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Trade Finance and Basel III: When Regulation Becomes Counterproductive

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Despite some of the good reasons given for the introduction of Basel III, this article argues that the regulation will harm the world of trade finance.

After the disappearance last year of entire stocks of wheat in the Ukraine and the recent rise in oil prices, there is another topic that has been agitating the world of trade finance for quite sometime now - regulation, and specifically Basel III.

The issue of Basel III is on every trade finance professional's lips, as these new guidelines could likely have a negative impact on the future of the industry, but most of all on international trade and global economic growth.

One must therefore understand what Basel III states when referring to trade finance transactions, why these rules have been issued, and how it could potentially cause conflict. This article aims to provide answers to these questions, as well as to identify the stakes involved in this topic.

Basel II

Let's briefly look at the path to the current situation. The first Basel agreement (Basel I) was quite discrete when addressing trade finance. It was only with the introduction of Basel II in 2008 that specific rules or clarifications regarding this activity came into effect.

In substance, the Basel II agreement sets the rate of capital required required to be maintained at 8%. But at the same time it requests that procedures for risk surveillance should be set up, and that sophisticated risk weight calculation methods should be introduced. From this moment on, banks could choose the calculation method most adapted to their needs - they could either opt for a standard method or for an internal rating-based approach. This enabled financial institutions to propose their own rating grid, subject to approval.

In summary, off-balance sheet commitments (such as documentary credits and guarantees) used in the calculation of capital was required to be a 20% weighting, according to the framework of Basel II.

Now that Basel III is here, does this mean that Basel II has failed? Even if the major criticism addressed to Basel II was based on banks' difficulties to supply reliable data and to apply an efficient method compliant with Basel II, it would nevertheless be an overstatement to say that Basel II rules were a failure. These rules have indeed contributed to give a framework that, while perhaps a bit light, have been useful for trade finance. However, the financial crisis called into question the pertinence of these norms.

Basel III: An Answer to the Crisis

Basel III is first and foremost the answer of regulators to the sub-prime crisis in the US in 2007 and the global financial crisis that followed. Its principles were ratified by the G20 summit in September 2010. These rules would have to be implemented in 2013 at the earliest and 2019 at the latest. The goal of Basel III is to increase quantity, quality and transparency of a bank's capital. This new framework sets a more restrictive interpretation in terms of quality of counterparty risk. Furthermore, the requirements in terms of capital and liquidity ratios are reinforced. Banks have to create cyclical capital buffers on top of existing equity. These buffers will be used in periods of crisis and must be reconstituted in periods of growth.

Finally - and this is the main worry for the trade finance world - Basel III will require of banks active in trade finance to hold five times more capital than before to finance their trade finance transactions. Indeed, if Basel II was requesting a weighting of 20% for off-balance sheet commitments, Basel III will require 100%.

Chain Reactions

One can obviously notice that key decision makers have not fully measured the potential collateral damage these new rules will have. The micro- and macroeconomical context could undergo a number of changes.

The first consequence could be the disappearance in time of numerous small to medium-sized banks that would not have the necessary resources to increase their capital. Consequently, corporates seeking financing would only be able to turn to the big banks. But the bigger the bank, the more rigid, less reactive and less capable it is to make quick decisions when facing increasingly complex financing requests.

The second problem would be the increase of financing costs that would be immediately passed on to the banks' customers. Since financial institutions would need to increase the percentage of equity in their balance sheet, and since the cost of this equity is higher than other means of financing, such as external capital, the cost would obviously have to be borne by someone. Therefore, the end user - the customer - would have to pay a higher cost for financing in order for this activity to remain profitable for the banks.

The third consequence lies at a macroeconomic level, but could nevertheless be disastrous. One must indeed consider the negative impact of Basel III on emerging nations. You could easily imagine that banks involved in the economy of these countries, and therefore contributing to their development, would not necessarily have the capacity to increase their equities, and could no longer be able to finance exports. Needless to say, this would slow down - if not block - exports from emerging markets. This could cause a global imbalance with dangerous political repercussions, particularly during this current period of political instability.

In this post-crisis period, small to medium-sized banks have an important role to play. Indeed, I would say they are the drivers of global economic recovery. They are the vessels irrigating local economies, and constitute a link between customers and the big banks. Their 'programmed disengagement' from trade finance would be counterproductive to economic growth, as it would deprive global trade of a key player.

Conclusion

Fortunately, during its latest summit in November 2010, the G20 has officially assigned the Basel Committee to consider the specificities of trade finance further to negative comments received. Hopefully dialogue is now open between the industry and the regulators, as important lobbying is taking place in this regard. Led by banks, these actions tend to defend the interests of international trade.

Basically, the main weakness of Basel III lies in the fact that it considers import/export financings like all other credits, or simply like a classic loan without any security. The committee seems to have omitted that, in this type of financing, the goods constitute a guarantee or a collateral for the bank. Therefore, it brings more security in terms of cover.

Furthermore, trade finance has demonstrated that it benefits from a low loss ratio and very high reimbursement ratio of allocated financings. Consequently, this industry deserves to have a specific status and rules that do not block its progress, but bring an acceptable level of security.

It is essential that the trade finance community continues to defend its own interests. When speaking of the trade finance community, I am not only talking about financial institutions but also corporates, who also have a lot to lose in this new context.