The impact of Basel 3 implementation on the Credit Insurance Industry

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1) Basel 3 in context

"Strengthening the soundness and stability of the international banking system"

Reform packages address the lessons learned of the financial crisis:

- Build up of excessive on- and off balance sheet leverage
- Gradual erosion of capital base
- Insufficient liquidity buffers

Reducing the risk of spill-over from the financial sector to the real economy.

Banks will now be required to hold much more equity and other loss absorbing buffers relative to their assets by various different measures. Each of them means more costly funding for banks, even more so for systemically important ones.

Basel 3 as a solidifier post GFC, co-exists with Basel 2.

Market pricing has in the last 12 months led to levels that definitively does not factor in B3.

2) Risk Mitigation in Basel 2 & 3

The relevant key drivers regarding Risk Mitigation are from the Basel 2 package.

Basel III was not supposed to add anything on Risk Mitigation and RWA. CRD / CRR is something like the EU translation of Basel 3 into European; thus it could be concluded that Basel 3 also deals with risk mitigation topics such as Credit Conversion Factor, Legal Opinions, Definition funded/unfunded risk protection etc.

However, Basel III introduced some changes for Trade (minimum duration removed, possible to rate a bank better than its sovereign)

Control over operational risk or credit insurance from Basel 2. Legal opinion as per CRR 194 is new: The lending institution shall provide, upon request of the competent authority, the most recent version of the independent, written and reasoned legal opinion…to establish whether its credit protection arrangement or arrangements meet the condition laid down in the first subparagraph.

Basel and Risk Mitigation

The Basel Committee confirmed in December 2002 that insurance could be used as a qualifying risk mitigant provided it meets the criteria applicable to guarantees. (These criteria will be familiar to anyone with a passing knowledge of the Solvency II rules applicable to insurers and their use of reinsurance and other risk mitigation techniques).

Credit Insurance
In particular, this is relevant to credit insurance, of which there are two distinct types: (i) "whole turnover", (ii) "single risk

Unconditionality
The main issue around whether credit insurance can be used as a risk mitigant in this way is the Basel II requirement for unconditionality. This means that the instrument must be irrevocable and within the direct control of the protection purchaser (i.e. the bank/insured).
Credit insurance policies have had to evolve so as to be Basel compliant.

Despite this, certain issues remain. As above these relate to absence or loss of control by the bank/insured, but tend to be fact-specific or trickier to deal with.

3) Basel 2 & 3, CRR and Trade Finance

- Basel II has no chapter “Trade Finance” !!!
- Basel II mentions only:
  - Credit Derivatives
  - Off-Balance sheet engagements
  - “Trade Letters of Credit”
- Other instruments like pre- or post-financing, guarantees, other collaterals like pledges, commitments, etc. are to be found elsewhere in the Basel II texts, as other on-balance or off-balance risks, if available at all…
- Commodities financing mentioned under “Specialised Lending”.

EU-specific issues in implementing Basel III

- Specific focus on **small and medium-sized enterprises (SMEs)** being one of the pillars of the Union economy given their fundamental role in creating economic growth and providing employment. Consideration of a specific supporting factor equal to 0,7619 on the capital requirements for SMEs up to EUR 1,5 mn.

- Recognition of **trade finance** exposures being diverse in nature and sharing characteristics such as being small in value and short in duration and having an identifiable source of repayment. As inflows and outflows are usually matched, the liquidity risk is therefore limited.

- In order to take account of the diversity of business models of institutions in the internal market certain **long-term structural requirements** such as the **NSFR** and the **leverage ratio** should be examined closely with a view of promoting a variety of sound banking structures which have been and should continue to of service to the Union's economy.

CRR – Capital Requirement Regulation

Within the European Union, Basel III is implemented via the „CRD IV reform Package“ consisting of a Directive („CRD IV“) and a regulation („CRR“)

- The package entered into force as of January 1st 2014 with transition periods
- Liquidity and Leverage regulation will be finalised during transition period taking into consideration the developments in Basel
- The CRR defines trade finance as “financing, including guarantees, connected to the exchange of goods and services through financial products of fixed short-term maturity, generally of less than one year, without automatic rollover.”
- Characteristics of trade finance:
  - ✓ Diverse in nature
  - ✓ Generally small in value
  - ✓ Short duration
  - ✓ Identifiable source of repayment
  - ✓ Inflows and outflows are usually matched

The CRR contains special provisions for trade finance exposures due to the generally low risk of trade finance products.

Some improvements for trade finance

Exposure class Financial Institution: in principal risk weight is derived from issuer rating that depended on the sovereign under Basel 2 for unrated banks:

- Under Basel 3 the risk weight is 50% for unrated banks with claims with an original maturity < 3 months
- Under CRR / CRD IV RW is 20% for trade finance exposures with a residual maturity < 3 months

Credit Conversion Factor (CCF) according to CRR for off-balance sheet items:

- 20% for Medium / Low Risk (L/Cs, contract bonding), 50% for Medium Risk (L/Cs issued or confirmed)
- For undrawn ECA-supported m/lt loans: 50% CCR if commitment period > 1 y, 20% below 1 year

4) The new Ratios

- **Leverage Ratio:**
  Maximum threshold for lending volume,
  not taking into account any risk weights (collateral)

$$\frac{\text{Tier 1 capital}}{\text{Total assets}} \geq 3\%$$

- **Liquidity Coverage Ratio:**
  Short term Liquidity Buffer

$$\frac{\text{Stock in high quality liquid assets}}{\text{Net cash outflows over a 30-day time period}} \geq 100\%$$

- **Net Stable Funding Ratio:**
  Matched Funding

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

Reduced counting for HQLA

The Leverage Ratio

The Basel III framework introduced a simple, transparent, non-risk based leverage ratio to act as a credible supplementary measure to the risk-based capital requirements. The leverage ratio is intended to:

• restrict the build-up of leverage in the banking sector to avoid destabilising deleveraging processes that can damage the broader financial system and the economy; and

• reinforce the risk-based requirements with a simple, non-risk based "backstop" measure.

For M/LT business many see the Leverage Ratio as a backdoor introduction of a higher risk weighting. I do not share that view, as it is a top down balance sheet restriction, not imposed on any product.

Reduced CCF is a success achieved both with Basel 3 and CRD / CRR.

The Liquidity Coverage Ratio

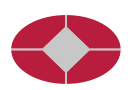
$$\frac{\text{Liquid Assets (HQLA)}}{\text{Liquidity outflows – Liquidity inflows (max. 75\%)}} > 1$$

Outflows of trade finance transactions 0-5%

-50% for payments contractually due within 30
-100% for all trade finance receivables with a remaining maturity < 30 day (CRR / CRD IV)

5) The Timing

Basel Committee on Banking Supervision



BANK FOR INTERNATIONAL SETTLEMENTS

Basel III phase-in arrangements

(All dates are as of 1 January)

	Phases	2013	2014	2015	2016	2017	2018	2019
Capital	Leverage Ratio		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015				Migration to Pillar 1	
	Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%				4.5%
	Capital Conservation Buffer				0.625%	1.25%	1.875%	2.5%
	Minimum common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%
	Phase-in of deductions from CET1*		20%	40%	60%	80%	100%	100%
	Minimum Tier 1 Capital	4.5%	5.5%	6.0%				6.0%
	Minimum Total Capital		8.0%					8.0%
	Minimum Total Capital plus conservation buffer		8.0%		8.625%	9.25%	9.875%	10.5%
	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital		Phased out over 10 year horizon beginning 2013					
Liquidity	Liquidity coverage ratio – minimum requirement			60%	70%	80%	90%	100%
	Net stable funding ratio						Introduce minimum standard	

* Including amounts exceeding the limit for deferred tax assets (DTAs), mortgage servicing rights (MSRs) and financials.

– – transition periods

6) ICC Trade Register Report

The goals of this report are:

- To provide an objective and transparent view of the risk profile and characteristics of Export Finance using a rich base of industry data, with the intention of contributing to informed policy and regulatory decisions relative to Export Finance
- To advance the understanding of Trade and Export Finance, its importance to global trade and the highly effective global risk mitigation capability of Trade and Export Finance products to a broad audience of interested parties
- To promote understanding of the international regulations affecting bank capital requirements for Trade and Export Finance, and their history and objectives, in order to create a uniform global view of this industry
- Achieved empirical evidence of low risk nature of st and mlt trade finance.

Basel III comments from WTO: avoid unintended consequences

Trade and Export Finance positively considered, but not necessarily translated in regulation. ST finance received concessions. LT, much less so

- The BCBS risk-based capital regime never required large amounts of capital for off-balance sheet trade finance exposures linked to underlying shipment, because of the low probability of risk. However on-balance sheet regular trade lending is treated like any other lending. From on-set, there was a prudential advantage for short term, self-liquidating trade finance.

- That relative advantage was maintained under Basel III. The BCBS agreed to a number of “concessions” regarding initial proposals (2010-2011), aimed at maintaining the banks’ ability to supply trade finance in a cost effective manner.

- The export finance industry did not receive as much attention from regulators, so some ask for a “trade specific treatment” for all categories of trade-related assets, be they short or long term, off or on-balance sheet.

Impact of Basel 3

Avoid the fallacy of universal knowledge, we are a niche business that has to apply all rules:

- Educate the public and the regulators about low risk nature of the product
- Requirement to act much in a much more co-ordinated manner with banks
- Work towards achieving evidence of High Quality nature of the underlying assets in cooperation with the ICC Banking Commission to achieve and justify low risk assets class acknowledgement
- Measures to make the assets more liquid, to ultimately qualify as HQLA
- Risk mitigation is rather encouraged but ECAs and commercial credit insurers must continue to clarify language, harmonise and standardise policy wording

7) Conclusions

- Trade finance must continue to provide empirical evidence but with more equity on the balance sheet, a tendency to firmer pricing must be expected. Banks balance sheets will be operated like warehouses, but jury is still out whether trade and ECA finance will be less attractive relative to other banking products.

- It is vital to have a clearly defined operating strategy for Basel III implementation, both for banks and ECAs.

- Financial Crime Legislation, in particular AML has strong impact on cost and availability to smaller banks. The regulators see the banks as first line of defence. Closer alignment is required.

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