Spanner in the works

Basel II's successor is proving far from popular with banks. And although well intentioned, it could have a negative impact on corporate lending and trade finance. Yet, observers say banks could do more to reduce the potentially negative impact of Basel III on their customers and that corporate treasurers will also need to become more "buyer aware".

"In my career I have never seen this kind of consensus by a group of banks in trade finance," says Olivier Berthier, solutions director, transaction banking, Misys. Berthier is referring to the lobbying effort by the International Chamber of Commerce (ICC) and the banks under the auspices of industry association BAFT-IFSA in response to the Basel Committee on Banking Supervision's Basel III capital proposals.

At SWIFTs annual customer conference, Sibos, in Amsterdam, last October, BAFT-IFSA president and chief operating officer Dan Taylor painted a somewhat apocalyptic picture of the future of trade finance if the Basel III capital proposals, which call for a leverage ratio to be applied to off-balance-sheet items including letters of credit and trade guarantees, were implemented as they stand. "From a trade perspective most people would say Basel I wasn't exactly right, Basel II got it even more wrong than Basel I and now we are jumping off the cliff [with Basel III]," said Taylor.

At Sibos, it was unusual to see so many transaction bankers explicitly agree on something and all appeared keen to have their say on the so-called dire consequences for world trade and economic growth (a 2% drop in global trade, half a percent of global GDP) if the Basel Committee does not heed banks' pleas. But as the banks readily admit, the Basel III proposals are not singling out trade finance. They are in fact aimed at reducing bank leverage and in that respect as McKinsey points out in its report, *Basel III and European Banking,* Basel III's impact is "universal" across all aspects of banks with the new "capital and leverage ratios" affecting all businesses "proportionally". McKinsey says the increased capital ratios will affect "many standard corporate banking products". So, for example, in the case of long-term corporate loans, it estimates that funding costs will increase by 10 basis points. The biggest increases (60 basis points) are likely to be for "uncommitted credit lines" to FIs and uncommitted liquidity lines to both banks and corporates.

Under Basel III, banks will have to hold more Tier 1 capital so they are going to be less willing to lend, particularly uncollateralised forms of lending, says Ann Cairns, managing director and head, Financial Industry Advisory Group, Alvarez & Marsal. "In that context, transaction banking, particularly payments, are likely to become more attractive as there is no credit attached to it," says Cairns. "Banks are not using risk-weighted assets so transaction banking will become an extremely attractive revenue stream."

So why have the Basel III capital proposals, which are not even finalised, got transaction banks up in arms? It may have something to do

with the fact that transaction banking continues to perform well even in volatile market conditions – at the height of the financial crisis in 2008, while global trade volumes declined, large global trade banks still enjoyed profitability as margins for trade finance products were higher and there was increased demand for traditional letters of credit (LC).

Banks also view trade finance more favourably as it is short-term working capital. "Commercial trade is a lower-risk low loss proposition for most of us and viewed as smart use of off balance sheet capability of the bank," stated Bruce Proctor, Trade & Supply Chain product management executive, Bank of America Merrill Lynch. And in a low interest rate environment, which puts pressure on margins in the cash business, trade finance remains an attractive business for a number of banks. It is also an important part of the flow business

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Olivier Berthier, Misys

of clients, which also includes cash management and FX. And although historically trade finance may not have been the largest revenue generator for banks, it is part of their "full service" proposition to corporate customers.

No leverage

Despite being off-balance sheet, the banks maintain that letters of credit and trade guarantees are not used to create leverage, but merely reflect the underlying nature of the transaction. "The underlying commerce – someone buying from someone and paying for the goods later – that is why LCs are off balance sheet," stated Stuart Nivison, head, Trade and Supply Chain Europe, HSBC. Although Basel III's overarching aim is to prevent banks increasing leverage, as the ICC points out, this "may have unintended, negative consequences on trade finance." Back in April 2010 it stated that the proposed reforms of the Basel II framework would "increase the Credit Conversion Factor (CCF) for all off-balance-sheet exposures, including trade products, to 100% when calculating a leverage ratio constraint. This compares with 20% for trade-related contingencies and 50% for transaction-related contingencies under the current framework." The ICC said this "blanket approach" to the treatment of off-balance-sheet items under the proposed leverage ratio constituted a misunderstanding by the Basel Committee "of both the operational context and the mechanics of trade financing."

McKinsey states in its report that when it comes to trade finance, "Basel III increases the risk weight for banks by some 20% to 30%." Under the standardised risk measurement approach for capital allocation under Basel II, Berthier says trade finance required 20% capital allocation. Yet, the larger banks that implemented the Advanced Measurement Approach were able to cope with Basel II much better. However, "Basel III appears to put everyone on the same level," says Berthier, and adds it is still unclear if there is any flexibility around customised models or whether banks will be forced to adopt the standardised approach, which would require 100% capital allocation for traditional trade finance. "If banks end up fighting against other products for limited capital, some may consider dropping out of trade finance," adds Berthier. "Trade as an overall part of their assets could decline."

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Hugo van Wijk, Vallstein

Collateralised lending

However, Cairns of Alvarez and Marsal says LC-based trade finance is still likely to be more attractive under Basel III than uncollateralised lending. "When a bank writes an LC they are extending credit until goods are shipped from one point to another. That is collateralised lending, which is still more attractive than if you are just lending outright. So both cash and trade should become more prevalent but Basel III will tighten things up so trade may not be as attractive as it was." But Cairns says that is going to be true for any "credit instrument". Tan Kah Chye, global head, Corporate Cash and Trade, Transaction Banking, Standard Chartered Bank, says Basel III will not kill trade finance. "Some of the policies may have a negative impact ... but the regulators are responsible people," he says. "What is more important is for business, banks and the regulators to have an open and ongoing dialogue" (*see video interview with Kah Chye on Basel III - www.financial-i.com).*

Banks will continue to offer LCs, says Berthier, but he adds that some banks are already looking at alternative means of providing working capital finance. "In these new models they are looking at wider financial supply chain services that are not as capital intensive as LCs," he explains. He says some of the supply chain financing programs that banks offer today may also require 100% capital allocation under Basel III. "So SCF may not be the magic bullet," he says. "An early payment program may solve the problem. Banks will need to be more innovative and look at the overall corporate value chain."

"Basel III means that banks will need to work differently," says Lars Millberg, head, Global Transaction Services, Corporate, SEB Merchant Bank. "They will have to review the content of their relationships with corporate clients as part of their fundamental business model. This means everything from attracting higher volumes of deposits (necessary to balance lending), reducing plain vanilla, general purpose lending, maximising locked-in cash, reviewing processes, working capital days and their balance sheet. Although this will be challenging, in the end it will be an improvement."

Hugo van Wijk, co-CEO of bank relationship management software provider, Vallstein, says corporates will also have to better understand their overall relationship with a bank and be more "buyer aware" as a result of Basel III. "Banks passing on the cost to customers happened with Basel II," he explains. "That is why it is so important that customers are aware what the new rules are and how they will impact them." Van Wijk says corporates should be more selective when choosing a bank and should look at the return on equity (ROE) promised by a bank to its shareholders. "If the bank is promising a reasonable 8% to 12% ROE to shareholders, the bank is likely to be more reasonable in the pricing it offers you. If a bank promises shareholders 25% ROE then it is probably coming out of the customer's pocket."

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> **Ann Cairns, Alvarez & Marsal**

Minimising the impact

Banks have the option to absorb parts of Basel III if customers vote with their feet, says van Wijk. Corporates should also have a better understanding of their banking requirements on a product-by-product basis. "Products that have a low capital requirement like treasury will be packaged in such a way that they become much more attractive," van Wijk explains. "However, if you go out and ask for a credit line, then that is less attractive from the bank's perspective. CFOs need to have a total overview of their relationship with a bank across treasury and capital markets."

While the banks are already warning of price increases in relation to Basel III, Berthier says they should be able to find a less negative way to minimise the impact on customers. "Basel III won't be rolled out before 2013 and it will be rolled out differently from one bank to the next in terms of how they manage it internally," he says. Some banks have already moved to shore up their capital base with rights issues, Standard Chartered being a good example of that with a GBP 3.3 billion rights issue last October. "The rights issue enables us to get ahead of the curve," explained Karen Fawcett, group head, Transaction Banking, Standard Chartered. "We have to make sure we can service our existing clients for at least a couple of years." Cairns of Alvarez and Marsal, says in light of capital constraints on the banks we are also likely to see more banks selling off capital-intensive parts of their business that they cannot afford to invest in, to private equity investors.

Banks are also under pressure to put up or shut up – to back up their statements that trade finance is not a risky proposition despite being off-balance-sheet. Speaking at Sibos in Amsterdam, Marc Auboin, economic counsellor with the World Trade Organisation, said it is assumed that trade finance is a safe proposition but not really demonstrated. In an effort to back up their claims with some empirical data, the ICC published the findings of a study across nine global banks over a period of five years, including two years of the financial crisis. Out of 1.2 billion transactions, the default rate was 1,400 plus transactions, a "statistically insignificant number", said Kah Chye, of Standard Chartered who is also bank chair of the ICC. During the two years of the crisis, the study also showed a default rate of 400 plus transactions out of 2 million plus transactions. "While the data may not be perfect it is sending the right messages," says Kah Chye.

Kah Chye says the regulators are listening and with time and patience, things will change for the better. "I don't know whether banks' lobbying efforts will be successful," says Berthier. "I am, however, an optimist. I can't see the Basel Committee accepting to threaten commerce and international trade as broader commerce could be a casualty." //