# Response to PRA proposals on Basel 3 Regulations

# 1 Trade as a driver for growth

**Trade plays a vital role in driving economic growth and prosperity across the UK, impacting all areas of public policy. Today, UK trade is worth £1.7 trillion[1] to the economy with an estimated 40% of goods trade funded by trade finance. The regulatory framework that supports trade finance, a vital source of short-term working capital for SMEs, needs to be viewed in the context of enabling and underpinning the growth of UK trade, not isolated to just finance and banking.**

While market sizing is a difficult exercise, conservative estimates quoted in The Committee on the Global Financial System (CGFS) publication, **'Trade Finance: developments and issues'**[2], suggest that bank-intermediated trade finance supports about 40% of total merchandise trade globally by value, when inter-firm credit and open account transactions are included in the estimates. With annual value of UK trade in goods totalling at GBP £1,061.7 billion and services trade at GBP £649.6 billion in 2022, the importance and impact of trade finance is easily appreciated.

The linkages between trade and the creation of economic value are well-established, and even in the current difficult economic environment, expectations are that these linkages will evolve, as the focus of trade shifts from **'Just-in-time'** to **'Just-in-case'** helping it to regain its long-held position as a driver of global GDP growth. What is relatively recent outside of a small group of practitioners is the appreciation of the linkage between trade financing (including traditional trade finance, fast-growing supply chain finance, and the risk mitigation capabilities of each) and the successful conduct of trade.

## Contents



1 Department for Business & Trade: UK Trade in Numbers (December 2022)

2 Trade Finance: developments and issues (January 2014)

# 2 Implications of Basel 3.1

**The proposed implementation of Basel 3.1 has significant implications for the bank-related provision of trade financing, which supports 40% of global merchandise trade valued at about US $20 trillion annually. Regulated financial institutions — primarily banks — still provide the majority of traditional trade finance today, including Documentary Letters of Credit, Documentary Collections, Standby and Guarantee products, and loans or risk mitigation solutions derived from these various instruments.**

Today, it is clear not only to banks but corporates, regulatory authorities and policymakers alike, that access to trade financing – on a timely and affordable basis – is essential to the conduct of international commerce. ICC United Kingdom, UK Finance, BAFT, ITFA, the Association of Foreign Banks and the Association of Corporate Treasurers fully support and acknowledge the need for thoughtfully designed, robust regulatory regimes on numerous fronts, and remain committed to contributing to the positive dialogue that has evolved on these matters, particularly over the last few years.

While we appreciate that there is limited sympathy in the market for cost-related impacts of regulation — including capital cost — it is a commercial and economic reality that bank balance sheets today are generally constrained, that there is significant competition across the industry for allocation of limited bank capital, and that hard-dollar as well as capital costs factor into strategic, long-term decisions about allocation of capital and the returns associated with various financial services lines of business. At the same time, the explicit and implicit pressure to reduce overall risk exposures in support of prudential regulatory objectives, coupled with a systemic sensitivity around reputational risk, further reduce the willingness of certain banks to engage in cross-border business, particularly in markets that are perceived to be relatively higher-risk.

While it is acknowledged that it is difficult for authorities to bestow differentiated regulatory treatments to a large number of financial sector products or lines of business, we believe that the unique characteristics of trade finance have been well and objectively demonstrated in the research, analytics and advocacy work conducted over the last several years.

Those unique characteristics can be observed at the level of economic value-creation (certainly in terms of scope and global reach) described above, as well as in the extremely favourable default and risk profile of the business overall, as demonstrated for the last thirteen years through the authoritative ICC Trade Register.

The ICC Trade Register, well-known to regulatory authorities and market stakeholders, illustrates compellingly the quality of the trade finance business as an asset class, doing so on the basis of industry data as well as expert analysis and qualitative observations.

In the end, the intention of advocates for trade finance is to propose and arrive at a risk-aligned regulatory and capital treatment of trade finance, with the understanding that risk models, data collection and analytics and overall advocacy efforts can and should improve year-over-year. It is the unintended, restrictive consequences of fundamentally necessary regulatory frameworks that must be avoided, while concurrently ensuring the continued health and sustainability of trade flows, the robust engagement of banks in the business of trade, and access to adequate (and increasing) levels of trade and supply chain finance for SMEs and for developing and emerging markets in particular.

The persistence and deterioration of the global "trade finance gap" — that is, unmet demand for trade financing, which increased to US $1.7 trillion

during the Covid crisis and has since worsened significantly, is a major concern from a policy, commercial and development perspective. Capital constraints are a contributor to the existence of the trade finance gap, which also links to a widely acknowledged financing gap for small and medium enterprises.

These factors combine to create a situation where ongoing positive dialogue and thoughtful advocacy with the PRA and others can help address multiple areas of financial, commercial, policy and development activity.

Accordingly, the following observations are submitted in order of priority for consideration by the PRA, both as expert commentary arising from the work of the six organizations, but also with an eye to the wider economic, trade and development context within which trade banking services are provided to the international community.

# 3 Supporting organisations

**The International Chamber of Commerce (ICC), BAFT (the Bankers Association for Finance and Trade), the International Trade and Forfaiting Association (ITFA), UK Finance, the Association of Foreign Banks (AFB) and the Association of Corporate Treasurers (ACT) welcome the opportunity to respond collectively and in alignment with the *'Prudential Regulation Authority (PRA) Consultation Paper (CP) on the proposed implementation of Basel 3.1'*, and to continue the constructive, substantive and informed dialogue that has evolved over years of ongoing engagement.**

- ICC represents 45 million companies of all sizes and sectors, employing 1 billion people in over 100 countries. ICC promotes open, cross border trade, acts as a self-regulatory and rule-making body for trade finance banks and helps companies and States settle international disputes. ICC rules underpin $25 trillion of world trade. ICC United Kingdom is the representative office of ICC in the UK.

- BAFT is an international financial services industry association whose membership includes a broad range of financial institutions throughout the global community with a significant number of BAFT members headquartered in the UK. As a worldwide forum for analysis, discussion, and advocacy in international financial services, BAFT member banks provide leadership to build consensus in preserving the safe and efficient conduct of the financial system worldwide. BAFT closely monitors the impact that new regulatory initiatives could have on the provision of trade financing and payment services that support real economic commerce.

- ITFA is the worldwide trade association for companies, financial institutions and intermediaries engaged in global trade, forfaiting, supply chain and receivables financing.

- UK Finance is the collective voice for the banking and finance industry. Representing more than 250 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

- AFB is a trade body which represents the interests of the foreign banking sector in the UK to industry stakeholders, including the Government, regulatory bodies, and financial services organisations. The AFB has around 175 international banking group members, representing around 80% of the UK's foreign banking market, providing financial services through branches, subsidiaries, and representative offices in the UK. AFB member firms include the full spectrum of banking entities, delivering services ranging from retails banks servicing small subsections of the community to significant wholesale market participants.

- ACT is the only professional treasury body with a Royal Charter. With over 5,000 members and students, the ACT sets the global benchmark for treasury excellence. It leads the profession through its internationally recognised qualifications, by defining standards and by championing continuing professional development. The ACT is the authentic voice of the treasury profession, representing the interests of the real economy and educating, supporting, and leading the treasurers of today and tomorrow.

# 4 Summary of issues and recommendations in order of business priority

## Amendment to the treatment of guarantees under transaction related contingencies

{PRA CP reference: Chapter 3. Credit risk — standardised approach (section 3.48 till 3.53) and Question 5. Do you have any comments on the PRA's proposed CFs for issued off-balance sheet items? Do you have any additional data that the PRA could assess? In particular, do you have any data relating to the appropriate CF for 'transaction-related contingent items' in downturn conditions?}

### PRA proposals

- PRA proposes to align with Basel 3.1 and apply a 50% CF for performance guarantees (bid, performance, associated advance payment and retention bonds) and guarantees not having the characteristics of direct credit substitutes.

### Concerns and observations

- We believe there is an opportunity to update CF values to better reflect the actual CF values for the range of performance guarantees that the industry has collected.
- The 50% CF value was calibrated by Basel in the 1980s and, in the light of the empirical data presented since then, CF values globally should be lowered to 20%.
- A 50% CF (instead of 20%) leads to a 150% increase in capital and a proportional increase in product cost which will become prohibitive. For example, the pricing on an obligor with a probability of default (PD) of 0.2% for a performance guarantee of one-year tenor will need to change from 1.2% to 3.0% p.a. For a £10m performance guarantee, this will equate to pricing going from £120k to £300k p.a.

### Recommendations

- The ICC/GCD (Global Credit Data) study covering both performing, and defaulted, performance guarantees are attached as a reference point for PRA to take into consideration for lowering the CF to 20%. Refer links below:
  - 2022 ICC Trade Register report: Global risks in trade finance
  - ICC United Kingdom/GCD 2023 — Update to ICC/GCD 2022 Performance Guarantees Paper
- Aligned with the data on performance guarantees, as well as with desirable policy outcomes such as assuring market access to guarantee products and the economic development impacts, they enable it is recommended that the CF for performance guarantees be changed to 20%.

## Definition of commitment for off-balance sheet items

{PRA CP reference: Chapter 3. Credit risk — standardised approach (section 3.27 till 3.29) and Question 4. Do you have any comments on the PRA's proposed definition of commitment and proposed CFs for commitments?}

### PRA proposals

- The PRA does not propose to use the National Discretion to exempt certain arrangements for corporate and small and medium enterprises (SME) which meet the criteria set out in Basel CRE 20.94, footnote 43 from the definition of commitments.

### Concerns and observations

- In general, this will lead to higher risk weights and leverage ratio requirements across the entire range of Trade Finance products with an impact on market access to these products and its associated effects on economic and development activities they enable.
- As other national regulators are using the national discretion allowed by Basel 3.1 standards it will place UK banks, and those UK companies they support, at a competitive disadvantage.
- For products within the trade finance world (including receivables finance and equipment finance) there will be a disproportionate impact given the short-tenor and low margins which characterise this business.
- A 10% CF (instead of 0%) will lead to differing levels of capital increases for a broad range of customers based on levels of utilisation. For example, on a 50% utilised trade loan facility (unconditionally cancellable and meeting other conditions of Footnote 43) with a probability of default (PD) of 0.2% for a loan with 120-day tenor, the pricing will need to change from 1% to 1.1% p.a. For a £10m trade loan facility, this will equate to pricing going from £100k to £110k p.a.

### Recommendations

- Recommend adopting Footnote 43 of Basel CRE20.94, as banks can only apply it if they meet the four conditions set out in the Footnote. This can be subject to an audit process to ensure the criteria set out in the Footnote is met consistently.
- If the PRA does not adopt the National Discretion provided in Basel CRE 20.94, footnote 43 then it is recommended that the 10% CF be phased in starting from 1st January 2030. This is in line with the approach adopted by the EU and will allow banks time to make suitable changes to their processing systems and business practises.

## Conversion factor (CF) calibration for other commitments

{PRA CP reference: Chapter 3. Credit risk — standardised approach (section 3.37 till 3.42) and Question 4. Do you have any comments on the PRA's proposed definition of commitment and proposed CFs for commitments?}

### PRA proposals

- The PRA proposes to apply a 50% CF for 'other commitments' while the Basel 3.1 standards propose a 40% CF. To make their case, the PRA is referencing a Basel Committee paper (somewhat outdated as at 2014), which establishes that CF data collected though the Quantitative Impact Study (QIS) exercises range from 50 % to 75%.

### Concerns and observations

- PRA proposals are based on realised conversion rates for mortgage offers which would typically be assigned to the 'other commitments' category before the loan is drawn down. In the event the PRA conversion rates have been derived from an aggregated data set across a suite of products with no allowance being made for the unique

characteristics of products across retail and corporate asset classes then there is a strong case for disaggregation.

- A 50% CF (instead of 40%) will lead to differing levels of capital increases for a broad spectrum of customers based on levels of utilisation. For example, on a 50% utilised trade loan facility (not unconditionally cancellable) with a probability of default (PD) of 0.2% for a loan with 120-day tenor, the pricing will need to change from 1.4% to 1.5% p.a. For a £10m trade loan facility, this will equate to pricing going from £140k to £150k p.a.

- The example illustrates that banks seeking to maintain comparable margins will face pressure to increase margins by a minimum of 10%. When aggregated across a broad spectrum of Trade Finance products and banks, the market impact is likely to be significant.

### Recommendations

- The case for disaggregation of product sets for corporate exposures is based on the fact that they are subject to the fulfilment of conditions precedent and financial covenants, which give banks the flexibility to stop draw downs and cancel limits in the event the credit deteriorates.

- UK banks and the UK companies they support, will be placed at a competitive disadvantage, as all national regulators are choosing to implement the not unconditionally cancellable facilities (NUC) conversion factor of 40% as recommended by the Basel 3.1 standards.

- Appears to be inconsistent with the PRAs stated objective of aligning with the Basel 3.1 standards.

## Maturity

### Maturity floor for purchased receivables

**{PRA CP reference: Chapter 4. Credit risk — internal ratings-based approach (section 4.309 (d)) and Question 31. Do you have any comments on the PRA's proposals for maturity?}**

### PRA Proposals

- The PRA (Article 162, 2(e)) proposes to align treatment of effective maturity for purchased receivables with the Basel 3.1 standards of a minimum of one year in lieu of the existing 90-day minimum.

### Concerns and observations

- The proposal is not in line with the actual risk profile of the transactions, as receivables transactions have shorter tenors and lower risks.

- Further, as the Basel 3.1 standards do not specify a maturity floor for purchased receivables, it is unclear why the PRA has chosen to set a one-year floor for this asset class

- This will have an impact on pricing and encourage a switch to using overdrafts in lieu of a product which links financing to the underlying sale of goods and services a more secure form of financing than overdrafts

### Recommendations

- As purchased receivables transactions are linked to the sale of goods and services, they should fall within the ambit of the definition of Trade Finance and get the benefit of the maturity floor waiver (MFW)

- It is important to note that liquidity regulations issued by PRA (CP17/21) have already incorporated this aspect. Both on-balance sheet and off-balance sheet factoring are already being treated as 'trade finance' in liquidity regulations and subject to same funding factors.

- Where purchased receivable transactions do not fall within the definition of Trade Finance then the maturity floor of one year should automatically apply

### Maturity for trade products which are open-ended in nature

**PRA proposal**

- The PRA allows banks to use effective maturity as the basis for calculating maturity when using the FIRB approach, in lieu of the fixed 2.5 years' maturity cap.

**Concerns and observations**

- Where products have no fixed tenor and are open-ended in nature (which is commonplace for beneficiaries that are Government departments or local authorities) can banks using the FIRB approach use a 2.5-year cap in lieu of the 5-year cap, with the proviso that effective maturity is the basis for calculating maturity on all other products where a tenor is available.

**Recommendation**

- It is recommended that a 2.5-year cap be used in conjunction with effective maturity for banks following the FIRB approach

## Self-liquidating trade letters of credit (L/C)

{PRA CP reference: Chapter 3. Credit risk — standardised approach (section 3.45 till 3.47) and Question 5. Do you have any comments on the PRA's proposed CFs for issued off-balance sheet items?}

### Single CF for DC with maturity less than one year and greater than one year

**PRA proposals**

- The PRA proposes separate conversion factors (CFs) for letters of credit when maturity is less than one year (20%) and when maturity is greater than or equal to one year (50%).

- This brings it into alignment with Basel 3.1 standards and reflects the higher risk in longer maturity transactions

**Concerns and observations**

- As the empirical data collected by the ICC Trade Register (TR) points to a lower CF irrespective of tenor, the 20% CF is reflective of the true underlying risk for L/Cs. Consequently the 50% is an overstatement of risk as the underlying risk only changes when documents are presented.

- For banks following the FIRB approach, applying a 50% CF to take account of the longer maturity is effectively a double count as maturity is factored in explicitly into the calculation of risk-weighted assets (RWA)

- The CF calibrations and the assignment of 100%, 50% and 20% values first set by the Basel committee in the 1980s for the Basel-1 framework needs a relook based on up-to-date empirical data collected by the industry. This is particularly true for Transaction related contingency items like L/Cs and Guarantees.

**Recommendations**

- It is recommended that the PRA keeps the 20% CF for L/Cs irrespective of tenor as the empirical data supports the case for this.

- In the event the PRA does want to keep the distinction between 20% CF for L/Cs less than one year and 50% CF for L/Cs greater than one year, then it is recommended that this bifurcation be kept only for the banks on the standardised approach as maturity is already an explicit factor in the calculation of RWAs under the FIRB approach.

## Inclusion of goods and services

### PRA Proposals

- Article 111 of the UK Capital Requirements Regulation (CRR) text and Table A-1 within this article sets out the exposure values for off-balance sheet items and commitments. The table does not make explicit reference to 'goods and services' when applying a CF for documentary credits, guarantees and irrevocable standby letters of credit.

### Concerns and observations

- As trade is broader than just 'goods' failing to include services within this definition may lead to practise-based differences in the calculation of risk-weighted assets (RWA) for services transactions

- Excluding services from the definition of trade may lead to a likely reduction in financing capacity with particular adverse effects on small and medium enterprises (SME) financing

- Further, there is likely to be a knock-on impact in the form of increased capital and pricing.

### Recommendations

- Table A-1 is changed to reflect that documentary credits, guarantees and irrevocable standby letters of credit include both 'goods and services'

- It is recommended that the PRA provides a definition of Trade Finance (TF) in line with what was provided in the EU CRR Article 4 (80) and below is the suggested wording:

  *(i) 'trade finance' means financing 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 and (ii) 'trade finance' includes guarantees (or standby letters of credit) connected to the exchange of goods and services.*

## Clarification of text associated with documentary credits

### PRA proposals

- Table A-1 under Article 111 does not incorporate 'documentary credits issued or confirmed' under items 3(b) (50% CF bucket) and 5(a) (20% CF bucket).

- 'Documentary credits issued or confirmed' is included within item 3(a) (50% CF bucket)

### Concerns and observations

- Might lead to improper interpretation

### Recommendations

- It is recommended that the table item 3(b) be amended to read Quote 'Documentary credits that are issued or confirmed in which the underlying shipment acts as a collateral and other self-liquidating transactions with maturity equal to or greater than one year' Unquote.

- In a similar manner item 5(a) be amended to read Quote 'Documentary credits that are issued or confirmed in which the underlying shipment acts as a collateral and other self-liquidating transactions with maturity less than one year' Unquote

## Exposure to institutions

{PRA CP reference: Chapter 3. Credit risk — standardised approach (section 3.79, 3.82) and Question 7. Do you have any comments on the PRA's proposed changes to ECRA, the proposed introduction of SCRA for exposures to unrated institutions, and the proposed treatment of covered bonds?}

### PRA proposals

- The PRA proposes to allow exposures to institutions (rated or unrated) to receive lower risk weights of 20% for short-term exposures, where the original maturity of the exposure is six months or less and the exposure arises from the movement of goods across national borders.

### Concerns and observations

- Limiting this rule set to 'movement of goods' means that services which are an important portion of trade finance globally — and a particularly important component of trade from the United Kingdom — will be excluded even though they form an increasing share of global trade.
- Additionally, limiting this rule to 'across national borders' will exclude in-country trade
- This will lead to services transactions and in country trade being priced higher to offset the increase in capital requirements

### Recommendations

- The inclusion of services-based trade and in-country trade for exposures to institutions (short-term) under the standardised approach is recommended

## When there is a commitment to issue an off-balance sheet item, and there are more than one off-balance sheet items then the lower of the two CFs is to be taken

{PRA CP reference: Appendix 4. Annex C, Article 111, 1. (c)}

### PRA proposals

- The PRA proposes to use the lower of two conversion factors be taken when there is a commitment to issue an off-balance sheet item

### Concerns and observations

- Conversion factors (CFs) aim to account for two events:
  - CF for commitments define the probability that an unutilised facility converts to an issued exposure (which may be on or off-balance sheet from an accounting perspective).
  - CF for issued transaction-related contingent liabilities (for example, issued letters of credit or issued guarantees) define the probability that such issued contingent liability exposures (which are off-balance sheet) convert to an on-balance sheet exposure.
- For an unutilised contingent liability facility, both of the above events (which are independent of each other) need to happen before it becomes an on-balance sheet exposure (i.e. unutilised contingent liability facility -> issued contingent liability exposure -> obligor default -> trigger event (e.g. a claim for a guarantee or a valid shipment followed by a bill presentation in case of a letter of credit) leading to a conversion to an on-balance sheet exposure).

- However, taking the lower of the two applicable CFs is conceptually or mathematically not the correct probability.
- For example, issued letters of credit get a 20% CF. 'Commitment to issue' letters of credit (which are not unconditionally cancellable in nature) will also get 20% CF. This means the risk is expected to be the same whether or not the product in question (letters of credit) is actually issued or not. This is not logical.

### Recommendations

- We recommend that the regulations be amended to state that when there are commitments pertaining to off-balance sheet items, then the two conversion factors should be multiplied.

**Below table highlights the way effective CFs will work as currently proposed:**

| Effective Conversion Factors (CF) | Issued | Unissued / commitment to issue — Not unconditionally cancellable | Unissued / commitment to issue –Unconditionally cancellable | Remarks |
|---|---|---|---|---|
| Loans | 100% | 50% (C) | 10% (D) | |
| Performance guarantees | 50% (A) | 50%* (lower of A & C) | 10%* (lower of A & D) | Using lower of the two CFs |
| Letters of credit | 20% (B) | 20%* (lower of B &C) | 10%* (lower of B & D) | |

(*assuming lower of the two CFs per PRA)

**However, based on correct mathematical multiplicative factors, the CFs should be as shown in the table below (which is the recommendation):**

| Effective Conversion Factors (CF) | Issued | Unissued / commitment to issue — Not unconditionally cancellable | Unissued / commitment to issue –Unconditionally cancellable | Remarks |
|---|---|---|---|---|
| Loans | 100% | 50% (C) | 10% (D) | |
| Performance guarantees | 50% (A) | 25% (= 50% * 50%) (Multiply A & C) | 5% (= 50% * 10%) (Multiply A & D) | Using multiplication to combine two CFs used for independent events to calculate risk of unissued moving to issued and then further moving to on balance sheet |
| Letters of credit | 20% (B) | 10% (= 20% * 50%) (Multiply B & C) | 2% (= 20% * 10%) (Multiply B & D) | |

Note that the above numbers use current proposed CFs i.e., 50% for NUC commitments and 50% for performance guarantees. If the proposed CFs for these items are changed in the final regulations, then these numbers will change accordingly as well

# Credit risk mitigation (CRM) — unfunded credit protection (UFCP)

{PRA CP reference: Chapter 5. Credit risk mitigation (section 5.35) and Question 35. Do you have any comments on the PRA's proposals for recognising UFCP?}

### PRA proposals

- The PRA is introducing a revised formula for calculating risk weights under the parameter substitution method. Under the revised formula, firms will calculate risk weights as the weighted average of:
  - The risk weight that would apply in the absence of credit protection for any part of the exposure not covered by UFCP and a revised risk weight using the PD and the risk weight function of the protection provider, and either the LGD applicable to the exposure (as if there was no UFCP) or the FIRB approach LGD applicable to the protection provider, for the part of the exposure covered by UFCP.

### Concerns and observations

- Using the risk-weight function of the protection provider will mean that the asset value correlation (AVC) for a guarantee received from any Financial Sector Enterprise (FSE) will be subject to a 1.25 scaling factor effectively increasing the capital charge by approximately 33%. This will impact the distribution of Trade Finance assets across a wider set of banks and capital market participants like insurance companies, large asset managers and hedge funds and contribute to a possible increase in the Trade Finance supply gap.
- We consider the capital charge to be excessive, as it not a direct exposure on the FSE, with the guarantee being called upon only in the event the underlying obligor has defaulted and not made good on its obligations to the bank.

### Recommendations

- Given that guarantees, insurance policies (TCI & NPI) are only called upon in the event the underlying obligor has defaulted (whose AVC is the primary driver of associated systemic risk for the bank to lose money on such an exposure), the risk weight formula of the underlying obligor should be used for RWA computation..

# Exposures to public sector entities (PSE)

{PRA CP reference: Chapter 3. Credit risk — standardised approach (section 3.58 till 3.70) and Question 6. Do you have any comments on the PRA's proposed approach to exposures to central governments and central banks, regional governments and local authorities, PSEs, and MDBs? and Appendix 4. Article 116}

## PRA proposals

- The PRA is proposing to remove the discretion provided in the current rules of classifying Public Sector Entities (PSE) as sovereigns. This has an impact on many Export Credit Agencies (ECA) as they are incorporated as PSE entities in many countries
- ECA exposures classified as a PSE, will get a 50% risk-weight when rated as credit quality step (CQS) 2. By contrast multilateral development bank (MDB) exposures with a similar risk profile get a 30% risk-weight for exposures rated CQS 2.
- PRA proposes not to exercise the discretion currently provided under Article 116 (4) of the EU-CRR which caters for PSE exposures to be classified as sovereign exposures, when there is no difference in risk between these exposures because of the existence of an appropriate guarantee by the government.

## Concerns and observations

- As some ECAs are structured as quasi-independent entities backed by a sovereign guarantee, they are not a government entity. Hence, such ECA exposures will get a risk-weight based on applicable risk-weights for PSE entities and not the treatment applicable to sovereigns, leading to material differences in risk-weights.
- As the risks are similar the risk weight differences between MDB and ECA exposures are difficult to justify.
- Not exercising this discretion means that UK banks may not be able to treat an exposure to an ECA as a sovereign exposure even though a third country regulator, may have classified this exposure to be a sovereign exposure. Note this is applicable only when the third country in question is deemed to have equivalent regulation

## Recommendations

- A clarification be provided that where ECAs are structured as quasi-independent entities backed by a sovereign guarantee then they should be classified as sovereigns and get the risk-weight treatment eligible for sovereigns
- If the argument to treat all ECA exposures as sovereigns is not accepted, then the PRA should consider amending the risk-weight table for PSE to apply a 30% risk-weight for CQS-2 exposures
- It is recommended that the PRA exercises this discretion for ECA exposures deemed to be sovereign exposures in third countries where the PRA recognises equivalence.

# PD floor increase from 3bps to 5bps

{PRA CP reference: Chapter 4. Credit risk — internal ratings approach (section 4.197) and Question 27: Do you have any comments on the PRA's proposed PD, LGD, and CF or EAD input floors?}

### PRA proposals

- The PRA proposes to align with Basel 3.1 standards and introduce a PD floor of 0.05% for all exposures *(except UK retail residential mortgage exposures and for QRREs categorised as transactors which would be subject to a 0.1% PD floor)*

### Concerns and observations

- A higher PD floor will create additional capital cost for Trade products against risk counterparties with AAA and AA ratings as well as top-rated insurers which may discourage the industry from applying insurance protection from better rated insurance providers.

### Recommendations

- It is recommended to continue with the current PD floor at 0.03% and not increase the PD floor.

# 5 Key supplementary comments on Trade Finance

## Trade Finance is a low-risk low-default portfolio

Trade Finance (TF) is a segment of the broader asset classes of Corporates and Banks within the regulatory capital framework. However, based on the empirical data collected it is the opinion of the industry and market participants that trade is a low risk (and low default) portfolio generally characterised by short-tenors, self-liquidating with underlying collateral and high-quality counterparties. This is illustrated by the ICC Trade Register (TR), an industry initiative first launched by the Asian Development Bank (ADB) and now sponsored by the ICC. The Trade Register has become widely recognised as an authoritative source of credit related risk data, and a reference point for addressing many of the regulatory concerns pertaining to the use of risk parameters with the standardised and Internal ratings based (IRB) approaches to measurement of credit risk.

The ICC Trade Register has, in past years, provided fairly detailed explanatory text and transactional case studies to further illustrate the character of the trade finance business. This element of the Trade Register Report [3]demonstrates the direct link between certain product and transaction characteristics, and the low risk profile of trade finance. The contingent nature of Documentary Credits and the reality that banks are under no obligation to effect payment in the event of non-compliant presentation of documents, in combination with the ICC/GCD study on claim pay out rates[4] for both the performing and defaulted performance guarantee portfolios are examples here, and directly relevant to the risk character of trade finance.

## Pricing

As pricing decisions must incorporate adequate compensation for risk, and a return on shareholders' capital, some of the proposals outlined by the PRA in the CP, are likely to result in higher capital consumption and will therefore likely lead to an increase in pricing to end-clients including corporates, SMEs and financial institution clients in global correspondent networks.

Note while banks may have a choice not to pass on this increase, this is commercially untenable as the proposed changes will impact a broad spectrum of UK banks. Therefore, price increases will need to be passed on to the end customer.

Further, it is likely to tilt the competitive playing field against UK banks wherever other regulators are proposing differing regulatory treatment for trade finance. (Many regulators are proposing to adopt implementation of Footnote 43, keeping the other commitments (not unconditionally cancellable) at 40% CCF, EU is proposing the 20% CF on performance guarantees).

**3** ICC Trade Register 2022: Executive Summary

**4** ICC/GCD 2022 Performance Guarantees Study

## Product/capital allocation

Internal bank balance sheet and capital constraints also create situations of significant and vigorous internal competition for capital within individual financial institutions. In this context, cost of capital and returns (together with the relationship value of a line of business or product) combine to influence strategic direction, as well as investment decisions aimed at product development, channel expansion and the overall institutional commitment to a particular offering. Overall, this may also result in Trade Finance being perceived as being riskier than other lending products when the exact opposite is true.

Trade finance, in terms of profitability, is perhaps best characterized as solid annuity business generating adequate returns. The comparative advantage of this business has been, and remains, in its favourable risk profile and competitive capital cost. To the extent that the proposed shift in capital requirements dilutes or distorts the latter characteristic of the trade finance business, it will weaken this line of activity relative to other bank businesses and make it increasingly difficult to persuade senior executives to allocate significant capital to this critical enabler of international business, development and economic growth

**ICC United Kingdom is the representative voice for ICC in the UK and provides a mechanism for UK industry to engage effectively in shaping international policy, standards and rules.**

We are the leading voice on digital trade ecosystems, act as the ICC representative to the Commonwealth and Co-Chair the Legal Reform Advisory Board at the ICC Digital Standards Initiative.

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