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Investment issue to be revived at WTO?

Moves are afoot to initiate discussions at the WTO to draw up multilateral disciplines on “investment facilitation”. If launched, such talks would effectively mark the return of the contentious subject of investment – which had previously been opposed by developing countries as a WTO negotiating issue – to the agenda of the international trade body.

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MAI at WTO under new avatar of MIF?

Proposals have been hatched to launch discussions at the WTO on framing multilateral investment facilitation (MIF) rules, sparking concerns that the controversial Multilateral Agreement on Investment (MAI) could make a comeback in a different guise.

by D. Ravi Kanth

GENEVA: Russia, China and Brazil appear to have intensified efforts to resurrect the failed Multilateral Agreement on Investment (MAI) under a new avatar called multilateral investment facilitation (MIF) rules at the World Trade Organization.

The three are preparing the stage for launching negotiations at the WTO's eleventh Ministerial Conference, which is to be held in Buenos Aires in December, several trade envoys told the *South-North Development Monitor (SUNS)*.

Almost 20 years ago, negotiations on the MAI, which were launched by the United States and other dominant members of the rich-country grouping Organization for Economic Cooperation and Development (OECD), collapsed in the face of worldwide protests from non-governmental organizations spearheaded by, among others, Third World Network.

Despite intense opposition to the investment facilitation initiative from India and South Africa at the G20 sherpas meeting in Berlin in March, their fellow members of the BRICS grouping Russia, China and Brazil have now decided to break ranks on this issue.

Clearly, the three BRICS members seem to have used India's proposal for starting WTO negotiations on trade facilitation in services (TFS) as a basis for their own proposals on MIF.

Significantly, Russia, China and Brazil took the mantle from their industrialized-country counterparts at the WTO to set the stage for robust discussions on MIF rules.

China and Brazil are yet to formally submit their proposals on MIF rules but they shared informally with several countries their proposed elements for discussion, according to trade envoys who reviewed the two proposals.

Russia, however, fired the first salvo by tabling a three-page restricted proposal titled "Investment Policy Discussion Group" to the WTO General Council on 31 March.

Russian proposal

The Russian proposal, almost modelled on the lines of the Indian TFS proposal, argues that WTO members have already undertaken commitments concerning foreign investment under Mode 3 of the General Agreement on Trade in Services (GATS).

It says that "as a general rule, national legal frameworks of WTO members do not differentiate between treatment of investments in services or non-service sectors" – suggesting that "basic laws governing establishment or activity of a juridical person do not depend on the specific sectors of economy where such establishment or activity takes place."

Citing the OECD Code of Liberalization of Capital Movement which "established a single set of basic rules for FDI [foreign direct investment] irrespective of the sector of economy they were made in," Russia says WTO members have used the OECD code in their bilateral investment agreements and free trade agreements that include disciplines for different aspects of investment facilitation.

Therefore, Russia argues, the time has come for incorporating multilateral investment facilitation rules in the WTO rulebook to improve the "investment climate." Such rules, it is claimed, will increase "efficiency for both investors and recipient economies."

Russia has, however, adopted the ruse that the proposed discussions on MIF rules "are not intended to cover such issues as market access and treatment of investments, as well as expropriation and investor-state dispute settlement."

However, everyone knows that such negotiations, once they start at the WTO, assume a life of their own down a slippery slope, said a developing-country trade envoy who asked not to be quoted.

Against this backdrop, Russia wants members to discuss several issues that would pave the way for "multilateral

disciplines” on investment facilitation. It says the MIF rules must remain “comprehensive” in scope, covering a priori all types of goods, traded services or intellectual property rights for investments.

The MIF rules, according to Russia, must aim at bringing about “a transparent, stable and predictable regulatory and administrative framework for investors, without questioning the rights of the members to regulate and without interfering with their policies of protection of investments, including issues of nationalization, expropriation and compensation for losses.”

In reality though, WTO rules become a handle for powerful members such as the US, the European Union and others to exert pressure through the backdoor to accomplish their goals, as demonstrated in the implementation of the WTO agreements on services and intellectual property, several trade envoys said.

“Major elements”

Russia has outlined two “major elements” relating to “transparency” and “domestic regulation” that must remain as the scaffolding for “future investment-related arrangements.”

With regard to transparency, Russia wants members to ensure that the MIF rules include “provisions that provide for transparency for relevant regulations concerning investments, as well as elements that ensure that such regulations provide a stable and predictable environment for investments.”

The elements for domestic regulation of investments, according to the Russian proposal, must lead to “streamlining and simplification of procedures.”

It calls on members to discuss the following procedures:

(i) Procedures and requirements for obtaining necessary permits: The rules should ensure that procedures and requirements for obtaining necessary permits are reasonable and that all relevant information, including exhaustive lists of requirements, is publicly accessible;

(ii) Fees and charges: The rules should ensure that information on fees and charges is publicly available, including information on the reason for such fees and charges, the responsible authority and when and how payment is made; and that such fees and charges are commensurate with the costs of services ren-

dered by such authority;

(iii) Timeframe for administrative actions: The rules should ensure that information on timeframes for administrative actions is publicly available and that such timeframes are reasonable and predictable;

(iv) Dispute prevention and resolution: The rules should include provisions that are aimed at the prevention and amicable resolution of investment-related disputes by availing the investor to refer to judicial, arbitral or administrative tribunals or procedures existing within a member jurisdiction;

(v) Disclosure of confidential information: Members should reserve the right to refrain from disclosing sensitive information;

(vi) Single window mechanisms: The rules should encourage the creation of single window mechanisms for investments and include provisions prohibiting authorities from requesting information already submitted by an investor through a single window mechanism;

(vii) Electronic procedures and online services: The rules should include provisions for adopting or maintaining electronic procedures and online services;

(viii) Penalties: The rules should include disciplines on the imposition of penalties for a breach of regulation concerning investment.

In addition to these particular procedures, Russia wants “government-investor feedback elements” such as mechanisms that enable investors to provide feedback to governments, and “self-assessment mechanisms for members to self-assess their ability to implement the rules.”

Finally, the Russian proposal brings in the issue of market access somewhat surreptitiously as “basis for future market access and treatment disciplines.” “The rules should include elements for their future development and expansion to regulating market access and treatment for investments,” Russia has emphasized.

To appease the developing countries, Russia has also included elements of special and differential treatment by taking the level of development and development needs into consideration.

It has called on members to discuss the following three issues:

(i) Examine relevant recent international investment-related disciplines and share experience regarding national policies and legal frameworks;

(ii) Examine the relation between the WTO legal framework and national legislation as well as international arrangements among members;

(iii) Explore possibilities to strengthen WTO disciplines.

The investment issue in the WTO

In short, the issue of trade and investment has staged a comeback at the WTO, ostensibly to help investors. The return, following several setbacks, is due to sustained attempts by industrialized countries and their new partners such as Russia, China and Brazil.

The chequered history of the issue started when the EU and several other countries brought in investment as part of the controversial “Singapore issues” at the WTO’s first Ministerial Conference, held in Singapore in 1996.

The other three Singapore issues were trade and competition policy, government procurement, and trade facilitation.

The four issues, despite massive opposition from developing countries, found their way into the WTO’s Doha Work Programme launched at the Doha Ministerial Conference in 2001. However, developing countries managed to ensure that negotiations on the four issues would only commence at the WTO’s 2003 Ministerial Conference subject to “explicit consensus” among all members.

At the 2003 meeting, which took place in Cancun, Mexico, the then EU Trade Commissioner Pascal Lamy faced intense opposition from a coalition of developing countries led by Malaysia and India when discussion commenced on the Singapore issues. In the face of sustained opposition, Lamy started withdrawing one after another of the four issues. He encountered opposition even on the fourth issue of trade facilitation, by when the meeting was abruptly terminated by the Mexican host.

Subsequently, Lamy and his counterpart from Washington, US Trade Representative Robert Zoellick, managed to retrieve one issue – trade facilitation – at the meeting of trade ministers who finalized the 2004 July Framework agreement. The US and the EU promised that they would address all the issues in the Doha Work Programme based on the development dimension in return for bringing trade facilitation back into the overall negotiations.

(continued on page 16)

Mexico has fared poorly under NAFTA, says study

Since entering into the North American Free Trade Agreement (NAFTA), Mexico's economic performance has been disappointing, finds a study by a US think-tank.

by Kanaga Raja

GENEVA: Mexico performed poorly over the past 23 years that it has been a party to the North American Free Trade Agreement (NAFTA), with its poverty rate going up while its per capita GDP growth was significantly lower than that of the rest of Latin America during this period.

This is one of the main conclusions highlighted by the Washington DC-based Center for Economic and Policy Research (CEPR) in a report titled "Did NAFTA Help Mexico?: An Update After 23 Years."

The report, released on 29 March, updates an earlier version released in February 2014 and is co-authored by Mark Weisbrot, Co-Director at CEPR; Lara Merling, Research Assistant at CEPR; Vitor Mello, International Program Intern at CEPR; Stephan Lefebvre, a former Research Assistant at CEPR; and Joseph Sammut, a former International Program Intern at CEPR.

"If NAFTA had been successful in restoring Mexico's pre-1980 growth rate – when developmentalist economic policies were the norm – Mexico today would be a high income country, with income per person significantly higher than that of Portugal or Greece," said the report.

It is unlikely that immigration reform would have become a major political issue in the United States, since relatively few Mexicans would seek to cross the border, it added.

"Many people think that since American workers lost out from NAFTA, Mexicans must have benefited, but the data show that this is not true," said CEPR Co-Director Weisbrot in a press release.

"The Mexican economy has performed poorly since NAFTA went into effect, as compared with the rest of Latin America or with its own past; and more than 20 million additional people are below the poverty line," he added.

"As the US and Mexico consider renegotiating NAFTA, there should be a serious discussion of what went wrong for Mexico, as well as for the United

States," Weisbrot stressed.

Economic failure

The CEPR report said that, as was well known at the time of NAFTA's passage, the main purpose of NAFTA was to lock in a set of economic policies, some of which were already well underway in the decade prior, including the liberalization of manufacturing, of foreign investment and of ownership, and other changes.

The idea was that the continuation and expansion of these policies would allow Mexico to achieve efficiencies and economic progress that was not possible under the developmentalist, protectionist economic model that had prevailed in the decades before 1980.

"While some of the policy changes were undoubtedly necessary and/or positive, the end result has been decades of economic failure by almost any economic or social indicator," it said.

The report compared the performance of the Mexican economy with that of the rest of the region since 1994 – when NAFTA came into effect – on the available economic and social indicators, and with its own past economic performance.

On the growth of income per capita in Mexico, the most basic measure of economic progress, the report found that per capita gross domestic product (GDP) has grown by just 28.7% cumulatively from 1994 through 2016. This translates to an average annual growth rate of just 1.2%, which is quite low compared with other countries in the region during this period. Mexico's growth ranks 15th of 20 countries in Latin America (South America and Central America).

"From these numbers, and in the absence of any natural disaster or war in Mexico during the past decades that could account for such poor economic performance, it would be difficult to argue that Mexico would have done much worse in the absence of NAFTA," said the report.

In comparing Mexico's growth rate since NAFTA with that of its past, again

in the context of the rest of the region, the report found that from 1960 to 1980, Mexico almost doubled its income per person, a growth rate that was higher than that of Latin America as a whole.

If this growth had continued, Mexico would be a high-income country today. However, both Mexico and the region suffered a sharp slowdown in the growth of income per capita over the following 20 years, 1980-2000, a period that coincided with, first, a badly handled debt crisis in the early 1980s and then a number of neoliberal policy changes.

Regional growth of GDP per capita dropped from 87% for the prior two decades to just 9% for 1980-2000, or just 0.4% annually. Mexico's per capita growth fell from 97% to 13%, or 0.6% annually.

In the 21st century, there was something of a rebound in the region, with per capita GDP growth averaging 1.5% annually for 2000-16, despite two recessions and a slowdown since 2011.

Looking just at the years since NAFTA, Mexico did not do as well as the region as a whole, averaging 1% in per capita GDP growth for these years.

In examining where Mexico would be today if its income per person had continued to grow at the rate it did over the two decades prior to 1980, the report said that Mexico in 2016 would have an income per person of more than \$39,000 in 2011 international purchasing power parity dollars, which would make its living standards comparable to, or even above, a number of Western European countries.

Looking at poverty levels, the report said that, as would be expected during such a period of very little economic growth, the poverty rate was not reduced in Mexico; in fact it increased. In 2014, Mexico's national poverty rate was 55.1%, compared with the 52.4% rate in 1994. As a result, there were about 20.5 million more Mexicans living below the poverty line as of 2014 than in 1994.

Measures of more extreme poverty – "unable to afford health care, education and food," and "unable to afford food" – improved very little since 1994, falling by just 0.6 and 0.9 percentage points, respectively.

For the region as a whole, there was no progress in reducing the poverty rate for more than two decades, from 1980 to 2002. The poverty rate for the region then fell substantially, from 43.9% in 2002 to 28.2% in 2014.

By the measure of the UN Economic Commission for Latin America and the

Caribbean (ECLAC), Mexico's poverty rate fell from 45.1% in 1994 to 41.2% in 2014 (3.9 percentage points). However, excluding Mexico, poverty in the region fell more than five times as much, from 46% to 25% (21 percentage points).

As for real (inflation-adjusted) wages in Mexico, the report found that there was a fall in real wages of 21.2% from 1994-96, associated with the peso crisis and recession. Wages did not recover to their pre-crisis (1994) level until 2006. By 2014, they were only 4.1% above the 1994 level, and barely above their level of 1980. The minimum wage, adjusted for inflation, fared even worse. From 1994 to 2015, it fell by 19.3%.

Although the unemployment rate jumped during the peso crisis and then fell steadily until 2000, it then increased again until 2014. Unemployment has averaged 4.0% during NAFTA (1994-2016), compared with an average of 3.1% for 1990-94 and a low of 2.2% in 2000.

The report pointed out that NAFTA removed tariffs (but not subsidies) on agricultural goods, with a transition period in which there was a steadily increasing import quota for certain commodities. The transition period was longest for corn, the most important crop for Mexican producers, only ending in 2008.

"Not surprisingly, US production, which is not only subsidized but had higher average productivity levels than that of Mexico, displaced millions of Mexican farmers," the report said.

Examining agricultural employment in Mexico in 1991 and 2007, it found that there was a 19% drop in agricultural employment, or about 2 million jobs. The loss was in family labour employed in the family farm sector. Seasonal (less than six months) employment saw a gain of about 3 million jobs, but it was not nearly enough to compensate for the 4.9 million jobs lost in the family farm sector.

The CEPR report said: "Proponents of NAFTA of course knew that family farms in Mexico would not be able to compete with subsidized US production but argued that displaced workers would shift to higher productivity agriculture (mainly vegetables and fruits for export), as well as industrial jobs."

Although vegetable and fruit production did expand considerably (from 17.3 million tons in 1994 to 28.2 million in 2012), and presumably accounted for many of the 3 million seasonal jobs created, it was clearly not enough in terms of employment.

According to the report, from 1994 to 2000, the estimated annual number of immigrants from Mexico to the United

States soared by 79%, with the annual flow of migrants rising from 430,000 in 1994 to 770,000 in 2000. The number of Mexican-born residents living in the United States more than doubled from 4.5 million in 1990 to 9.4 million in 2000, and peaked at 12.6 million in 2009.

The report said that if the Mexican economy had continued growing at its 1960-80 rate, Mexico would be a high-income country today, and that it would also have become a high-income country if its pre-1980 growth rate had been restored after NAFTA. There would still be a significant income and wage differential between Mexico and the United States, but the incentive to emigrate to the United States would have been tiny as compared with what actually materialized.

"It is questionable whether immigration would have become a political issue in the United States, as it did especially in the 2016 election and now under the Trump administration, if not for the poor performance of the Mexican economy in the post-NAFTA years."

Competition with China

The report pointed out that NAFTA was just one variable among others that could account for Mexico's poor economic performance since 1994. However, it appears to be related to other economic policy choices that have negatively affected the Mexican economy during this period.

It said that today China accounts for 21% of US imports while Mexico accounts for 13.5%. This is very tough competition for Mexico for a number of reasons. First, Mexico has, throughout the vast majority of the post-NAFTA period, been a much higher-wage country than China, although the gap has narrowed and there is no definitive data for China in recent years.

Labour compensation costs in Mexico, in US dollars, were \$3.05 per hour in 1996 and rose to \$5.59 by 2002. For China, in 2002, hourly compensation costs in US dollars were \$0.73. Although these data are not exactly comparable because of differences in their construction, they indicate a huge gap in dollar terms – which is what matters for export or import-competing industries. By 2009, the gap was still very large: \$1.74 for China versus \$6.36 for Mexico. So it was difficult to compete on the basis of wages.

Second, China maintained a commitment to a competitive exchange rate throughout the 2000s, in effect fixing this exchange rate against the dollar or (since

2005) a basket of currencies. The Mexican central bank, by contrast, has had, as the International Monetary Fund notes, "a firm commitment to exchange rate flexibility." In other words, the Mexican central bank would typically raise or lower interest rates as necessary to reach its target inflation rate (3%), and let the exchange rate go where it may.

This means that Mexico's exchange rate was, for most of the past two decades, unlikely to be competitive with China's, which further worsens Mexico's cost disadvantage.

In the past few years, said the report, the Mexican peso has significantly depreciated against the US dollar, while China's currency has seen an overall slight appreciation since 2007. The combination of a rapidly depreciating peso (with relatively little wage growth) in Mexico and rising labour costs in China has narrowed the gap in labour costs between the two countries. "However, it is not yet clear how much difference these changes will make going forward in the competition between Mexico and China in US markets."

CEPR said the Mexican peso is difficult to predict, since its value depends on monetary policy decisions by the Mexican central bank that are unrelated to exchange rate policy, and on decisions of the US Federal Reserve, as well as speculation on international markets.

It noted that China has other advantages that make it a formidable competitor for Mexico in the US market: the Chinese government controls most of the banking system in China and can therefore ensure that its most important exporting firms have sufficient access to credit. In Mexico, by contrast, the banking system is not only private but 70% of it is foreign-owned.

The Chinese government also has an active industrial policy that enables it to help its exporting firms in various ways. China also spends over 2% of its 10-times-larger GDP on research and development, as compared with Mexico's 0.54%.

For all of these reasons, said the report, it is an uphill battle for Mexico to compete with China in the US market.

Although Mexico has done better than other countries in the US market in terms of this competition since China joined the World Trade Organization and achieved "permanent normal trade relations" with the US in 2001, its share of US imports is still only about half that of China's.

NAFTA also increasingly tied Mexico to the US economy. Much of this synchronization is because over two-

thirds of Mexico's exports now go to the United States.

Unfortunately, 1994 was a particularly bad time for Mexico to hitch its wagon to the United States. First came the peso crisis, which was brought on by the US Federal Reserve's increases in US monetary policy rates beginning in 1994. Mexico lost 9.5% of GDP in two quarters during the resulting crisis and recession, which started in December 1994 and continued into the first half of 1995. The fall in the peso helped boost exports for a while, but the peso appreciated as capital flowed back into the country and the advantage of a competitive exchange rate was soon lost.

Perhaps more importantly over the longer run, the US economy was just beginning a period in which its growth

would be driven by enormous asset bubbles. First there was the stock market bubble, which burst in 2000-02, causing a recession in both the United States and Mexico.

The stock market bubble was then immediately replaced by what would then become the biggest asset bubble in world history, the US real estate bubble. This bubble burst in 2006-07, causing the Great Recession. Mexico's loss of output from the US Great Recession (and world recession) was the worst in Latin America, with a decline in real GDP of 6.7% from the second quarter of 2008 to the second quarter of 2009, said the report. (SUNS8435) □

The CEPR report can be found at: <http://cepr.net/publications/reports/did-nafta-help-mexico-an-update-after-23-years>

El Salvador votes for water over gold

In response to enormous public pressure, lawmakers in El Salvador have rejected appeals by global corporations and voted to protect the country's people and water supply by banning metallic mining.

by Pedro Cabezas

The people of El Salvador and their international allies against irresponsible mining are celebrating a historic victory. After a long battle against global mining companies that were determined to plunder the country's natural resources for short-term profits, El Salvador's Legislative Assembly has voted to ban all metal mining projects.

The new law is aimed at protecting the Central American nation's environment and natural resources. Approved on 29 March with the support of 69 lawmakers from multiple parties (out of a total of 84), the law blocks all exploration, extraction and processing of metals, whether in open pits or underground. It also prohibits the use of toxic chemicals like cyanide and mercury.

In the lead-up to the vote, communities in the town of Cinquera had rejected mining through a local referendum and the Catholic Church of El Salvador had called for massive participation in a public protest to demand that legislators start discussions on the prohibition of mining. When the protesters arrived at the Legislative Assembly, on 9 March, they were greeted by a multi-party commission that committed to starting discussions immediately and have legislation ready before the Easter holidays.

Despite the fact that there is a na-

tional consensus among communities, civil society organizations, government institutions and political parties for a mining prohibition, the Australian-Canadian company OceanaGold and its subsidiaries in El Salvador consistently attempted to slow the bill's progress and sought to gain support for their so-called "Responsible Mining" campaign.

The company launched the campaign at a fancy hotel in San Salvador after losing a \$250 million lawsuit against El Salvador in October 2016. The company had filed a claim with the International Centre for Settlement of Investment Disputes (ICSID) demanding compensation when the government declined to grant the firm a permit for a gold extraction project that threatened the nation's water supply. In the face of tremendous opposition from a wide range of groups inside and outside El Salvador, the ICSID tribunal ruled against the company.

When legislators announced that they would begin serious discussion on the mining ban, the company intensified its activities. Besides publishing paid communiqués in local pro-business newspapers, OceanaGold representatives reportedly met with government officials to lobby against the bill.

On 23 March, a pro-mining protest was organized by the El Dorado Foun-

dation (a foundation created and funded by OceanaGold) in front of the Legislative Assembly while the Assembly's Environment and Climate Change Commission deliberated over the bill. It was later reported by the President of the Commission, Guillermo Mata, a lawmaker from the ruling Farabundo Martí National Liberation Front (FMLN), that the busloads of people brought by the foundation from the Department of Cabanas had each been paid \$7 plus a free lunch to attend. They were also directed not to talk to the press. Also on 23 March, Luis Parada, the lawyer who led the defence team for El Salvador in the ICSID case, denounced through his Twitter account a letter sent by OceanaGold and its subsidiary Pac Rim containing veiled threats of further legal action should El Salvador vote to ban mining.

Forging ahead

But the push for a mining prohibition remained strong. To support the anti-mining coalition, Carlos Padilla, Governor of Nueva Vizcaya in the Philippines, visited El Salvador to share his province's adverse experience with OceanaGold. On 28 March, in presentations to the Environment and Climate Change Commission, Padilla reported that the mine had brought no significant economic growth, had violated human rights, and posed a threat to the province's agricultural activity, the environment and future generations.

His testimony helped break down the myths of economic growth and responsible, sustainable mining propagated by OceanaGold. After Padilla's presentation, the legislators on the Commission unanimously voted to advance the Law to Ban Metal Mining to the floor of the Legislative Assembly.

Also in advance of the assembly vote, many foreign organizations and individuals wrote to the president of the Legislative Assembly, Guillermo Gallegos, expressing solidarity with the people of El Salvador and support for the law.

By voting in favour of the mining ban, these lawmakers in El Salvador have chosen water over gold, and people and the environment over corporate profits. And they showed that even a very poor country can stand up to powerful global mining firms. □

Pedro Cabezas is based in El Salvador, where he coordinates the International Allies against Metal Mining. Sebastian Rosemont also contributed to this commentary, which is reproduced from Inequality.org under a Creative Commons licence.

Trade finance: effects of the Basel capital framework and other regulatory developments

This article updates and expands the discussion in *TWE* No. 570 (1-15 June 2014) on the impact of the global agenda for regulatory reform on banks' participation in trade finance. The article includes, in addition to standard subjects under this heading, topics growing in importance such as Anti-Money-Laundering/Know Your Customer regulations, pressures on correspondent banking, and initial indications as to banks' incorporation of environmental issues into their decision making.

by Andrew Cornford

The impact of bank regulation on trade finance is an esoteric subject. It merits only small articles in the main organs of the business and financial press, though more detailed coverage in specialist publications. The Basel capital framework for banks has a central role in the international agenda of financial regulatory reform. The framework has been prominent in discussion of the effects of new regulations on trade finance. This reflects widespread belief, evident in recent industry surveys, that the revised framework has contributed to the slowdown of world trade since the beginning of the global financial crisis (GFC).

Although the Basel capital framework has received the lion's share of the discussion of regulation, capital requirements and trade finance, other subjects have also been raised. Three of these subjects are treated here. One – rules directed at money laundering – is longstanding but has recently acquired greater urgency owing to effects on correspondent banking relationships, which play an important role in the trade of many developing countries. Another subject concerns banks' participation in trade financing through arrangements which enable them to avoid committing their own capital. A third subject is the changes – expected but still largely future – in banks' trade-finance operations in response to the challenge posed by global environmental problems.

Basel capital framework

Banking risk and capital requirements

The objective of the Basel capital framework is to control banking risks through capital requirements and prescriptions as to good risk management. The evolution – still not complete – of the Basel capital framework started with the 1988 Basel Capital Accord (Basel I), which has since been followed by substantially revised versions in the form of Basel II and Basel III. These are agreements drafted by the Basel Committee on Banking Supervision (BCBS), a body originally consisting of a small group of advanced countries but currently with an expanded membership of regulators and central bank governors from 27 countries.

There are various classifications of banking risk with categories that unsurprisingly often overlap since such risk covers the likelihood of loss on a financial asset or other exposure within a specified period for many different causes and in many different contexts. There are four key categories under this heading: *credit risk* is that resulting from loss arising from the failure of borrowers or of parties to other obligations to meet

payments due to the bank; *market risk* is that of loss arising from changes in market prices and other market rates; *liquidity risk* is that due to an entity's inability to meet its obligations as they fall due owing to either insufficient funds on hand or inadequate market liquidity for the sale of assets required for this purpose; and *operational risk* is that of loss due to failures of a bank's internal systems and procedures or to external causes such as legal rulings, government actions, natural disasters or criminal activity. Other categories of banking risk frequently encountered include solvency risk, settlement risk, rating migration risk and event risk, all of which overlap with one or more of the four key categories above.

A bank's capital serves as a buffer against future unidentified or unexpected losses. Expected losses due to credit risk are covered by a bank's loan-loss reserves or provisions. The capital of banks consists of equity and other financial instruments which have the properties of being available to support an institution in times of crisis through reducing the probability of insolvency, i.e., the condition when a bank's liabilities exceed its assets. Financial instruments classified as capital are usually associated with higher rates of return, and are thus a more costly way of financing banks' assets than other liabilities such as deposits and short-term and longer-term debt instruments. The rate of return on capital is a determinant of a bank's pricing of loans and of other transactions involving its exposure to risk. As such, the bank's rate of return is a factor of its competitiveness vis-à-vis other banks.

The Basel capital framework initially addressed primarily credit risk and thus fitted comfortably into this conceptual framework. However, developments in the financial markets and other aspects of banking operations were to lead to extension of its scope from 1996 onwards – firstly to market risk and then to operational and liquidity risk. This extension led to the inclusion of methods of measurement for the purpose of setting capital requirements which could not so easily depend on the longstanding distinction in banks' financial management between expected and unexpected losses – inclusion of which in the Basel agreements was predictably the subject of lengthy negotiations.

The initial versions of the capital framework had two principal objectives:

- One was microprudential, namely to help to ensure the strength and soundness of individual banks – and thus of course, indirectly, of the banking systems of which they are a part.
- The other was to help to equalize cross-border competition between banks (provide “a level playing field”) by

eliminating competitive advantages due to differences among countries in their regimes for capital adequacy.

Since the initiation of Basel III, the objectives of the framework now incorporate a macroprudential dimension. This refers to more explicit acknowledgement than hitherto amongst regulators and other policymakers that many of the risks to a single bank targeted by regulation in crisis situations can spill over into risks affecting many banks and thus threaten essential functions of the financial system such as payments, lending and deposit taking.

As will become clear, the effects of new regulation on trade finance arise primarily under the headings of credit risk and liquidity risk. However, the availability and terms of trade finance can also be affected by factors other than those classified under credit and liquidity risk but which affect banks' financial standing and thus the terms on which they lend.

Basel I

Capital under Basel I was to serve as a buffer against credit risk. Capital was to constitute 8% of banks' risk-weighted assets and – very importantly for trade finance – of their exposures to risk due to counterparties' off-balance-sheet commitments to them.

Measurement of these risk-weighted assets was based on the attribution of weights reflecting the credit risk of different classes of counterparty. Examples of the classes of counterparty in Basel I were sovereign, OECD or non-OECD, other public sector, corporate, etc.

Off-balance-sheet commitments are contracts which are generally excluded from a bank's balance sheet but nonetheless involve a potential future profit or obligation. Off-balance-sheet positions are described in the notes of a bank's financial reports. From the point of view of this article, the most important items under the heading of off-balance-sheet exposures are contingent liabilities such as financial guarantee contracts, including letters of credit that provide for payments to the beneficiary in specified circumstances such as trade transactions.

In Basel I off-balance-sheet exposures were converted to their on-balance-sheet equivalents by multiplying them by credit conversion factors (CCFs). The resulting figures were then weighted according to the credit risk of the class of the counterparty, and the exposure was then estimated as for on-balance-sheet exposures. For example, collateralized documentary credits received a CCF of 20%. The on-balance-sheet equivalent estimated in this way would then be multiplied by the risk weight of the counterparty to which the collateralized documentary credit was made available.

The attribution of credit risk weights under Basel I (0, 10, 20, 50 and 100%) followed a scheme which favoured governments and certain other entities from OECD countries over those from non-OECD countries, and banks over other commercial borrowers.

Through an amendment in 1996, Basel I was extended to cover market risks in banks' trading books. As mentioned earlier, market risks are those due to the impact on a bank's portfolio of tradable assets of adverse changes in interest and exchange rates and in the prices of stocks and other financial instruments.

The rules for estimating a bank's exposures to market risks

are currently being substantially revised, largely in the light of experience during the GFC. Market risks will be mentioned only tangentially in this article since they are not essential to an understanding of the relation between the Basel capital framework and trade finance.

Basel II's response to Basel I's perceived weaknesses

Basel I was originally designed for internationally active banks. However, by the second half of the 1990s, it had become a global standard and had been incorporated into the prudential regimes of more than 100 countries. This was a source of problems for both design and implementation since the rules must be appropriate for cross-border banks with constituent entities in several jurisdictions often subject to regulatory systems reflecting the different histories and different levels of financial sophistication of the countries involved.

Basel I became the subject of increasingly widespread dissatisfaction owing to its crude calibration of credit risks and to the growing importance of practices such as securitization as well as of new financial instruments, for which its rules were not well adapted. Thus a decision was taken to initiate what proved to be the much-lengthier-than-anticipated process of drafting a successor agreement. What was intended to be the definitive version of the new accord, Basel II, became available in mid-2004.

Basel II consists of three pillars in a framework which has been retained in Basel III. Under Pillar 1, minimum regulatory capital requirements for credit risk are calculated according to two alternative approaches, the standardized and the internal ratings-based.

Under the first of these two approaches – the standardized – credit is classified on the basis of externally determined indicators.

Under the second – the internal ratings-based – an attempt is made to disaggregate the different determinants of credit risk:

- the capacity and willingness of the obligor (borrower or other counterparty) to meet its obligations;
- the external environment as it affects the probability of default, the severity of the loss to a bank due to default, and a bank's exposure at default;
- the characteristics of the credit instrument or other exposure in question (loan, facility, debt security, guarantee, etc.);
- the quality and adequacy of so called credit-risk mitigants (described below);
- the maturity of an exposure, i.e., the length of time during which the exposure exists; and
- correlations of positions in the bank's portfolio (which can give rise to concentration risk).

Under the standardized approach, the measurement of credit risk was based on ratings provided by external credit assessment institutions. Export credit agencies (ECAs) as well as credit rating agencies were indicated for this purpose, though the rating agencies were expected to play the more important role.

Banks and non-financial corporations were differentiated according to their credit ratings (the BCBS used those of Standard & Poor's for illustrative purposes) or an analogous measure when there was no rating. For example, according to this measure of credit risk, claims on banks and non-financial cor-

porations rated from AAA to AA- received a risk weight of 20%, while those rated below B- for banks and below BB- for non-financial corporations received a weight of 150%.

Under the internal ratings-based approach, a bank's exposures were classified as corporate, sovereign, bank, retail, equity, purchased receivables and specialized lending.

For corporate, sovereign, bank, and retail exposures, subject to the satisfaction of certain conditions with respect to banks' internal controls and the availability of relevant data, banks were to use their own rating systems to measure some or all of the determinants of credit risk, classified under four headings: the probability of default, loss given default, exposure at default, and the remaining effective maturity of the exposure.

Under the first – foundation – version of the internal ratings-based approach, banks were to estimate the determinants of default probability but were to rely on their supervisors for measures of the other three determinants of credit risk. However, this was not to apply to retail exposures for which banks were to provide their own estimates of all the determinants of credit risk.

Under the alternative – advanced – version of the internal ratings-based approach, banks were to be responsible for estimating all the determinants of credit risk, though the remaining maturity of loans was subject to a floor of one year and a ceiling of five years.

For other exposures consisting of equity or purchased receivables, banks were to calculate credit risk weights on the basis of frameworks which also incorporate to varying degrees banks' own estimates of credit risk's determinants. The formulae differ from those for corporate, sovereign, bank and retail exposures.

The term "specialized lending" covers categories of corporate exposure with special characteristics such as project finance, commodities finance and certain kinds of real-estate financing. The categories include certain specialized types of trade financing. Under the rules for specialized lending, banks that met the supervisory requirements for the estimation of the determination of default probability could use the formula prescribed for the internal ratings-based approach for corporate exposures. Banks not meeting these requirements could use a special set of supervisory categories and risk weights for unexpected losses.

Both the standardized and the internal ratings-based approaches provide for the possibility of credit risk mitigation. This is the use of instruments and transactions which have the objective of reducing credit risk, and thus the risk-weighted exposures in the denominator of a bank's capital requirements, through a sharing or shifting of the risk. Such mitigation can be achieved by collateral, guarantees and certain derivatives designed to hedge credit risk. However, there is a lack of clarity concerning the potential of insurance under this heading.

Unlike Basel I, Basel II and the successor agreement, Basel III, contain regulatory capital requirements for operational risk, which, as mentioned above, covers losses due to events such as human errors or fraudulent behaviour, computer failures or disruptions from external events such as earthquakes. This category of risk has become much more important recently owing to the huge fines which banks have incurred for fraud and other forms of misconduct.

Pillars 2 and 3 of Basel II are concerned with supervisory

review of capital adequacy and with the achievement of discipline in banks' risk management through disclosure to investors.

On to Basel III

Overview

Partly on the basis of quantitative impact studies of Basel II, regulators in different countries became concerned that levels of capital under Basel II were not going to be sufficient. This concern was accentuated by the stress on banks resulting from the GFC.

The initial resulting revisions of Basel II, dubbed Basel II.5, concerned the rules for the market risk of exposures in the trading book, and thus will not be covered in the discussion here which is focussed on the treatment of exposures involving trade finance.

Agreement on major changes to the Basel II rules for the banking book followed in September 2010. The revised rules, now called Basel III, incorporate much of Basel II. But they were also extended and changed (Scott and Gelper, 2012: 586-592):

- Basel III contains more stringent rules for the categories of financial instrument which are eligible for inclusion in different categories of minimum required regulatory capital. Of total minimum required capital of 10.5%, 7% is to consist of equity, the category of capital best suited for absorbing losses.

- The capital is to include a conservation buffer. This consists of equity and is intended to absorb losses during periods of economic and financial stress. The buffer can be drawn down at such times but may be accompanied by restrictions on the distribution of earnings to shareholders.

- Additionally national authorities may impose a countercyclical capital buffer as a way of countering rapid credit growth. This can be relaxed during periods of stress.

- For global systemically important banks (GSIBs) – as defined by the Financial Stability Board (FSB, the body entrusted by the G20 with the task of coordinating the implementation of the different components of the global agenda for financial reform) – there is an additional capital charge in the range of 1% to 3.5%.

- The correlation parameter in the formula for risk-weighted assets in the estimates of exposures to credit risk is now to be multiplied by the factor 1.25 (asset value correlation / AVC multiplier) for regulated financial institutions whose total assets are equal to or greater than \$100 billion and for all unregulated financial institutions whose main business includes lending, factoring, provision of credit enhancements and securitization, all of which could be included in trade finance.

- Basel III now includes rules for the management of banks' liquidity risk. Basel III also includes overall restrictions on the leverage of banks' balance sheets. These are both discussed in more detail below.

- Basel III specifies higher risk weights than Basel II for selected credit and market risks. For example, higher weights apply to a bank's exposures to securitized assets. Securitized assets are pools of financial assets which are individually illiquid but after aggregation become marketable securities.

Securitized assets, particularly pools consisting of packaged mortgages of often questionable quality, played an important role in the illiquidity and insolvency of major parts of the banking sectors in Europe and the United States during the GFC.

The countercyclical buffer is set on the basis of national regulatory discretion and is intended to achieve the macroprudential goal of protecting the banking sector from periods of excess credit growth which can trigger economy-wide financial crises.

The capital surcharge for GSIBs is also to serve the objective of macroprudential stability. Moreover GSIBs are to be subject to additional rules on absorption capacity, another extension of the capital framework to cover macroprudential risks. These rules, enunciated by the FSB, specify total loss absorption capacity (TLAC) in the form of 16-20% of a bank's risk-weighted assets. TLAC will consist of instruments meeting certain conditions as to their capacity for absorbing losses. Such instruments will include some – but not all – of the instruments which count towards Basel III capital minima. The rules are designed to facilitate the resolution of GSIBs during the process following insolvency, minimizing the resulting costs to governments and to taxpayers.

As part of risk-weighted assets, a bank's exposures to trade finance will contribute to determining the level of liabilities to be covered by TLAC. However, only a limited set of banks will be affected by the TLAC rules, which do not pose new questions of principle concerning the management of risks associated with trade finance. They are not discussed further in this article.

Liquidity management

As just mentioned, in Basel III the rules for capital requirements for risk-weighted assets are supplemented by rules for the management of the liquidity risk associated with the relationship between a bank's assets and liabilities.

Since the outbreak of the credit crisis in mid-2007, many banks have faced serious difficulties in obtaining through borrowing or the sale of assets liquidity adequate for the ongoing funding of their operations. A bank's critical condition and the threat of its insolvency are frequently first manifested in deterioration of its liquidity position. Difficulties experienced by banks during the GFC led to unprecedented levels of liquidity support from governments and central banks together with other official intervention such as the arrangement of mergers for weakened or failing institutions.

Under its rules for liquidity management, Basel III defines two minimum quantitative measures intended "to achieve two separate but complementary objectives": the liquidity coverage ratio and the net stable funding ratio.

The liquidity coverage ratio "is to promote short-term resilience of a bank's liquidity by ensuring that it has sufficient high-quality liquid assets to survive a significant stress scenario lasting for one month". The ratio is designed to identify the amount of unencumbered high-quality liquid assets available to offset the net cash outflows which the bank would encounter during short-term stress scenarios specified by its supervisors. Under this standard, the ratio of high-quality assets to net cash outflows over a 30-day period should be at least 100%. Cumulative cash outflows for this purpose are calculated by multiplying outstanding balances of different categories of liability on the bank's balance sheet by percentages

reflecting the expected run-off over a 30-day horizon, and by multiplying off-balance-sheet commitments and contingent liabilities by factors also reflecting expected rates of drawdown.

The bank's off-balance-sheet commitments and contingent liabilities include guarantees, letters of credit and other trade-finance instruments. The drawdown factors for such contingent liabilities are to be determined by national supervisors.

The net stable funding ratio "is to promote resilience over a longer time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis". The ratio is designed to measure the amount of longer-term, stable sources of funding in relation to that required by the liquidity profiles of the assets funded by a bank as well as by the potential for liquidity calls on a bank due to contingent off-balance-sheet obligations over a one-year time horizon under conditions of extended stress. Under the standard, the ratio of available stable funding to required stable funding should be at least 100%.

A bank's available stable funding includes its capital, preferred stock with a maturity of at least one year, other liabilities with effective maturities of at least one year, and the portion of other shorter-term deposits which would be expected to stay with the institution during extended stress scenarios. Each category of stable funding is multiplied by a factor reflecting its degree of stability. Equity capital, for example, is multiplied by 100% and unsecured wholesale funding from entities other than non-financial corporations, sovereigns, central banks and public-sector bodies by 50%.

Required stable funding (RSF) is measured on the basis of supervisory assumptions, reflected in RSF factors, concerning the liquidity risk of the bank's assets, off-balance-sheet exposures and certain other commitments including guarantees, letters of credit and other trade-finance instruments. The RSF factors assigned to different categories of asset approximate the amount of the asset which could not be monetized through sale or use as collateral in a secured borrowing during a period of liquidity stress lasting a year. Off-balance-sheet exposures and contingent liabilities generally require little immediate funding but can be associated with significant drains of liquidity during periods of stress.

The requirement of an RSF factor for off-balance-sheet exposures involves the establishment of an allocated reserve. For the contingent liabilities due to trade finance, the RSF factors are left to national supervisory discretion.

Thus management of banks' balance sheets in accordance with the new standards for liquidity risk will involve estimates of expected net cash outflows and of required amounts of stable funding due to contingent liabilities linked to trade finance. The impact of such management on trade finance will depend on the changes from a bank's existing practices which are required by introduction of the liquidity coverage ratio and the net stable funding ratio.

The details of the rules for required stable funding for most of the instruments of trade finance are left to national supervisory discretion. This has the advantage of providing for flexibility which can take into account variations in national circumstances and in national policy objectives.

Leverage ratio

In addition to capital requirements for credit, market and operational risk and to rules for the management of liquidity

risk, Basel III contains an aggregate leverage ratio. Leverage can be measured in various ways intended to indicate a firm's exposure to loss in relation to its capital.

The BCBS itself has provided a succinct description of the rationale of the leverage ratio as follows: "One of the underlying features of the crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while still showing strong risk based capital ratios [i.e., capital in relation to risk-weighted assets as estimated in accordance with Basel II or national rules – estimation which could and in practice did provide banks with considerable flexibility in setting their levels of risk-weighted assets and thus the denominator of their regulatory capital ratios]. During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses, declines in bank capital, and contraction in credit availability" (BCBS, 2011a: 61).

Thus the BCBS decided to introduce "a simple, transparent, non-risk-based leverage ratio" which would "reinforce the risk based requirements with a simple, non-risk based 'back-stop' measure".¹

The leverage ratio is designed to achieve this objective by setting a minimum level for banks' high-quality (so-called Tier 1) capital in relation to on- and off-balance-sheet positions (where the latter include derivatives and contingent liabilities).

As explained below, the leverage ratio has been a major bone of contention between the trade-finance industry and the BCBS regarding Basel III. Its measurement in Basel III has already been the subject of revisions which may not yet be complete.

Trade finance in the Basel capital framework

Trade finance and credit risk

Trade finance fits into the Basel framework through the rules for credit and liquidity risk and through the position of trade finance in the denominator of the leverage ratio.

The rules for exposures to credit risk, it will be recalled from the discussion of Basel I, prescribed the use of CCFs for off-balance-sheet exposures multiplied by the capital requirement of the counterparty covered by the exposure.

The discussion here can start from the risk weighting for estimating the capital requirements under the standardized approach of Basel II and Basel III.

Where trade finance takes the form of bank lending, the rules are subsumed under those for lending generally. Where trade finance takes the form of off-balance-sheet exposures or contingent liabilities, it is covered by the system of CCFs which has just been described:

- Direct credit substitutes, e.g., general guarantees of indebtedness such as standby letters of credit serving as financial guarantees for loans and securities, and acceptances (including endorsements which entail the same exposure to credit risk as acceptances) are attributed a CCF of 100%, that is to say, they are treated in the same way as lending.
- Certain transaction-related contingent items (such as performance bonds and standby letters of credit related to particular transactions) are attributed a CCF of 50%.
- Short-term self-liquidating trade letters of credit arising

from the cross-border movement of goods (e.g., documentary credits collateralized by the underlying shipment) are attributed a CCF of 20% in the case of both the issuing bank and the confirming bank (the distinction between which will be explained below). Under the 8% capital ratio of Basel II, this would imply a minimum capital requirement of 1.6%, and under the new and higher required capital ratios of Basel III, a somewhat higher minimum capital requirement in the range of 2-2.5%.

In the light of the revision of the rules concerning exposures to trade finance in October 2011, one feature of the standardized approach as originally formulated in Basel II (and retained in Basel III) deserves special attention. Under one of the two options for exposures to banks (Option 2), claims on unrated banks carried a risk weight of 50% (corresponding to a capital requirement in Basel II of 4%) or, in the case of claims with an original maturity of up to three months, a risk weight of 20% (corresponding to a capital requirement of 1.6%).

As a result, unrated banks issuing letters of credit in low-income countries might become eligible for the lower risk weights – and thus lower regulatory capital charges – in the exposures of confirming banks. The latter are typically chosen for the role of confirming – i.e., guaranteeing payment on – letters of credit owing to their location in higher-income countries which are viewed as offering a surer prospect of payments being made under letters of credit.

However, application of these low risk weights was subject to a sovereign floor under which no claim on an unrated bank could receive a risk weight lower than that which applied to the sovereign claims on the country in which it was incorporated. This could have the consequence of nullifying the benefits of the lower risk weights for trade-financing transactions involving claims on unrated banks in low-income, developing countries.

As already explained, under the alternative internal ratings-based approach of Basel II and Basel III for the major categories of exposure to credit risk, banks use their own rating systems to measure some or all of the four determinants, the probability of default, loss given default, exposure at default, and the remaining effective maturity of the exposure. The internal ratings-based approach provides only a framework of rules for estimating one or more of these determinants. Otherwise the actual levels of these estimates are the responsibility of banks themselves.

The following rules for the CCFs for off-balance-sheet exposures for trade finance apply in the internal ratings-based approach of both Basel II and Basel III:

- In the foundation version, the CCFs used to estimate the exposures to instruments of trade finance follow those of the standardized approach.
- In the advanced version, banks make their own estimates of applicable CCFs subject to floors applicable in certain cases.
- Before the October 2011 revision of the rules by the BCBS, in the case of both the foundation and the advanced versions of the internal ratings-based approach, the remaining effective maturity for trade-finance exposures was generally subject to a one-year floor. However, in the case of the advanced version, exceptions to this floor could be accorded to banks at supervisors' discretion in cases which specifically included short-term self-liquidating trade transactions such as "import and export letters of credit and similar transactions".

These “could be accounted for at their remaining maturity”.

Leverage ratio and trade finance

As noted earlier, in Basel III the rules for capital requirements for risk-weighted assets are to be supplemented by an aggregate leverage ratio. In the version fleshed out in the blueprint for Basel III of June 2011, the ratio sets a minimum level of 3% for banks’ high-quality (so-called Tier 1) capital in relation to on- and off-balance-sheet positions (where the latter include derivatives and contingent liabilities).

The items in the ratio’s denominator, i.e., a bank’s on- and off-balance-sheet exposures and contingent liabilities, including those associated with trade finance, were to have a CCF of 100%, and not the lower CCFs allowed in the estimation of risk-weighted exposures for the minimum regulatory capital requirements for credit risk of Basel II and Basel III (described above). The only exception admitted to the CCF of 100% was “commitments that are unconditionally cancellable by the bank without prior notice”. These received a CCF of 10%.

Industry representations and the risks of trade finance

At a general level the target of the trade-finance industry’s representations has been the emphasis of Basel II and Basel III on counterparty rather than product or performance risk. In the industry’s view, this emphasis leads to the attribution of insufficient importance to the risk-mitigating factors of trade-finance instruments such as the self-liquidating character of many short-term trade-finance instruments, their collateralization, and the short maturity of a large part of such financing.

Attention has also been drawn by the industry critics of Basel II and Basel III to the procyclicality of risk weights such as those of the internal ratings-based approach, which are determined by the probability of default and by loss given default, both of which increase during downturns such as the current one, again without proper account being taken of the mitigating factors inherent in the instruments of trade finance.

Failure to take account of the risk-mitigating features of trade financing is held by the industry to be likely to raise capital requirements for all but highly rated borrowers – from developed as well as developing countries. Representations of this kind were initially made by the trade-finance industry early in the process of drafting Basel II. However, only more recently has the industry supported its position with statistical data. Of these, the most important are batches of data assembled under the International Chamber of Commerce (ICC)-Asian Development Bank (ADB) Trade Finance Default Register and under the ICC Trade Finance Register. These were the outcome of an initiative of the ICC and the ADB to extend available information on trade finance. The batches of data have provided support for the expectations of the industry as to the relatively low risks associated with trade finance.

In one of the first batches of data covering 11,414,240 transactions of 14 international banks during 2005–10, the average maturity of the transactions was only 147 days; fewer than 3,000 defaults were observed for the total sample; and fewer than 500 losses out of more than 7.5 million transactions were observed during the crisis period of 2008–10 (ICC, 2011: section 2).

More recently the ICC Trade Finance Register has been

extended with a larger sample of banks. Results now cover both short-term transactions (with a maturity typically of less than a year) and medium- to long-term trade-finance products (defined as loans backed by official ECAs in high-income OECD countries with protection for commercial or political risk or both). Definitions of the Register have been refined to bring data into closer alignment with those of the Basel framework.² Published data for 13 million transactions from 23 banks now cover the period 2007–14, with a separate classification in the case of short-term transactions for export letters of credit, import letters of credit, performance guarantees and loans for import/export (ICC, 2015).³

For short-term financial products, the transaction default rate varied between 0.01% for export letters of credit and 0.22% for loans for import/export. The customer default rate (total number of customer defaults divided by the total number of customers) varied between 0.04% for export letters of credit and 0.72% for import/export financing. These figures compare favourably with the figures for comparable expected default rates of the credit rating agency Moody’s. Most of the products covered other than performance guarantees had a maturity of less than 170 days.

Transaction and customer defaults in the case of medium- and long-term transactions backed by ECAs are also low compared with normal corporate lending. However, ECA backing in the form of insurance or guarantees can reasonably be considered credit-risk mitigation. This could be seen as blurring the usefulness of this category of defaults as indicators of the intrinsic riskiness of medium- and long-term trade finance.

The ICC data on default strongly suggest that the risk actually observed in the case of trade-finance transactions is low and remained so during the GFC. However, other available information suggests that the terms of trade finance nonetheless became widely more restrictive in the early part of the GFC. This, for example, was the conclusion of surveys of commercial banks between December 2008 and early 2010 conducted by the International Monetary Fund (IMF), the Bankers’ Association for Finance and Trade (BAFT), and by BAFT-IFSA (the organization formed by the merger of BAFT with the International Financial Services Association, IFSA), cited in a working paper of the IMF (Asmundson et al., 2011). The less drastic slowdown in global trade in 2011–12 was also accompanied by similar downward movements in trade finance for many countries. But throughout the GFC there has been considerable variation in the experience of banks in different regions, and declines in trade finance have been far from universal (Committee on the Global Financial System, 2014: 16–24).

The unfavourable impact of Basel II and Basel III has been a continuing preoccupation of banks throughout the period since the outbreak of the GFC. According to the description of a recent survey in an ADB brief, 77% cited Basel III as an impediment to trade finance and as an impediment whose importance actually increased in 2015 (Di Caprio, Beck, Yao and Khan, 2016).

Data on reduced availability since the outbreak of the GFC and those in the Trade Registers are not measuring the same dimension of trade finance. The latter indicate no evidence of greater intrinsic riskiness of trade finance as measured by actual defaults during this period. Nonetheless, as just mentioned, trade finance has not escaped the impact of the GFC much of the time and in many countries. Here one can specu-

late that reduced availability may have reflected to some degree the procyclicality of risk weights under the internal ratings-based approach of Basel II and III mentioned in the industry's representations as stated above.

The 2011 changes announced by the BCBS

Changes in the rules for trade finance in Basel III were announced by the BCBS in October 2011 (BCBS, 2011b). The changes involved two waivers:

- Firstly, a waiver of the one-year floor for the maturity of issued and confirmed letters of credit for banks estimating risk weights on the basis of the advanced version of the internal ratings-based approach. (As mentioned earlier, this waiver could already be accorded to banks at the supervisor's discretion in the case of letters of credit and similar transactions.)
- Secondly, a waiver of the sovereign floor under which no claim on an unrated bank can receive a risk weight lower than that of the claims on the country in which it was incorporated. As explained earlier, this waiver could reduce the capital requirement for the trade finance of low-income countries.

2014 revision of the leverage ratio

In a January 2014 document on the leverage ratio, the BCBS shifted its position on risk-weighting of trade-finance items in the denominator of the leverage ratio, which had been the subject of representations of the trade-finance industry that it failed to take account of their low risk (BCBS, 2014).

Short-term self-liquidating letters of credit associated with the movement of goods in international trade (commitments by the bank to pay which are collateralized by the underlying shipments) now receive a CCF of 20% in the case of both the issuing bank and the confirming bank in estimating their contributions to the leverage ratio's denominator. (The confirming bank, it will be recalled, provides a guarantee of payment under letters of credit additional to that of the issuing bank and is usually located in the country of the issuer.) Moreover, certain transaction-related contingent items (such as performance bonds, bid bonds and standby letters of credit, which are vehicles for guaranteeing performance related to particular transactions) now have a CCF of 50%.

CCFs of less than 100% facilitate for a bank the achievement of the target level of 3% for the ratio since the size of the ratio's denominator is reduced.

Further changes in the regulatory framework

Basel III still not complete

One might have expected that the definitive version of Basel III was now ready for agreement but this would have proved overoptimistic. National officials appear still undecided as to the effectiveness of some of the framework's rules. Moreover, there has been no let-up in lobbying by the banking sector concerning levels and methods of estimating regulatory capital. Not least the arrival of the Trump administration in the United States is associated with uncertainty as to its plans for financial regulation, which is further delaying final agreement on Basel III. As of the time of writing, revised rules for market risk, credit risk and the leverage ratio are still at the consultative stage.

Revision of the rules for market risk reflect a view amongst regulators that the GFC indicated that banks' trading activities were still undercapitalized. Moreover, many banks are seen as having gamed the distinctions in the rules of the Basel framework through shifts in exposures between the banking and trading books in order to reduce their capital levels and thus increase their returns to equity. It is conceivable, but not especially likely, that more stringent rules for the dividing line between credit and market risk may have an impact on the rules for trade finance.

Subjects likely to be covered by the revisions of the rules for credit risk are enhanced rules to be met for recourse to the ratings of credit rating agencies in estimating risk weights; rules for the risk weights of exposures to real estate with overriding criteria for borrowers' capacity to pay and for cash flows generated by the property securing the exposure; and a "broader and more holistic" approach to sovereign-related risks. Revisions under the first and last of these headings may have implications for trade finance via their effects on risk weights.

Further revisions of the leverage ratio under consideration include the method for measuring derivative exposures, the accounting framework for the recognition of unsettled purchases and sales of financial assets, the treatment of provisions in relation to total exposures in the denominator of the ratio, alignment of the CCFs for off-balance-sheet exposures in the denominator of the leverage ratio with those in the rules for the risk weights for credit risk elsewhere in the capital framework, and a higher leverage ratio for GSIBs. Revisions of factors determining the CCFs may lead to changes for the CCFs for off-balance-sheet trade-finance exposures. As one scrutinizes proposals under these headings, it is difficult not to wonder how they contribute to achievement of the objective of "a simple, transparent, non-risk-based leverage ratio" designed to serve as a backstop to capital requirements based on risk-weighted exposures.

Additional issues targeted by trade financiers

As part of the Trade Register project, the ICC has submitted further recommendations regarding the standardized approach of Basel III to credit risk. Owing to the interdependence of certain rules concerning off-balance-sheet exposures in the standardized approach and the foundation version of the internal ratings-based approach, these recommendations also affect the latter (ICC, 2015: 28-29).

The recommendations include the following: differentiated treatment of claims on banks less than 90 days old and rolled over by lenders, and trade-finance exposures to corporate counterparties; reductions in the CCF for various categories of commitments and guarantees; specific or lower risk weights for commodity trade finance when supported by strong structures and liquid collateral; greater consistency and clearer guidance concerning the applications of CCFs; and clarification of the risk of exposures covered by insurance contracts meeting the eligibility requirements of the collateral mitigation framework.

The industry has also argued that there should not be a special AVC multiplier of 1.25 for large and unregulated financial institutions for trade finance-related exposures owing to the fact that size and regulatory status have no effect on the low risk of such transactions (Committee on the Global Financial System, 2014: 48).

AML, KYC and correspondent banking

Threats to correspondent banking

In a 2016 survey of banks by the ADB, 90% cited Know Your Customer (KYC) and Anti-Money-Laundering (AML) regulations as impediments to expanding their provision of trade finance (Di Caprio, Beck, Yao and Khan, 2016). Much of the attention under these headings has focused on the effects of these regulations on correspondent banking relationships, especially those between banks in emerging-market and other developing countries, on the one hand, and advanced countries, on the other.

Correspondent banking involves the provision by one bank (the correspondent) to another (the respondent) of account and other services. These include payments and transfers, trade finance, liquidity management, and short-term borrowing and investment in different currencies. Correspondent banking may involve agreements under which the correspondent bank executes payments on behalf of the respondent bank and its customers. It may also involve “nested” correspondent banking where one correspondent banking relationship is also used by banks other than of the initial respondent.

In a survey for the ICC’s 2014 review of trends in trade finance, almost 40% of banks covered reported closing correspondent account relationships owing to the increasing cost and complexity of KYC and AML regulations (ICC, 2014: 39).⁴ Research carried out by the Commonwealth Secretariat found that in 23 countries covered, 17 had experienced a decline in correspondent banking relationships since 2012, and that more than 70% of these closures had taken place since 2015 (King, 2017). Surveys by the World Bank, the IMF and regional associations of banking supervisors indicate the precariousness of many correspondent banking relationships in the present business and political climate. Pressures due to AML and KYC need to be viewed in the broader context of broader prudential regulation more generally. The categories of institution and counterparty most affected have been small and medium-sized banks and exporters, especially in smaller countries (IMF, 2016: 9–10).

Banks’ withdrawal from correspondent relationships is often justified as “derisking”. This is a response not only to AML and KYC rules but also to risks due to armed conflicts and the incidence of economic and trade sanctions, and to tougher enforcement of regulations more generally, which, *inter alia*, has led to large penalties for some banks. Even when banks do not actually withdraw from relationships with certain categories of customer, “derisking” may lead to substantial increases of their fees in the order of 30–50%.

The reduced availability of correspondent banking for smaller developing countries can have, at least in the short run, drastic effects on banking services, and has also handicapped the provision of humanitarian assistance. In May 2016, for example, the correspondent lines of the Capital Security Bank, the only private bank in the Cook Islands (an offshore centre in the Pacific), were cut, with the result that for several days the bank was unable to pay out any money (Caplen, 2017). An example of the frustration by “derisking” of a humanitarian initiative involved a plan by an aid organization to deliver assistance to victims of the Syrian civil war. This ran afoul of the unwillingness of the aid organization’s bank to transfer funds to a neighbouring jurisdiction from which the money

would be transferred across the border by informal *hawala* payments networks (King, 2017: 48).⁵ This illustrates a dilemma facing such initiatives. Moreover, steps leading to dependence on *hawala* rather than banking channels can actually handicap regulators and law enforcement agencies since they become less able to track many money flows which are routed through such informal networks.

Owing to the focus in this article on the disruptive impact of AML and KYC rules on correspondent banking and thus also on trade finance, the discussion concerns principally the situation faced by emerging-market and other developing countries, i.e., those most seriously affected, rather than the participation of institutions in major OECD countries in activities such as money laundering and tax avoidance. The financial sectors of the latter are actually well suited to the establishment of shell companies for these purposes owing to the depth and sophistication of their markets as well as to the anonymity which they can provide (Persaud, 2014). Various evidence points to extensive exploitation in some of these countries of the opportunities which these advantages provide.⁶

Protecting correspondent banking relationships

The policy response to pressures on correspondent banking has predictably emphasized efforts by banks themselves in the form of more rigorous internal controls and compliance as well as better exchange of information amongst institutions through, for example, promotion of the use of the Legal Entity Identifier (LEI). The IMF has particularly endorsed the LEI owing to its potential through the unambiguous identification of banks and customers for enhancing screening and implementation of customer due diligence requirements amongst banks participating in correspondent banking (IMF, 2016: 33).⁷

The effectiveness of measures of this kind is not necessarily simple. In large diversified financial firms multiple layers of authority can handicap internal controls regardless of the intentions of top management, and information exchange amongst institutions – including sometimes the branches and subsidiaries of the same firm – can be hampered by privacy requirements and data-protection rules.

The work under the auspices of the FSB has so far emphasized fact-finding surveys designed to identify more clearly the causes, effects and other dimensions of problems caused by the decline in correspondent banking (FSB, 2016). The aim of this work is to provide guidance to national regulators on actions within their jurisdictions and on cross-border cooperation. Results will take time since action on both national and international fronts will have to deal with thorny problems. National regulators are painfully aware of the shortcomings of their existing systems of identifying money-laundering transactions in vast quantities of transactional data. Cross-border cooperation will prove difficult partly for the usual reasons hampering such cooperation but also because of the complexity and sensitivity of the frameworks of rules within which the cooperation must take place.

Thinking on correspondent banking relationships in the United States is of special interest here because of the country’s role as the principal classifier of countries, organizations and individuals as involved in terrorism and as targets of other AML regulations. A major banking regulator, the Federal Deposit Insurance Corporation, has nonetheless emphasized the importance for banks to take a case-by-case approach to cus-

tomers rather than to cut services to whole categories.

Moreover, other private and official initiatives to mitigate the impact of stricter enforcement of KYC and AML regulations have already been taken or are under consideration. Proposals have been put forward by some banks for an agreed form of certification which would give US banks greater confidence in compliance systems of local banks in other countries. Alternatively there could be an intermediate body which would serve as a clearing house between US and, say, Latin American banks. Under an already existing arrangement along these lines, the Federal Reserve Bank of Atlanta enables financial institutions to transfer funds through the FedGlobal Automated Clearing House to both unbanked and banked receivers in several countries in accordance with procedures compliant with requirements designed to prevent money laundering and terrorism (IMF, 2016: 35).

The eventual impact of such initiatives on correspondent banking relationships will depend on how widely similar steps are also taken by different countries. One can anticipate facilitation of transfers for trade finance and remittances under normal conditions. But success may not extend to financial transfers and banking operations for countries in or close to conflict zones.

New issues

Among developments affecting trade finance which can already be observed and are likely to become more important from both business and regulatory points of view, two will be mentioned here, though they will not be the subject of extended discussion. One involves transactional shifts, and the other the influence of environmental considerations on banking operations.

Under the first heading, the banks have been increasing their participation in trade financing through primarily or exclusively fee-earning activity which does not absorb capital to cover exposure to trade-finance risk. This shift reflects at least partly efforts to economize on capital in response to Basel II and Basel III.

For example, banks' role in supply-chain trade finance can take the form of techniques which avoid commitment of their own capital. Here corporations themselves use their own (currently large) cash balances to finance their supply-chain operations. The role of the bank in such cases is to provide the framework and infrastructure for such financing but not to commit its own funds. Moreover, there has also been some, still limited recourse by banks to securitization in trade finance. Here the process consists of selling to non-bank investors securities backed by short-term trade-finance assets originated by banks (Committee on the Global Financial System, 2014: 27).

A second issue follows from the growing attention of both policymakers and the public to environmental issues. This is reflected in data assembled from banks and discussed in the ICC's 2016 Global Survey of Trade Finance (Voysey, Verhagen and Slater, 2016). The findings of this survey of banks included the following:

- 75% tracked developments and market demands/expectations related to sustainable trade and sustainable trade finance;
- 65% were implementing (or considering implementing) more stringent environmental and social criteria in respect of

trade-finance transactions;

- 55% had rejected trade-finance transactions due to internal or external environmental policies.

The relationship of banks' practice so far to statements of increased awareness of the new context of their operations is difficult to gauge. This is acknowledged by the ICC: "The direction of travel is clear; factoring sustainability into the strategy and operations of banks' trade finance activities is only going to be more important with time. The evolution of sustainable trade finance practice, however, is still in its early stages" (ICC, 2016: 138). Nonetheless the ICC accepts that the agreement to a commitment on restricting the global rise in temperatures at the 2015 Paris climate change conference "is nothing short of an economy-wide industrial revolution".

Some initial steps have been taken in response to this "revolution". A group of international banks convened under the Banking Environment Initiative (BEI) has developed a Sustainable Letter of Credit designed for trade finance for palm oil.⁸ The bank is responsible for checking whether the documentation of the letter of credit includes the "Certified Sustainable Palm Oil" stamp. Banks are eligible for a reduced cost of capital if they book such transactions with the International Finance Corporation under its Global Trade Finance Programme.

The ICC has identified three areas where banks can – and presumably should – take action: client engagement which involves integrating sustainability risk considerations into due-diligence processes and other aspects of relationships with clients; risk screening of trade transactions from a sustainability point of view; and pricing, with banks adjusting their pricing practices to reward better sustainability practices.

A classification of this kind is a useful starting point. But its practical content will depend on the extent and character of the changes in trade relations as countries respond – or fail to respond – to the challenges posed by environmental and sustainability issues. □

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Endnotes

1. Prior to the Basel capital framework, many advanced countries included in their regulatory frameworks gearing and capital/assets ratios. These spanned a range from rules similar to the leverage ratio of Basel III to ratios conceptually closer to the required capital of the post-1988 Basel framework (Dale, 1984: 91-92).
2. For example, the definition of default for the ICC Trade Finance Register is now designed to reflect that of the Basel capital framework.
3. Loans for import/export include loans classified by reporting banks as "trade", including clean import loans, pre-export and pre-import finance.
4. Money laundering can be defined as "washing" financial proceeds to disguise their source, which can be legal as well as illegal activities. Amongst the latter are activities linked to terrorism. Money laundering can involve moving money, reducing its volume and changing its character, while sheltering it from detection and taxation. Knowing Your Customer requires a financial institution to be aware of unusual practices which are not consistent with a customer's business. A new customer's identity and the true ownership of ac-

counts must be verified. Internal controls must be maintained to ensure compliance and detection (Manning, 2000: 293 and 318).

5. *Hawala* is a payment method which operates through a network of agents in different countries who maintain running balances with each other that are settled periodically.

6. Activities in the United Kingdom and the United States analogous to those in more frequently cited offshore centres are described in McCann (2006: Chapters 17 and 18).

7. The Legal Entity Identifier is a code used to provide unique identification to legally distinct entities that engage in financial transactions. It is issued by Local Operating Units of the Global Legal Entity System (IMF, 2016: 30).

8. The BEI was convened by the University of Cambridge Institute for Sustainability Leadership (CISL) with the mission of leading the banking industry in collectively directing capital towards socially and environmentally sustainable development.

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However, during the negotiations on all issues of the Doha Work Programme between 2005 and 2008, the US created several roadblocks to paralyze the talks while ensuring that negotiations on trade facilitation continued uninterrupted.

With effective assistance from successive Directors-General of the WTO, particularly the current head Roberto Azevedo, according to trade ministers and envoys, the US along with the EU and other industrialized countries achieved their goal of a binding agreement on trade facilitation at the WTO's Ministerial Conference in Bali, Indonesia, in 2013.

After bagging the trade facilitation agreement, the US simply walked away from addressing the remaining core de-

velopmental issues in the Doha Work Programme and eventually, with its supporters, atrophied the Doha Development Agenda (DDA) negotiations in 2015 at the WTO's tenth Ministerial Conference in Nairobi, according to people who took part in the meeting.

In a nutshell, the developing countries, which seem fragmented and splintered, will find it difficult to stop the onward march of investment facilitation rules at the coming Buenos Aires meeting, unless they remain solidly united behind their DDA issues, several trade envoys said.

Of course, much would also depend on what the US proposes to do in relation to investment facilitation rules, particularly given the Trump administration's aversion to multilateral agreements, trade envoys said. (SUNS8436) □

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