings/advanced_approaches_market_risk_FR_final_draft_20120607.pdf p. 81

[10] Advanced Approaches NPR at 52,994

[11] Please See Appendix 1 for background on the importance of Trade Finance to International Trade

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with two separate leverage ratios, US banks will face onerous capital management processes in relation to their overseas competitors, which will in turn create an uneven playing field for US institutions and, ultimately, the businesses they serve.

Though the final design of the supplementary leverage ratio is far from clear, BAFT-IFSA believes that if off-balance sheet trade finance instruments are included in the calculation at "notional" value, this would impose an unnecessary and burdensome regulatory treatment for trade finance. Though the proposal does not define "notional", if OBS trade finance products were included in the calculation at 100% of their face value, the result would disadvantage trade finance-focused banks, and by extension, companies that rely on trade finance for growth, as discussed below. Under Capital Requirements Directive IV (CRDIV), the European Union is considering amendments to elements of Basel III, including the leverage ratio, that reflect the nature of trade finance as an important real economy financing tool. If other jurisdictions recognize this and the United States does not, banks and businesses in the US will be faced with a competitive disadvantage to international competitors in the financing of global trade.

As noted, trade and transaction related contingencies are viewed as less risky forms of lending relative to other lending products. The most frequently used values of 20% for trade related contingencies and 50% for transaction related guarantees adjust the risk weighted asset calculation to reflect that not all of the OBS exposures will necessarily convert to on-balance sheet exposures[12]. Where the supplementary leverage ratio becomes the binding constraint on a bank, it may encourage banks to divert capital to other financial instruments, cease to provide OBS trade/transaction lending or increase the cost of providing these products to customers. These scenarios will most likely result in a reduction of trade activity by diminishing the availability of trade finance to the end user exporter/importer, both in terms of pricing and general obtainability, as banks could potentially exit the marketplace in favor of focusing capital on other types of products without such onerous regulatory treatment. Industry estimates on pricing for trade finance, taking into account the cumulative effect of Basel III, shows the potential for an 18-40% increase overall, which will lessen available support to companies reliant on trade finance across the United States. Additionally, the supplementary leverage ratio has the potential to eliminate the benefit of Export Credit Agency (ECA) guarantees, which drive a large percentage of big industrial exports.

While we recognize that the Basel Committee intentionally designed a global leverage ratio (on which we presume the supplementary leverage ratio is based) to be simple and not based on any differential risk weighting, we are of the view that incorporation at 100% of the value of trade finance is excessive given the objective a Basel leverage ratio intends to achieve. The Basel Committee leverage ratio aims to constrain the build-up of leverage in the banking sector to avoid destabilizing deleveraging processes which can damage the broader financial system and the economy. Trade finance instruments are underpinned by the movement of goods and services; hence they do not lead to the kind of leveraging that may endanger real economic activity.

As trade finance products require an underlying commercial client transaction (*e.g.*, shipped goods or infrastructure projects) they cannot contribute to an excessive build-up of leverage. They also don't contribute to downward pressure of asset pricing as they are short-term in nature and liquidated by fulfillment of the underlying transaction and payment at maturity. Therefore, trade finance products can be excluded from the supplementary leverage ratio calculation without any harm to the presumed objective of the Banking Agencies' recommendations. Alternatively, the Agencies should consider calculating the trade finance OBS items in the denominator of the supplementary leverage ratio at the conversion factor currently set for OBS trade finance instruments under the General Risk Based Capital Rules[13]. Under this model, trade finance instruments would be calculated at 20% of the notional value for trade-related contingent items that arise from the movement of goods with an original maturity of one year or less; or 50% of the notional value for transaction-related contingent items, including performance bonds, bid bonds, warranties, and performance standby letters of credit. This model takes into account the nature of the instruments (short-term, self-liquidating and secure) to ensure prices do not increase relative to their capital allocation. A separate calculation for trade finance is consistent with the application of a

[12] Please see Appendix 3 for details on OBS Trade Finance Exposures

[13] General Risk Based Capital Rules: http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?&c=ecfr&tpl=/ecfrbrowse/Title12/12tab_02.tpl

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calculation under the supplementary leverage ratio proposal for unconditionally cancelable commitments, recognizing that these instruments also have a different risk profile than other OBS products.

By clarifying the treatment of OBS trade finance exposures under the calculation of the supplementary leverage ratio, and by recognizing the intrinsic real economy financing nature of these products, the Banking Agencies will ensure the pricing of trade finance does not increase relative to its nature and the availability of trade finance does not decline due to an onerous and unnecessary regulatory burden. This will assist in the goal of increasing US exports and aid in the competitiveness of US businesses globally.

2. Creation of Separate Asset Value Correlation for Trade Finance

Capital on trade finance exposures is determined by using the generic Asset Value Correlation (AVC), known as the corporate risk curve. This is despite trade finance having low product default rates, trade assets having low correlation, and trade assets being small in value and diversified (multi-geography and multi-industry). This results in banks maintaining much higher capital than what corresponds to the true risk for trade finance exposures. This ultimately reduces the availability of trade finance and increases the cost of providing trade finance for businesses globally.

Currently, for wholesale banking, the only differentiation on the AVC is on counterparty. As such, there are two separate AVCs – one for exposures to Corporates and small Financial Institutions (FI) and another one for exposures to large FIs. Under Basel II, only one AVC (12% to 24%) is applicable for all products and all counterparties for the wholesale banking book. During the last financial crisis, it was observed that exposures to large FIs were more correlated to the macro environment than the Basel II AVC (12% to 24%). As such, Basel III proposes to apply a 1.25 multiplier to the AVC values which range from (12% to 24%), for exposures to large FIs, which are defined as institutions with assets on-balance sheet greater than 100 Billion USD. We note, however, that under the US advanced approaches capital rulemaking, the Banking Agencies propose to increase the AVC values from (12% to 24%) to (12% to 30%) and then apply the 1.25 multiplier for exposure to large FIs[14]. This will increase the capital charges for all US based banks and move the competitive playing field in favor of non-US institutions. As such, we recommend reducing the range of AVC values to (12% to 24%), in order to bring them in line with the AVC values in the Basel framework, and we recommend creating a separate, lower AVC for trade finance.

The current calculation of the AVC increases the cost for the industry in providing trade finance to the end user and its application is disproportionate to the nature of the instrument, as demonstrated by the International Chamber of Commerce (ICC) register data on trade finance[15]. Trade is primarily denominated in US dollars (USD) and banks around the world need to borrow USD (FI Trade Advances) from major banks that have access to USD funding in order to fund their client's trade flows. This is especially true for most emerging markets, where the access to USD deposits is limited. The calculation of the AVC outlined in the Capital Proposals will increase the cost for much of this interbank lending. It will also increase the cost for confirming/advising Letters of Credit (LC). As such, BAFT-IFSA believes that as short-term, self-liquidating instruments, trade finance products warrant a separate AVC from other types of corporate banking products.

As we recently emphasized to the Basel Committee[16], a separate AVC for trade finance will accord the correct capital treatment for trade, recognizing the self-liquidating, short-term, diversified nature of these products. It will result in greater availability and modified pricing for trade finance and also enable more banks to become active in providing this important, real economy financing. This will in turn increase

[14] Advanced Approaches NPR
http://www.federalreserve.gov/aboutthefed/boardmeetings/advanced_approaches_market_risk_FR_final_draft_20120607.pdf
p. 81

[15] Appendix 1 and International Chamber of Commerce: http://www.icctraderegister.com/docs/public/ICC-Register_Report_26_October_2011%20-%20Public%20Report.pdf

[16] BAFT-IFSA Letter on Trade Finance AVC to Basel Committee on Banking Supervision; July 26, 2012: http://www.baft-ifsa.com/eweb/docs/BAFTIFSAAVCLetter.pdf

trade financing for SMEs, increase export/import business and propel economic activity that results in job creation and growth.

3. Clarification of the Waiver of the One-Year Maturity Floor for Trade Finance Instruments

Under the Basel II advanced approaches rules, Maturity (M) must be no greater than five years nor less than one year, unless the bank has a legal and practical ability not to renew or roll over the exposure in the event of credit deterioration of the obligor; makes an independent credit decision at the inception of the exposure and at every renewal or rollover; and has no substantial commercial incentive to continue its credit relationship with the obligor in the event of credit deterioration of the obligor.[17]

In September 2009, BAFT-IFSA submitted to the Banking Agencies the rationale for why trade finance meets the criteria outlined in the Basel II advanced approaches rule exemption to the one-year maturity floor for facilities that are not part of a bank's ongoing financing of the obligor[18]. In June 2010, the Federal Reserve and the Office of the Comptroller of the Currency (OCC) confirmed that short-term, self-liquidating trade finance instruments generally constitute exposures not part of the banking organization's ongoing funding of the obligor and thus would be exempt from the one-year maturity floor under the advanced approaches rule[19]. As noted previously, in October 2011 the Basel Committee also revised the Basel II advanced internal ratings-based approach to remove the one-year maturity floor for certain trade finance instruments.[20] Though this was an important step forward by the Basel Committee, the broader waiver granted by the Banking Agencies would ensure all traditional trade finance products are allowed use of actual tenor in calculation. This is consistent with the national discretion allowed by the Basel Committee on this issue, which has been exercised by other jurisdictions, including the United Kingdom and Germany, and which is being considered by the European Union through CRDIV.

Under the Banking Agencies' Advanced Approaches rulemaking, the Agencies noted that the proposed rule would specify that an exposure's effective maturity must be no greater than five years and no less than one year, except that an exposure's effective maturity must be no less than one day if the exposure is a trade-related letter of credit, or if the exposure has an original maturity of less than one year and is not part of a banking organization's ongoing financing of the obligor.[21] BAFT-IFSA respectfully requests clarification that under the final rule, short-term self-liquidating trade finance instruments are indeed considered exempt from the one-year maturity floor, as they do not constitute an ongoing financing of the obligor. This clarification would bring consistency with the Agencies' 2010 interpretation of the waiver and provide greater certainty to market participants on the trade finance products covered by the waiver.

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[17] 73 Fed. Reg. 43,982 (July 29, 2008); *See also* U.S. Basel II Advanced Approaches Final Rule at 69,333 ("Examples of transactions that may qualify for the exemption from the one-year maturity floor include amounts due from other banks, including deposits in other banks; bankers' acceptances; sovereign exposures; *short-term self-liquidating trade finance exposures*; repo-style transactions; eligible margin loans; unsettled trades and other exposures resulting from payment and settlement processes; and collateralized OTC derivative contracts subject to daily remargining.")(emphasis added).

[18] The requirement of a one year floor for maturity is not appropriate for trade finance credits, which are generally short-term in nature (*i.e.*, a tenor of 147 days or less, per the ICC Registry data previously cited) and self-liquidating. A one year maturity floor requirement can result in increased costs for the end user importer/exporter. Most trade finance exposures generally are granted with an expiry date for each draw down. In providing the facility to the customer, banks take measures to understand the trade cycle of the customer and, prior to a draw down under the facility, to ensure that the underlying transaction is in line with the stated purpose of the credit and is evidenced with trade documentation. This level of monitoring and analysis allows a bank to structure a facility to match the working capital cycle of the customer and make informed decisions about whether to renew an exposure. If, at expiry, the customer does not repay the facility, the bank is alerted to this and can review the current financial position/health of the customer as well as the underlying transaction. The ability to make a new credit decision at each renewal should mean that the institution does not have a substantial commercial incentive to continue its credit relationship with the obligor in the event of credit deterioration of the obligor.

[19] Federal Reserve/OCC Letter to Bankers' Association for Finance and Trade (BAFT); June 7, 2010: http://www.baft-ifsa.com/eweb/docs/FedOCCMaturityLetter.pdf

[20] Basel Committee, *Treatment of Trade Finance under the Basel Capital Framework* (Oct. 2011) http://www.bis.org/publ/bcbs205.pdf

[21] Advanced Approaches NPR at 52,994

Conclusion:

Trade finance fuels international commerce and the availability of trade credit is crucial to continued US growth. Trade exposures are contingent liabilities that arise from trade-related obligations, underpinned by the movement of goods or services and evidenced by commercial contracts that document the arrangements between buyer and seller. As such, trade finance instruments benefit from a low-risk profile in relation to other types of financial instruments. The Agencies' proposals do not fully take into account the intrinsically safe structure of trade finance instruments and overlooks the fact that, by design, trade finance products do not contribute to excessive leverage as they are tied to client transactions.

Recommendations in the Capital Proposals in relation to the inclusion of OBS exposures in the supplementary leverage ratio could have the effect of amplifying business cycle fluctuations, thus forcing banks to curtail lending in recessionary climates in order to comply with capital requirements. Trade-related OBS instruments, including trade related contingencies and transaction related contingencies could be reduced or canceled under the proposed changes, leading to substantially reduced trade flows and inhibiting companies that do business internationally. Basel II standardized approach values should, at a maximum, be considered instead of a 100% or "notional" factor.

The current calculation of the AVC increases the cost for the industry in providing trade finance to the end user and its application is disproportionate to the nature of these instruments, as demonstrated by the ICC register data on trade finance. As such, BAFT-IFSA believes that as short-term, self-liquidating instruments, trade finance products warrant a separate AVC from other types of corporate banking products.

Lastly, a clarification on the waiver of the maturity floor for short-term, self-liquidating trade finance instruments will provide greater certainty to market participants on the trade finance products covered by the waiver.

Without these important changes, the net impact of the Capital Proposals will lead to higher pricing and less bank support for trade finance, which in turn will have a negative impact on global trade and global GDP. This outcome would run counter to the stated goals of the G-20 and the US administration. BAFT-IFSA believes that a more rational regulatory treatment for trade finance will ultimately have a positive effect on trade finance markets and will spur job creation and growth in the real economy.

We very much appreciate the opportunity to comment on the proposed rulemakings and look forward to further dialogue with the Federal Banking Agencies on these issues, and on other issues relating to Basel III liquidity proposals as they relate to trade finance and transaction banking, going forward.

Very truly yours,

Tod R. Burwell
President and Chief Executive Officer

Appendix 1

The Importance of Trade Finance

Global trade relies upon accessible financing for trade transactions. Trade financing assists customers with their import and export requirements, by providing import/export financing and country and counterparty risk mitigation. Trade finance, as a transaction banking product, is a core banking business serving the real economy[22]. In order to set our comments on the rulemakings in context, a review of the secure and unique nature of trade finance as a financial instrument, and its significance to the US economy, is important.

Trade finance has historically maintained a low risk profile in comparison with other financial instruments. Trade finance transactions are generally fixed, short-term instruments that are not automatically renewed or extended upon maturity and are self-liquidating by nature (*i.e.*, exposures are liquidated by payment at maturity). In stress situations, countries and banks have traditionally continued to prioritize the repayment of short-term trade finance obligations as they fall due. Furthermore, banks active in trade finance are generally able to react swiftly on deteriorations in bank and country risk, as a result of the short-term, self-liquidating nature of the transaction.

According to an ongoing registry project conducted by the International Chamber of Commerce (ICC), banks have experienced relatively minimal losses on trade lending[23]. The ICC has created this Trade Finance Register to track default and loss rates for trade finance, creating a living database of the trade finance market which has helped to demonstrate the resilience of this important business. The ICC data reveals that a minimum of 60-65 percent of traditional global trade finance activity is based on assets (or about $2.2-2.5 trillion USD) and the pooled data within the Register supports the view that trade finance is a low-risk asset class, particularly when compared with corporate loans[24]. According to that data, accumulated over 11.4 million transactions, the average tenor for all trade finance transactions was 147 days and the average tenor for off-balance sheet trade finance transactions was 80 days. Only three thousand defaults were recorded in this total dataset.

These low-risk, short-term trade financing instruments are pivotal in supporting international commerce and contributing to the growth of the world economy. At the G-20 meeting in London in April 2009, during the height of the financial crisis, it was recognized widely by world leaders that trade finance is the lifeblood of $19 trillion USD in annual global commerce and one of the fundamental engines of growth and development, especially in the emerging markets. Restricting the flow of credit to this area, by increasing the risk weight of trade finance instruments disproportionate with their nature, means essential goods cannot be traded, posing a threat to international trade, with smaller banks and small- and medium-sized enterprises (SME) disproportionately affected.

President Obama has maintained that a critical part of stimulating economic growth in the US is ensuring that businesses can actively take part in international markets by increasing their exports of goods and services[25]. Ninety-five percent of the world's consumers live outside of the United States.[26] Firms that are only selling domestically are reaching just a small share of potential customers. Exporting enables SMEs to diversify their portfolios and insulates them against periods of slower growth. Free trade agreements have opened in markets such as Australia, Canada, Central America, Chile, Israel, Jordan, Mexico, Colombia, Panama, South Korea and Singapore, creating more opportunities for US businesses. Trade

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[22] BAFT-IFSA recently defined the specific products that the industry considers traditional trade finance: BAFT-IFSA Traditional Trade Finance Definitions; February 2012: http://www.baft-ifsa.com/eweb/docs/BAFTIFSATFDefinitions.pdf

[23] International Chamber of Commerce: http://www.icctraderegister.com/docs/public/ICC-Register_Report_26_October_2011%20-%20Public%20Report.pdf

[24] Please See Appendix 2

[25] Executive Order 13534 - National Export Initiative: http://www.whitehouse.gov/the-press-office/executive-order-national-export-initiative

[26] US Department of Commerce Trade Finance Guide: http://trade.gov/media/publications/pdf/trade_finance_guide2007.pdf p. 1

finance, through private sector sources and in coordination with Export Credit Agencies like the Export-Import Bank of the United States (Ex-Im), assists these businesses in building new opportunities for growth internationally.

Recognizing the importance of trade to US companies, in January 2010 the President set a goal of doubling exports by the end of 2014 by way of the National Export Initiative (NEI). The NEI is estimated to support two million additional jobs in the US and the Obama Administration has, through this endeavor, committed to marshaling the full resources of the United States government behind American businesses that sell their goods and services abroad. BAFT-IFSA believes that the NEI could be impeded by the implementation Banking Agencies' proposals as they relate to trade finance. The proposals could inhibit the ability of banks to provide the financing needed to ensure US businesses can compete internationally and thus create jobs.

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Appendix 2

Trade Finance Data Comparison

Parameter	Trade Finance[27]	Corporate Loans[28]
Default rate:	0.013% to 0.290%	1.01%[29]
Loss rate:	0.0007% to 0.07%	0.20%[30]
Tenor:	Average ~147 days	1-3 years
Diversification:	Diversified- $454k average transaction size	Less diversified than Trade given large corporate focus

Default and Loss Rates by Trade Finance Product[31]

Product	Default Rate	Loss Rate
Import LC	0.077%	0.007%
Export LC	0.09%	0.03%
Standby LC	0.013%	0.0007%
Import Loan – Corp.	0.06%	0.07%
Import Loan – Bank	0.09%	0.05%
Export Loan – Corp.	0.29%	0.017%
Export Loan - Bank	0.17%	0.01%

[27] Data from ICC Trade Register—Rated & Unrated Counterparties; Data for 2008-2010

[28] Data from Moody's report—Global Corporate Finance- Feb 2011- Rated Counterparties

[29] Data analyzed: 1982-2010

[30] Data analyzed: 1987-2010- 80.3% recovery rate

[31] Data from ICC Trade Register: http://www.icctraderegister.com/docs/public/ICC-Register_Report_26_October_2011%20-%20Public%20Report.pdf

Appendix 3

Off-Balance Sheet Trade Finance Exposures

Certain Off-Balance Sheet (OBS) exposures are used in trade flows. These include trade related contingencies and transaction related contingencies. These should be incorporated at less than "notional" value when calculating the supplementary leverage ratio in order to avoid a possible reduction in the volume of trade flows and an increase in the cost of goods and services. This adjustment is consistent with the nature of the OBS exposures used in trade, as outlined below.

a. Trade Related Contingencies

Trade Related Contingencies (TRC) are contingent liabilities that arise from trade-related obligations underpinned by the movement of goods or services and evidenced by commercial contracts that document the arrangements between buyer and seller. These include documentary letters of credit, confirmations of letters of credit, and shipping guarantees. From historical experience, it has been observed that companies prefer to prioritize payment for their trade obligations over other obligations, as they have a tendency to avoid defaults on trade obligations as far as practically possible to ensure their businesses remain an ongoing concern. Moreover, TRCs do not necessarily materialize into an exposure, even if the obligor is in financial difficulty. Historical evidence has shown that the default of the obligor does not necessarily induce drawing of the guarantee by the beneficiary, as the underlying trade contract might still be fulfilled as contracted between the two parties. On the rare occasions that the bank is obliged to make payment following default of the obligor, there will often be constructive possession of the underlying goods validating a prior pledge, allowing the bank to make a recovery from that channel.

Incorporation of these instruments at 100% their value in the calculation of the supplementary leverage ratio would be inappropriate for these liabilities due to the fact that TRC exposures are rarely speculative in nature and 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 through TRCs (predominantly import documentary letters of credit) as the level of risk perceived by the market increased.

TRC's (documentary letters of credit, confirmations of letters of credit (LCs) and shipping guarantees) have unique aspects which emphasize their reliability and security as financial instruments. The LC is the primary TRC used to facilitate trade and provide assurance to the exporter that if they deliver the goods/services requested by the importer and present compliant documents, the bank that issued the LC irrevocably undertakes to pay the exporter. The LC also provides confidence to the importer that they will receive the goods they have requested, evidenced by documentation, and that the exporter has complied with any additional specified terms/conditions that may have been part of the purchase agreement. To this extent, the obligation of the issuing bank to pay the beneficiary of the LC (typically the exporter) is highly contingent on the exporter not only delivering the correct goods/service as detailed in the LC, but also that all requirements of the LC have been complied with. As such, an LC will remain an off-balance sheet exposure until the documents are presented and accepted in accordance with the terms of the LC. Until this event occurs, there is a high probability that the LC might never convert to an on-balance sheet exposure, even in the event that the importer defaults.

Additionally, the LC may not convert to an on-balance sheet exposure due to the fact that the documents presented to the issuing bank may be discrepant, and thus 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 LC will be canceled. Whilst re-presentation remains a possibility, in only a small number of cases are the documents subsequently compliant, as payments under LCs are made at the discretion of the banks involved following a request by the applicant. In the event of a buyer default, in many cases, the supplier will make the decision not to ship under the LC, as there is the risk that the documents may be discrepant and rejected by the bank. In this instance, no documents would be presented and the LC would expire with no liability to the issuing bank, even if the importer defaulted.

From the data in the ICC trade finance registry, the ICC found that documentary and (implied) performance contingencies inherent in trade products mitigated potential defaults for on-balance-sheet exposures. In the case of import LCs, for instance, an average of 70 percent of document sets presented to banks to make drawings under import LC contained discrepancies on first presentation. In these cases, the bank has no obligation to waive the documentary discrepancies and make payment unless it receives reimbursement or unless the discrepancies are corrected within the validity period of the LC.[32]

In some cases an exporter may wish to ensure the credit worthiness of the bank that issues the LC. In this case, the exporter may request its bank to "confirm" the LC. 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 LC 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 LC being met, and the issuing bank failing to honor its commitment to pay. Where an issuing bank fails to honor its commitments, it is important to note that historically sovereigns and multilateral development banks have intervened to ensure that trade commitments in the issuing bank's country are honored.

In a scenario where the issuing bank fails to honor its commitments and there is no other support from a sovereign of multilateral development bank, even where compliant documents have been presented and additional terms and conditions of the LC have been met, all of the OBS exposure may not convert to on-balance sheet debt. This may occur where the importer purchases the goods and the funds from the sale would be used to reimburse the funds paid the exporter.

Finally, shipping guarantees are issued by banks in favor of the shipping company where the goods have arrived before the documentation. The primary purpose of the guarantee is to ensure 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 evidence 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. It is very rare for shipping guarantees to be called, even where the importer may default. The bank's obligation to the shipping company under the guarantee is eliminated by presentation of the original title documents once they arrive.

The impact of the Capital Proposals on TRC will reflect each banks leverage ratio constraint. By incorporating these instruments at 100% their value in the calculation of the supplementary leverage ratio, banks with leverage ratio constraints will be incentivized to divert capital to other products, increase the cost of offering these products, or cease to offer key trade products.

b. Transaction Related Contingencies

Transaction Related Contingencies (TRCP) are performance standby letters of credit or performance guarantees. Examples of these types of exposures include performance bonds, bid bonds, tender bonds, advance payment guarantees. These guarantees support certain performance obligations of a borrower, with the drawing on these guarantees being contingent on the specific performance of the borrower rather than the financial soundness of the borrower. Prior to providing a TRCP, the bank will ensure that there is an underlying transaction and that any drawing on the TRCP is triggered by a performance event and not the customer failing to pay. As such, even in the event of default, a contingent standby letter of credit or bank guarantee will not necessarily result in an on-balance sheet exposure and internal bank data suggests that it is more likely that these types of exposures never become a liability for banks. Bonding is used predominantly in support of the performance obligation of borrowers and the likelihood of performance-related bonding resulting in an on-balance sheet exposure is remote, with bank evidence putting the default rate generally below 2%.

[32] International Chamber of Commerce: http://www.icctraderegister.com/docs/public/ICC-Register_Report_26_October_2011%20-%20Public%20Report.pdf

Guarantees issued by a bank in connection with trade-related transactions usually facilitate commercial transactions by providing the beneficiary with coverage during a bid process, related to advance payments as well as payment, delivery, performance and warranty obligations. Drawing of such a guarantee is widely dependent on the performance of the applicant related to the underlying commercial contract, so that in case of a credit event related to the applicant, actual drawings under guarantees are still dependent on the commercial performance of the counterparty which, to a large extent, is not directly correlated with the financial standing of the counterparty. Default of the obligor does not necessarily induce drawing of the guarantee by the beneficiary as the underlying trade contract will likely be fulfilled as agreed. Moreover, in most cases, guarantees do not allow for drawing by the beneficiary in case of insolvency of the applicant, but are triggered by the non-performance of the underlying contract.

By incorporating these instruments at 100% their value in the calculation of the supplementary leverage ratio, banks constrained by the leverage ratio will likely either increase the cost of these products or cease offering these products to customers.