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Trade's Renaissance in a Time of Regulatory Change

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Over the past three years, transaction banking has been recognised as a key strategic pillar in global wholesale banking. Indeed, since the financial crisis broke in 2008, the world's leading international banks have increased their focus on this genre as a stable form of revenues in a very uncertain business environment.

Within the transaction banking offering, trade finance products, invariably traditional, well-developed instruments, have become more fashionable as clients have sought more diverse forms of financing.

Regulatory discussions, most notably around Basel II and Basel III, have cast something of a cloud on the horizon for these instruments. Trade products are user-friendly – and in the aftermath of the first stage of the crisis, so vital to oil the wheels of trade – but over-regulation has threatened to stifle their use and, ultimately, make them more expensive for clients.

Deutsche Bank, and other major players in the trade finance market, led discussions with regulators over the need to ensure trade products do not become too expensive for clients. This was echoed by the G20 leaders who expressed concern over the possible impact of an over-aggressive regulatory regime on trade-related products, especially given its importance to fast-growing developing countries.

The International Chamber of Commerce (ICC) provided firm evidence of the relatively low-risk nature of this business. The ICC's recently released data revealed that in over USD 2tn of trade, over a five-year period, defaults totaled just 3,000. These statistics covered 65% of the world's trade finance transactions.

The Basel Committee eventually relaxed the Basel III regulatory capital adequacy framework for trade finance by issuing two waivers relating to letters of credit.

Firstly, the committee is waiving the one-year maturity floor for certain trade finance instruments under the advanced internal ratings-based approach for credit risk. This is applicable for issued and confirmed letters of credit and reduces the risk-adjusted capital charge on those assets.

Secondly, the committee is waiving the so-called sovereign floor for certain trade-finance related claims on banks using the standardised approach for credit risk – in other words, on trade loans to businesses in countries where the sovereign debt is unrated. This applies to standardised and FIRB risk-based approaches.

These decisions are important for the market and demonstrate that the Basel Committee recognises the crucial role played by trade finance in low income countries – particularly in the current climate.

It is important to realise that if the cost of capital of a relatively low-risk, low-margin activity like trade finance is the same as a higher-risk, higher-margin activity, banks will naturally gravitate toward the higher-margin business. This is exactly what the Basel Committee is trying to avoid in its far-reaching directives. Therefore, an unintended consequence of Basel III may have been a negative effect on business models and clients' access to the trade finance solutions offered by banks.

These waivers represent only two of the concerns that the trade finance industry has over Basel. There will be further discussions. But trade finance will play a key role in the eventual recovery of the global economy, however slow that now may be. All relevant parties should be aware that overbearing regulation could choke its progress.