INTERNATIONAL CHAMBER OF COMMERCE

The world business organization

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

23 March 2015

Subject: Revisions to the Standardised Approach to credit risk

Dear Ladies and Gentlemen,

The International Chamber of Commerce (ICC) Banking Commission welcomes the opportunity to respond to the proposals published by the Basel Committee on Banking Supervision (BCBS) entitled “Revisions to the standardised approach (RSA) for credit risk” and “Capital floors: The design of a framework based on standardised approaches”. The industry supports the recalibration of the existing framework which is aimed at ensuring its continued suitability for calculating the capital requirements for credit risk exposures, increasing risk sensitivity and improved comparability across the different approaches to measurement of credit risk.

As the industry body representing global banks active in the area of Trade Finance, our comments and recommendations which are attached to this letter are focused on the impact of the proposed new regulatory initiatives on trade finance exposures.

Given the duration that the existing framework including the treatment of off-balance sheet exposures has been in place, we concur with the BCBS, that a review of the framework is timely. Our comments and recommendations outlined enclosed for consideration, are focused on off-balance sheet exposures and the calibration of credit conversion factors (CCF), given their particular relevance in the context of trade finance.

By way of background, the ICC Banking Commission is a leading global standard setting body for the banking industry. For over 85 years it has a key role to play in bringing the industry together and promoting cooperation and stability in cross-border trade by providing a forum for professional exchange among its over 600 members in 93 countries.

The ICC Banking Commission highly appreciates the opportunity to respond to the specific queries raised by the BCBS in the consultation paper.

Yours sincerely

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ICC Banking Commission
RSA – ICC Response

INTRODUCTION

The International Chamber of Commerce (ICC) Banking Commission welcomes the opportunity to respond to the consultation paper of the Basel Committee on Banking Supervision (BCBS) on *'Revisions to the standardised approach (RSA) for credit risk' and 'Capital floors: The design of a framework based on standardised approaches'*. The industry supports the recalibration of the existing framework which is aimed at ensuring its continued suitability for calculating the capital requirements for credit risk exposures, increasing risk sensitivity and improved comparability across the different approaches to measurement of credit risk.

Given the duration that the existing framework including the treatment of off-balance sheet exposures has been in place, we concur with the BCBS, that a review of the framework is timely. Our comments and recommendations outlined below for consideration, are focussed on off-balance sheet exposures and the calibration of credit conversion factors (CCF), given their particular relevance in the context of trade finance.

EXECUTIVE SUMMARY

The following submission proposes to clarify certain product and transaction-based characteristics of trade finance, with the objective of ensuring appropriate and equitable regulatory treatment of trade finance activity, aligned with both the BCBS's objectives, and the views of industry specialists on the precise nature of trade finance.

The ICC Banking Commission respectfully proposes several definitional clarifications, reviews relevant commercial and risk characteristics related to trade finance, and proposes specific treatment of certain products based on the BCBS Consultation Paper. The text which follows proposes clarifications to definitional text related to CCF, Commitments and Contingencies. Additionally, the Banking Commission recommends:

- Differentiated treatment for claims on banks less than 90 days old and rolled over
- Differentiated treatment for trade finance exposures to corporate counterparties
- CCF for Commitments be revised to 20% or 50% based on exposure/product, in lieu of 75%
- The application of 0% CCF for certain types of trade finance commitments
- Recalibration of CCF from 50% to 20% for certain types of trade-related guarantee exposures
- Continued use of external ratings for emerging market MDBs when they not highly rated or qualifying MDBs
- That consideration be given to the introduction of a new sub-clause aimed at providing greater clarity and guidance around the application of CCF to off-balance sheet items.
- A redrafting of clause 53 aimed at ensuring consistency in the application of CCF to Letters of Credit (L/C)
- That the Basel Committee provides specific guidance relative to appropriate/best practices in the reporting of CCF, specifically around aggregation of sub-limits covering multiple products and the risk weighting assigned in the context of such structures.
- Specific or lower risk weights for commodity trade finance when supported by strong structures and liquid collateral
- Clarify the use of insurance contracts issued by ECAs and other insurance companies when they satisfy the eligibility requirements for set out under the collateral mitigation framework.

The ICC Banking Commission appreciates the opportunity to respond to the specific queries raised by the BCBS in the consultation paper. We propose that important definitional clarifications can flow from the consultation process and that the probabilities linked to CCF can be better aligned to commercial realities and industry practice.

TRADE FINANCE

Definitional Clarifications and Nuances

Definition of CCF: The dual use of CCF as a means of: (i) estimating off-balance sheet exposures and (ii) as a proxy for the estimation of the likelihood that undrawn commitments when made available for off-balance sheet exposures will be drawn, has been the source of varying practices within banks. Whilst an off-balance sheet exposure and a commitment to create an off-balance sheet exposure are similar in nature, they are not identical. It is recommended, that either the definition of CCF be revised or a clarification be made to include the use of CCF as a proxy to determine the utilisation of undrawn commitments.

Definition of Commitments: There is a case for updating the definition of commitments as it was last done in 1986, and banking practice has evolved significantly since that time. Such an update should clarify the meaning of terms such as: commitments, limits, facilities and lines and within the broad term commitments revocable versus irrevocable, conditional versus unconditional and committed versus uncommitted as these terms in practice are used interchangeably (sometimes without it being clear in which context). Updated examples of what constitute revocable and irrevocable commitments would also be useful, together with an overhaul of the definitions in part 1 of the glossary of the 1986 paper (which contains definitions / descriptions of guarantees and similar contingent liabilities) many of which are unhelpfully misleading in light of current banking practice.

Definition of Transaction Related Contingencies: A formal definition of transaction related contingencies for products which fall within the ambit of this definition, along with recognition that products may share overarching limits will reduce variability and promote comparability across reported risk weights.

For further elaboration on all three definitional issues please refer to the section 'Responses to Basel Committee Questions on CCF'.

Proposed Revisions to the Standardised Approach for Credit Risk

(2.1) Exposures to banks: It would seem inappropriate to implement a system where banks that are not subject to Basel III standards are forced to calculate and report metrics on a Basel III basis. Given that local regulators would not verify these numbers it is unclear how this will work in practice, particularly as the alternative for such banks would be a punitive and commercially untenable 300% risk weight. This will have a knock on impact on short-term trade related transactions which often involve inter-bank exposures (e.g. confirmation/negotiation of export L/Cs and trade related guarantees). In this context it is worth noting that since many banks who have not adopted Basel III will frequently be involved in real economy trade business, they would be impacted by the proposed changes. Further, since the incidence of default amongst such banks has been insignificant and since trade related exposures are one of the safest asset classes due to their preferred status when a country or counterparty event arises, it is our recommendation to continue with the use of external ratings where available.

We recommend that the existing use of external ratings for Bank exposures, where available, should continue

Treatment of short-term claims

We recommend a differentiated treatment for short term claims which are less than 90 days old and are rolled over.

The proposal not to extend a differentiated treatment to short-term claims which are less than 90 days old when they are subject to roll-over is punitive since many short-term trade related facilities are subject to utilisation in line with the working capital cycle of a company. Even though the working capital cycle may necessitate the roll-over of trade lines it should be noted that in practice, given that banks are controlling drawdowns and repayments on a transaction basis, they have the ability not to finance transactions if a decision not to finance is indeed made. It is therefore our recommendation that short-term claims for trade related exposure be exempt from the proposed roll-over clause. Trade finance draw down is different from overdraft. In the case of overdraft, the bank has little or no control over drawdowns and repayments.

(2.2) Exposures to Corporates

We recommend a 20% reduction in risk weights for corporate trade finance exposures, with a cap on risk weights of 150% for such exposures

Given the low risk nature of trade finance as supported by the ICC trade register data and the direct support to real economy activities and global trade flows, there is a case for arguing in favour of a differentiated treatment for corporate trade finance exposures. In this context, applying a preferential risk weight in line with the treatment proposed for short-term claims for banks under section (2.1) is proposed. The recommendation is also consistent with the treatment accorded by the committee for trade finance products when calculating the leverage ratio (applying risk based CCF factors for off-balance sheet trade products).

(2.7) Off-balance sheet exposures (Commitments)

Application of a 75% CCF to Commitments

We recommend that the CCF for Commitments should be the exposure/product based CCF of 20% and 50%, not 75%.

Reason 1- Maturity: Whilst we recognise that the alignment of CCFs across different approaches is a laudable objective, it is unclear why the committee feels that 75% is more appropriate than the existing 50% and 20% CCF values which distinguish between commitments less than and greater than one year in duration, particularly as maturity is explicitly recognised under the internal ratings based foundation approach (IRB). Doing away with the maturity distinction eliminates risk sensitivity and penalises off-balance sheet exposures (e.g. documentary letters of credit (L/C), acceptances and guarantees) which are typically short-tenor in nature, and are core to the overall capacity of the banking industry to finance international commerce.

Reason 2- Alignment: In this context, providing guidance that Annex 1, section 10, clause 55 will apply when the availability of off-balance sheet exposures (e.g. import L/C, export L/C confirmations, acceptances and guarantees) and officially supported export credits are structured as committed facilities/limits is an important addition to the current BCBS paper in our view. These terms are used interchangeably to reflect current practices within banks and in line with both regulatory intent and banking practice, the CCF for these facilities will be the exposure/product based CCF of 20% and 50% and not 75%. This will assist in keeping the existing risk sensitivity but also help in achieving the BCBS's objectives of greater alignment across different approaches. We note that such a clarification will bring about greater consistency with the Capital Requirements Regulation (CRR) in the European Union (EU) and reduce variability in reported risk weights.

Application of 10% CCF to commitments that are unconditionally cancellable

We recommend the application of a 0% CCF to commitments for certain Trade Finance based facilities.

Whilst the industry acknowledges the reasons outlined by the document for the application of a 10% CCF it should be noted that for a number of trade related products, uncommitted lines are structured and operated in a manner where facilities/ lines can be withdrawn. Further, given the nature of trade all drawings are subject to individual review and approval either by the banks' operations, risk or relationship teams. For example, banks will evaluate each request for the opening of an L/C or the proposed text of the guarantee meets banks' internal standards before issuing them. This is particularly the case when obligors' creditworthiness deteriorates and that deterioration is identified through due diligence and account monitoring activity. Putting a cost on the unutilised portion of these uncommitted lines will require banks to charge for them. This has the potential to reduce usage of credit facilities, already felt by public sector and international authorities, as well as the end-client. As well as being an impediment to the pursuit of international commercial opportunities. We note that applying a 10% CCF will still not be consistent given that it will remain at 0% under the IRBF approach.

Certain transaction related contingencies

We recommend the recalibration of the CCF values for certain trade related guarantee (e.g. bid bond/performance/advance payment/retention) exposures from 50% to 20%.

This is supported by a case study published by the ICC Trade Register in 2014. (Please refer Q 18 for details). This case study, though based on a limited data pool clearly shows that the CCF applicable to Trade related guarantee exposures is far lower than the recommended 20%. Bringing the CCF value down to 20% allows for some buffer, while appropriately reflecting risk, and concurrently aligning the Basel rules with the Capital Requirements Regulation (CRR) in the European Union (EU), reducing one potential source of variability in risk weighted assets reported by banks.

It is recommended that the work done by the ICC Banking Commission on the Trade side be supplemented by a detailed industry study on the overall calibration of CCF values and current modelling practices adopted by banks on the IRB approaches. The Banking Commission stands ready to assist the Basel committee in this process as we believe that such a study will help in determining relevant risk drivers and prudent levels of capital for trade finance as an asset class without unnecessarily penalising the industry.

(2.9) Exposures to multilateral development banks (MDB)

We recommend the use of external credit ratings to assess risk weightings of all MDBs that do not meet the eligibility criteria for highly rated MDBs or the reduced criteria for qualifying MDBs under the revised standardised approach.

The industry strongly believes that the fall back treatment of exposures to non-eligible MDBs being classified as corporate exposures is not fit for purpose for determining risk weights for such institutions as they have differing ownership structures, financial ratios, business models and management structures and in many cases even benefit from preferred creditor status. We agree that where a MDB meets the criteria listed in Annex 1, section 3, paragraph 11 (a), they should be treated as an eligible MDB. As many emerging MDBs may not always fulfil the requirements of paragraph 11 or the reduced criteria requirements outlined under paragraph 11(b) for qualifying MDBs there is a strong likelihood of a knock on negative impact on the availability of trade credit in such countries. To avoid possible negative effects in developing countries we recommend the continued use of external ratings.

Annex 1

Section 10 Off-balance sheet items

Clause 49: The text states that off-balance sheet items will be converted into credit exposures by multiplying the committed but undrawn amounts by a credit conversion factor. Further, clauses 50 to 56 set out the CCF factors applicable to transaction related contingencies, commitments and other products. As clause 49 refers only to the application of CCF as a proxy for estimating the committed but undrawn amounts it is recommended that the proposed text be amended as proposed **quote** 'off-balance sheet items will be converted into credit exposures by multiplying the committed but undrawn amounts and the drawn amounts by a credit conversion factor' **unquote**. This will make it clear that the CCF is applied to estimate the utilisation of undrawn limits and the exposure value of off-balance sheet products which will include transaction related contingencies.

A potential alternative solution is to make it clear that the CCF is applied only to off-balance sheet exposures as a means of converting such exposures to on-balance sheet exposures and introduce a new term 'drawdown or conversion factor' to explain the likelihood of undrawn amounts of off-balance sheet products (e.g. L/Cs and Guarantees) being drawn down, when they are structured as facilities/limits/lines. This may require the introduction of a new sub-clause.

We recommend that consideration be given to the introduction of a new sub-clause aimed at providing greater clarity and guidance around the application of CCF to off-balance sheet items.

Clause 53: This clause applies a 20% CCF to L/Cs which are backed by the movement of goods and goes on to explain that L/Cs are generally collateralised by the underlying shipment of goods. We recommend the redrafting of this clause because in practice, this definition has been subject to varying interpretations by banks and regulators with knock on implications for the variability in risk weights reported by banks. The essential characteristics of documentary letters of credits or L/Cs are briefly set out below, to assist in ensuring intended and appropriate treatment of these products by the BCBS:

- An L/C, when issued by a bank, is an irrevocable written undertaking given by a bank—at the request of a buyer (or "applicant")—to pay a seller ("beneficiary") of goods or services up to an agreed maximum amount, provided that the seller presents before expiry of the L/C, a defined set of documents specified in the L/C. These instruments are without exception issued subject to ICC's Uniform Customs and Practice ("UCP").

- The short-term nature of L/C transactions has been demonstrated by the data collected under the ICC Trade Finance Register—the results highlight that L/C transactions have an average tenor of 110 days.

- Often in an L/C transaction, as well as recourse to the applicant for reimbursement, a bank will have some form of recourse to the underlying goods to which the LC relates. Recourse of this kind may take a number of forms dependent on the nature of a particular transaction and/or the relationship between a bank and its customer. In some circumstances, rights may be obtained via the use of negotiable bills of lading—i.e. bills made out to a consignee whose name is left blank or to "bearer" or to "order"—which can transfer property in or rights concerning the cargo covered. By mercantile custom, these bills of lading have come to be treated as documents of title to cargo; although it only confers the "right" to obtain a delivery order subject to payment of any outstanding charges and not an outright title to the goods. It should also be noted that a much broader range of documents or agreements may be used to provide security in L/C transactions, including bank drafts and bills of exchange, frequently included in the documentary requirements defined under the applicable letter of credit.

- It is also the norm that an L/C exposure is repaid by money generated by the assets that the instrument is used to purchase. The repayment schedule and maturity of an L/C will typically be designed by an issuing bank to coincide with the timing of the assets' income generation (e.g. the sale of goods by the applicant).

- L/Cs are not just restricted to goods but can also cover services.

We recommend that this clause be redrafted along the following lines. **Quote** 'A 20% CCF will be applied to both issuing and confirming banks of short-term commercial letters of credit arising from the sale of goods or the delivery of services (For example: Documentary Credits with an underlying shipment of goods by sea, land, or air, evidenced by the presentation of documents).' **Unquote**

Calibration of CCF for Guarantees and L/Cs: A linked issue worth highlighting is the calibration of CCF parameters for banks on the IRB approach. At one level it is fairly simple to estimate CCF for off-balance sheet exposures and undrawn commitments at product level or at least at an aggregated level for products with a similar risk profile. However, as there is a regulatory expectation to model exposure-at-default (EAD) at a facility level and as a facility can have sub-limits and a number of products as part of this limit, banks have the flexibility to adopt varying aggregation methodologies in estimating CCF. In practice, as CCF is reported as a single number at a facility level, banks have the freedom to make assumptions on utilisation of facilities/products and use differing aggregation methodologies. This operational flexibility has presented banks with modelling challenges, and has been the source of variability in risk weights reported by banks, providing additional guidance and promoting best practices on this issue would be welcome.

We recommend that the Basel Committee provide specific guidance relative to appropriate/best practices in the reporting of CCF, specifically around aggregation of sub-limits covering multiple products and the risk weighting assigned in the context of such structures.

Capital Floors: The design of a framework based on standardized Approaches

It is the industry's view that the introduction of capital floors for banks on the IRB approach will have the undesirable effect of reducing risk sensitivity, increasing systemic risk as capital ratios will converge and ultimately raise the cost of borrowing for trade finance customers. Capital floors, if set at an artificially high level will give wrong incentives to banks that currently have higher quality trade finance and commodity portfolios and negate many of the benefits trade finance enjoys under the current IRB approach.

We therefore recommend that in lieu of floors, the committee pursue and refine the existing work done on creating more consistency and less variability in risk weighted assets (RWA) or tweak the capital floors to take into consideration the benefits currently enjoyed by trade finance exposures under the IRB approach

Commodity Trade Finance (CTF)

CTF is a sub asset class within Trade Finance. It straddles specialised lending and corporate exposure class and is focused on the financing of commodity companies using a number of trade finance products/instruments (e.g. L/Cs, guarantees, trade loans) which are collateralised by liquid commodities. CTF as a business is penalised under the proposed rules as it takes a borrower specific approach and ignores the structured nature of CTF transactions and the collateral supporting them. The use of leverage and revenue as a risk metric to determine capital charges for CTF is not recommended as there is very little reported risk differentiation in the leverage ratios and revenues are volatile as they are vulnerable to variations in commodity price levels. An alternative set of financial measures such as gross margins, solvency and liquidity factors, averaged over a multiyear period, in combination with qualitative factors such as quality of management, risk management sophistication, trading practices and hedging methodology are considered to be far more useful indicators. While we acknowledge that finding a simple and risk sensitive approach for CTF is challenging, it should at least revolve around the factors proposed above instead of those currently proposed. Since it is the industry norm to ensure that CTF transactions are highly structured and backed by easy to value liquid collateral for which markets exist we recommend introducing the following alternatives.

- Specific risk-weights for CTF, taking into account structure/collateral, particularly where the exposure is 100% covered by commodity collateral
- Recognise liquid non-financial collateral like, exchange-tradable commodities within the credit risk mitigation framework, similar to gold
- Introduce lower risk-weights for CTF, at least when supported by a strong structure and collateralised liquid commodities

Responses to Basel Committee Questions on Credit Conversion Factors (CCF)

Q17. Do respondents consider the categories for which a CCF is applied under the standardised approach to be adequately defined?

In broad terms, the ICC Banking Commission considers that there is opportunity for clarification related to definitional text around the CCF, particularly in light of product and transaction characteristics that are core to the business of bank intermediated trade finance. Current definitions can be enhanced on the basis of consideration of the following:

CCF Definition

Credit conversion factor (CCF) as defined in the Basel text and as operationalized by banks, is a means by which categories of off-balance sheet exposures are converted to on-balance sheet exposures (i.e. nominal principal amounts are multiplied by a CCF value based on the nature of transaction or commitment) which are then appropriately risk weighted according to the nature of the counterparty. Whilst the application of CCF to off-balance sheet exposures under the standardised approach is the normal practise within banks, the additional use of CCF values as a proxy to estimate the utilisation of facilities/limits under the standardised and internal ratings based foundation approach (IRB) has proved to be challenging for banks.

These challenges stem from the original definitional focus on off-balance sheet exposures without subsequent clarifications that the CCF values used to categorise off-balance sheet exposures as on-balance sheet exposures can also be used as a proxy to estimate the likelihood of drawdown of unutilised facilities/limits.

Commitments Definition

Commitments as defined by the original Basel text make a distinction between commitments which are in practice binding on a bank in all circumstances (irrevocable) and those from which a bank could withdraw, notably in the event of a deterioration in the credit quality of the borrower (revocable). However, having made this distinction between revocable and irrevocable, the examples given for irrevocable commitments include some facility types (e.g. standby facilities and irrevocable revolving lines of credit) that are more typically provided on a revocable committed basis. A facility for any product can be provided on an uncommitted (or committed, or committed once drawn) basis so to describe a product as irrevocably committed (or otherwise imply it can only be made available on one basis of commitment) is misleading and unhelpful for many products, particularly trade products.

Very few (if any) trade product facilities are made available on an irrevocably committed basis. Even where a facility involves the bank issuing irrevocable commitments to third parties (eg issuing an L/C under an L/C issuance facility) it does not mean that the bank must have made an irrevocable commitment to the applicant (its customer) to provide the facility. There are actually five bases of commitment on which a bank could provide such a facility. Below are brief descriptions using an L/C issuance facility as an example.

- **Uncommitted**: if an L/C facility is uncommitted, this means the bank has no obligation to issue any L/C the customer asks it to issue. The bank can refuse to issue for any reason and without any obligation to give reasons. Any "limits" stated in the documentation for this type of facility are not amounts up to which the bank has committed to provide the facilities but an indication of the bank's maximum potential appetite for providing that type of facility to that customer. They do not bind the bank in any way. If the bank agrees to issue an L/C under the facility, the bank will be making an irrevocable commitment to the beneficiary of the L/C but not to the bank's customer. If the facility is truly uncommitted, having issued an L/C under the facility and so taken on an amount of off-balance sheet exposure to its customer, the bank will have the right at any time to reduce or extinguish that exposure to its customer by requiring the customer to provide cash cover. Holding cash cover might be characterised as reducing the loss given default to zero rather than extinguishing the exposure but because it is not possible to cancel the irrevocable commitment made to the third party beneficiary of the L/C, reducing the loss given default to zero is the only practical equivalent to extinguishing the exposure that is available.

- **Revocably committed once drawn:** this means the bank has no obligation to issue any L/C the customer requests, but if the bank does issue, it cannot require the customer to provide cash cover unless one or more specified events (often termed an "event of default" or "termination event") happens. The events specified usually relate to deterioration in the customer's credit quality or a dispute or other problems with the trading activities of the customer that the L/Cs issued under the facility are supporting. Any "limit" specified in the facility would be an indication of the bank's appetite for exposure, not a binding limit, but in practice it would be less likely that the bank would agree to go above the limit than might be the case with a truly uncommitted facility.

- **Irrevocably committed once drawn:** same as a revocably committed once drawn facility except there are no trigger events that could entitle the bank to demand cash cover, so once the bank has issued the L/C it is irrevocably committed to its customer as well as the beneficiary of the L/C and cannot demand payment from its customer unless and until the bank is obliged to make a payment under the L/C. This type of facility is uncommon but is sometimes provided for large customers in some industry sectors (e.g. oil).

- **Revocably committed:** this means the bank has an obligation to issue any L/C the customer requests subject to certain utilisation conditions being satisfied. The bank's rights to call for cash cover after utilisation will be the same as under a revocably committed once drawn facility. Some utilisation conditions will relate to the L/C and the underlying trade transaction to which it relates. Others will relate to the credit quality of the customer at the time of the request. The utilisation conditions related to credit quality usually amount to a condition that the same or a slightly more stringent set of events of default that trigger the bank's right to demand cash cover have not happened or are not continuing. Any "limits" specified in this type of facility would be binding in nature, i.e. the bank would, subject to satisfaction of the utilisation conditions be bound to issues L/Cs with a total face value of up to the specified limit until the commitment availability period ended.

- **Irrevocably committed:** In practice, this type of L/C facility does not exist because even if the credit quality of the customer was so good as to justify no trigger events entitling the bank to call for cash cover after issuing an L/C, the utilisation conditions relating to issues other than the customer's credit quality would have to be included. For instance, no bank would commit to issue an L/C in any form (e.g. without an expiry date) or to any beneficiary (e.g. to a sanctioned entity) or in support of any underlying trade transaction (e.g. one involving the sale of sanctioned goods or services to a sanctioned country). If such a facility did exist, the bank would be obliged to issue L/Cs with a face value up to the facility's limit until the committed availability period ended.

- **Variations:** Above are descriptions of the five basic types of commitment but there could be variations of these. For instance, you could have an L/C facility that had a revocable utilisation commitment, but that was irrevocably committed once drawn. Since the combination of many variations in the types of commitments along with their interchangeability with products can become complex in practise, there is a case from a simplicity perspective, to focus on the facility level rather than the product level.

Transaction Related Contingencies Definition

Letters of credit (L/C), guarantees (financial, bid bond, performance, advance payment, retention, customs duty and other guarantees) are classified as transaction related contingencies, however, as there is no formal definition of what constitutes transaction related contingencies clarifying what transactions fall under the purview of this definition will provide banks with the necessary clarity required for the application of CCF values. In this context, it should be noted that as transaction related contingencies are off-balance sheet exposures, applying a CCF value is necessary not only to derive the on-balance sheet exposure value of these exposures but to the extent they are structured as facilities/limits the CCF value is also applied to determine the level of commitment to make the undrawn part of the facilities available.

It is standard industry practice to treat letters of credit (L/C), guarantees (GTE) and other transaction related contingencies as stand-alone products that can be made available on a one-off, ad hoc basis or under pre-agreed facilities/limits that may or may not be committed and may be subject to different types of commitment. It is recommended that this industry practice be taken into consideration when clarifying the definitions of CCF.

Q18. Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

We respectfully submit to the BCBS, that the probabilities implied by current definitions and approaches to the determination of CCF, can benefit from further refinement, to align with industry practice that is consistent with the regulatory objectives of the Basel Committee.

CCF Calibration for Guarantees

A case study on a guarantees portfolio published in the ICC – Trade Register report of 2014, is outlined below to make a case for the application of a 20% CCF value for certain trade related guarantee exposures. Based on this case study there is a strong case for conducting a broader study on the calibration of CCF factors across the entire range of products/transactions/ commitments.

Overview

This case study on guarantees with a particular focus on performance related guarantees seeks to establish the low risk nature of performance guarantees by analysing a regional portfolio of performance guarantees. To establish the low risk nature of these performance guarantees the case study provides:

- A brief description of the various types of performance and project related guarantees used by market participants
- Tracks the process which triggers a claim, settlement, default and losses on these guarantees by means of a flow chart
- Applies this process to a portfolio of guarantees to derive the default rate on these guarantees

The conclusion that is meant to be supported by the following illustration is that the probability of drawdown can vary significantly based on the intent of a Guarantee and the nature of the underlying transaction, and likewise to illustrate qualitatively, that the risk profile of this category of instruments is favourably low.

Description of Types of Guarantees

Market Practice: It is becoming increasingly common in the market to issue guarantees which are subject to the provisions of the 'International Chamber of Commerce (ICC) rules Uniform Rules for Demand Guarantees (URDG) 2010, revision, ICC publication 758'.

Tender/Bid-Bond (TEB): This bond is a pre-requisite for a commercial or trade related tender and is issued to support the applicant's tender for a contract. The bond will be claimed by the beneficiary in the event that the applicant is awarded the contract but is unable to proceed further.

Performance Bond(PEB): Is a common type of guarantee which covers a wide range of trade-related obligations, a performance guarantee supports the applicant's obligation under the contract and can be claimed in the event of non-performance or non-delivery.

Advance Payment Bond/Guarantee (APB): This bond is issued on behalf of the applicant to cover receipt of an advance payment for a commercial or trade-related contract. The bond will be claimed if the applicant does not meet its obligations under the terms of the contract.

Retention/Warranty/Maintenance (RTB) Bond: This bond is usually issued after completion of a contract to support the applicant's obligation to maintain the goods or services for a specified period of time.

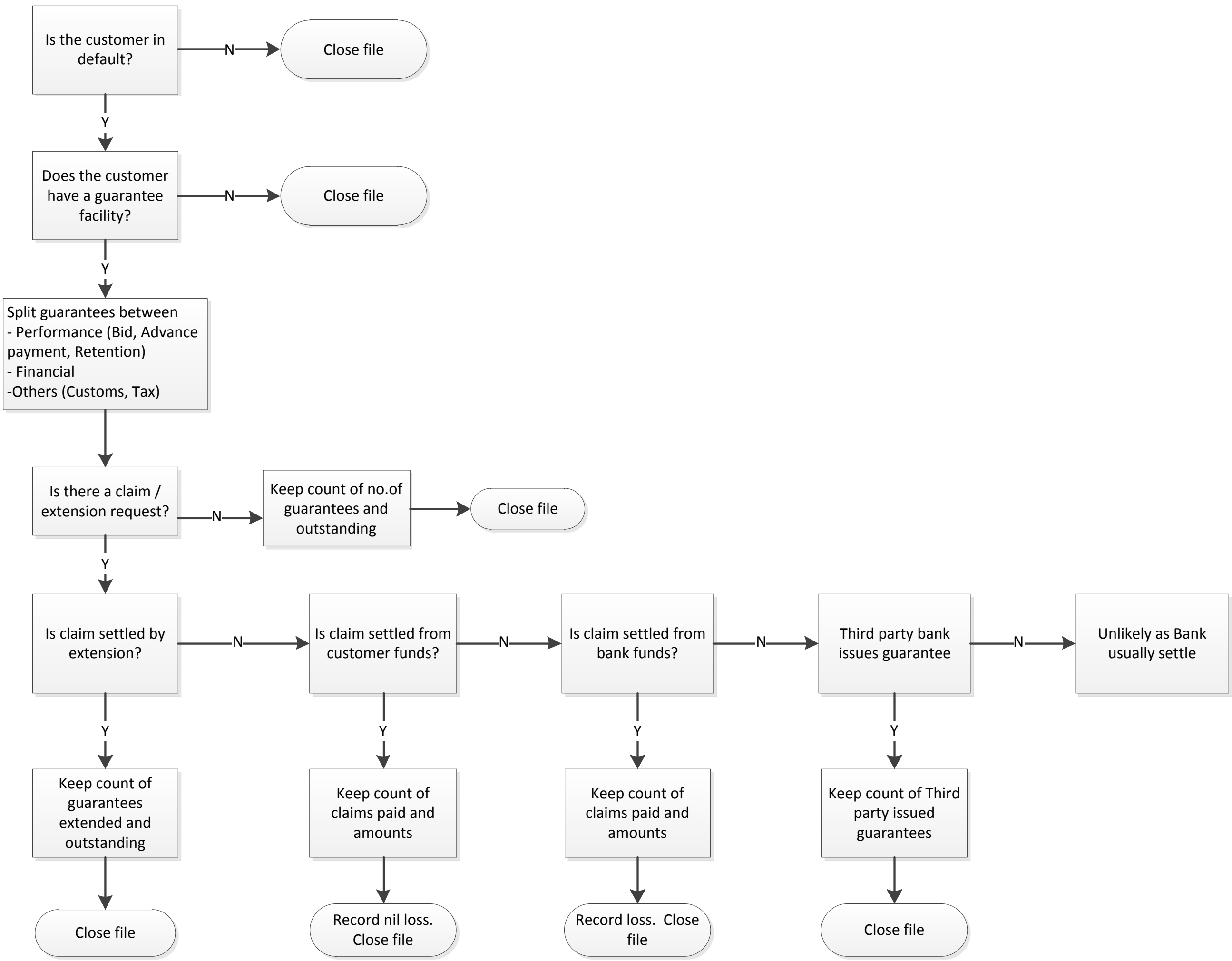
Customs Duty (CSB) Bond: A Customs Guarantee is issued to support the importer's obligation to pay for import duty in relation to regular shipments of goods into the country or in connection with the issuance of a Carnet. Non-payment of import duties will trigger a claim on this guarantee.

Financial Bond (FNB): A financial Guarantee is issued to support various types of financial obligations of the applicant which allows the beneficiary to claim upon non-payment of monies, for example, rent payments under a lease agreement, utility payment in lieu of a deposit, or the obligations of the issuer of a commercial paper or note.

Government Agency Bond (GAB): This Guarantee is issued to support a payment obligation to a government agency e.g. labour, immigration, and is usually in a fixed text dictated by the agency. Note in many instances these guarantees are often subject to local law and ICC rules are not acceptable. Failure to meet obligations will trigger a claim.

Legal Bonds (LGB): A legal bond is an irrevocable undertaking to make a payment into court on demand by the relevant court. The trigger for such a demand will usually be a judgement or an award for (legal) costs being made against the applicant and the applicant failing to satisfy (i.e. pay to the relevant claimant or into court itself) the amount of that judgement or award for costs.

Process Flow for Claims, Defaults and Losses on Guarantees: To capture the process by which guarantees can trigger a claim which could translate into a default and a loss a flow chart is shown below. . For ease of reference, we have limited the source of repayment/settlement to customer, bank and third party bank guarantee. However, in practice a repayment could also come from sale of collateral, insurance payment or sale of debt in the secondary market.



Analysis of Guarantees Portfolio: Applying the process flow chart for recording claims, defaults and losses on a portfolio of guarantees irrespective of whether the customer in question is in default indicates the following:

Year	Total Number of Guarantee Transactions	Extend or Claim Requests	Number of claims paid from customer funds/bank funds	Claims paid from customer funds	Claims Paid from Bank funds	Conversion Factor
2012	9,900	-	118	118	Nil	1.19%
2013	10,700	-	113	113	Nil	1.05%

Estimation of CCF as per the regulatory guidelines should be based on the defaulted population of corporate obligors but as the defaulted population of obligors is small, CCF values derived from this population are very low, so as a proxy we have taken the total population of corporate obligors including defaulted obligors with guarantee facilities and then tracked the extension/claim requests and counted all claim requests paid whether they are from customer funds or bank funds. Note estimating CCF based on the total population will not be the equivalent of estimating CCF based on the defaulted population of customers. However, the point to note is that CCF values estimated either way are lower than the regulatory defined values. The approach taken in the above illustration is conservative, yet supports the view that there is room for consideration in applying a 20% CCF to bank guarantees.

When claims are paid from customer funds there are two situations and both are analysed below.

Situation 1: Claim triggered and paid from customers funds with obligor/customer not in default as per the Bank's internal definition of default which is also consistent with the regulatory definition of default. Though the customer has sufficient funds, because the claim has been triggered it is classified as a defaulted transaction (i.e. technical default) however, it does not translate into a loss.

Situation 2: Claim triggered and paid from customer funds with obligor/customer in default as per the Bank's internal definition of default. As obligor is classified as defaulted customer and as a claim has been triggered the transaction counts as a defaulted transaction, however if customer has sufficient funds no loss may be triggered. Note there is a strong likelihood that the transaction will incur a loss as the obligor is in default but loss may be registered under the overdraft account.

The transaction count for guarantee transactions also includes transactions for defaulted customers. Note all claims in 2012 and 2013 have been paid from customer funds or cash margins held by the bank so no losses have been incurred by the bank on the portfolio. In estimating a conversion factor for the guarantees portfolio we have taken all the claims paid irrespective of whether they are from customer funds or bank funds and this indicates that the conversion factor for the guarantees portfolio is low.

To further substantiate the case for lower CCF values for guarantee exposures, data collected from a select few banks in 2014 is given below.

(Amount 000)	Performance guarantees issued	Claim requests made	Claims paid	Percentage claims not made	Percentage claim made but not paid	Percentage claim made and paid
Total Transactions	117,989	17,003	15,818	85.6	1.0	13.4

The CCF factor for this portfolio of guarantees is 13.4%.

Q24. What are respondents' views on the proposed corporate guarantee eligibility criteria?

There is an opportunity to clarify the use of insurance contracts in the calculation of capital requirement. This is when they satisfy the minimum operational conditions necessary to be recognised as a valid risk mitigant tool

The industry acknowledges that claims on sovereigns and their central banks is not within the scope of the current proposals since the committee is considering an alternative approach to such exposures. There is however, a case for clarifying that the use of insurance is a valid risk mitigant tool, similar to the use of guarantees and credit default swaps (CDS), when these instruments are issued by Export Credit Agencies (ECAs) and fulfil the appropriate operational and legal conditions set for guarantees in Annex 1 section 5 clauses 125, 126, 127 and 128..

It is considered important to highlight the crucial role played by officially supported Export Credit Agencies (ECAs) which participate in the "Arrangement on Officially Supported Export Credits" supported by the OECD (Organisation for Economic Co-operation and Development). ECAs help SMEs as well large corporate groups to secure export contracts and to create jobs in their home countries. In addition to direct lending programs, ECAs offer unfunded credit protection in the form of guarantees and insurance contracts, with a cover rate usually ranging from 95 to 100%. The covered loans are extended to banks, corporates and sovereigns, which are often unrated, especially when they are established in low income countries. It is also important to highlight that due to their countercyclical nature, ECA credit insurance/guarantees can help overcome market disruption and maintain the flow of credit and exports during crisis scenarios.

It is therefore recommended that external ratings should be used for the part of the loan covered by ECA credit insurance/guarantees. The risk weighting of ECA credit insurance/guarantees should be categorized according to the sovereign rating of the respective country supervising the ECA.

For the portion of the loan not covered by an ECA, if any, banks should be free to choose to use the risk scores published by individual ECAs that are recognized by their national supervisors, or the consensus risk scores of ECAs participating in the "Arrangement on Officially Supported Export Credits", as currently recognized within the existing Basel II framework and suggested under Annex 1 (Section 1 - Exposures to sovereigns - Clause 6) of the proposed document.

Additionally, there is also a case for clarifying that similar to guarantees and credit default swaps, other insurance contracts which meet the minimum operational and legal conditions set out under section 5 clauses 125, 126, 127 and 128 of Annex 1 be recognised as eligible collateral in the calculation of capital requirements. In this context it should be noted that it is the norm for many trade finance exposures to be collateralised by insurance contracts. In this context we would like to refer to the clarification provided by the committee in December 2002, under the Bank for International Settlements (BIS) frequently asked questions section. See link attached (http://www.bis.org/bcbs/qis/qis3qa.pdf).

INTERNATIONAL CHAMBER OF COMMERCE
The world business organization

The International Chamber of Commerce (ICC)

ICC is the world business organization, a representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world.

The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. Its conviction that trade is a powerful force for peace and prosperity dates from the organization's origins early in the 20th century. The small group of far-sighted business leaders who founded ICC called themselves "the merchants of peace".

ICC has three main activities: rule setting, dispute resolution, and policy advocacy. Because its member companies and associations are themselves engaged in international business, ICC has unrivalled authority in making rules that govern the conduct of business across borders. Although these rules are voluntary, they are observed in countless thousands of transactions every day and have become part of the fabric of international trade.

ICC also provides essential services, foremost among them the ICC International Court of Arbitration, the world's leading arbitral institution. Another service is the World Chambers Federation, ICC's worldwide network of chambers of commerce, fostering interaction and exchange of chamber best practice. ICC also offers specialized training and seminars and is an industry-leading publisher of practical and educational reference tools for international business, banking and arbitration.

Business leaders and experts drawn from the ICC membership establish the business stance on broad issues of trade and investment policy as well as on relevant technical subjects. These include anti-corruption, banking, the digital economy, marketing ethics, environment and energy, competition policy and intellectual property, among others.

ICC works closely with the United Nations, the World Trade Organization and intergovernmental forums including the G20.

ICC was founded in 1919. Today its global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. National committees work with ICC members in their countries to address their concerns and convey to their governments the business views formulated by ICC.

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