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EBCAM / Afrika-Verein Policy Paper

Basel IV: Is financing foreign trade with Africa going to become more difficult?

As a consequence of the 2008 financial crisis, attention has been drawn to improving banking supervision and regulation in order to make the financial system as a whole more resilient to risks. With Basel IV[1]*, an expanded set of rules is now being discussed, which the European Commission has proposed for implementation in Europe by means of the draft Capital Requirements Regulation III (CRR III). This proposal is currently being negotiated in the European Council and the European Parliament.*

In this paper, the European Business Council for Africa (EBCAM) and Afrika-Verein der deutschen Wirtschaft (German-African Business Association) do not intend to discuss the necessity of Basel IV, as it is obvious that the aim of tightening banking regulation is not to make foreign trade more difficult, or more difficult with respect to Africa in particular. Rather, there are proposals in Basel IV that, as an unintended side effect, may have a negative impact on the financing of international trade and thus also on trade with Africa.

In particular, the consequences of the following five proposals for the financial sector in the EU are addressed in this paper:

1. Provision of fixed Loss Given Default (LGD) rates
2. Increased Credit Conversion Factors (CCFs) on foreign trade guarantees
3. Maturity restrictions (provision of a fixed maturity of 2½ years) on short-term foreign trade financing
4. Disadvantaging companies without external ratings
5. Use of derivatives (e.g., currency hedging transactions) made more difficult

1. Provision of fixed Loss Given Default (LGD) rates

In the past, financial institutions were able to set Loss Given Default (LGD) rates based on their own advanced internal models and thus manage their risk appetite. This approach has thus far proved its worth, and has enabled banks in the EU to manage their African business activities in a risk-sensitive manner based on prior experience. This will no longer be possible to the same extent in the future, as the LGD will be fixed for all banks.

EBCAM and Afrika-Verein recommend that banks should retain the option of setting individual Loss Given Default rates, at least with respect to their foreign trade business.

2. Increased Credit Conversion Factors (CCFs) on foreign trade guarantees

To successfully conduct their foreign trade business with Africa (and the rest of the world), companies in the EU need a large number of letters of credit and guarantees, such as performance bonds, bid bonds, and advance payment bonds.

Basel IV provides that, in future, banks will have to take contingent liabilities (including letters of credit and foreign trade guarantees) into account at 50 percent and no longer at 20 percent when calculating risk-weighted assets (RWAs). Ceteris paribus, this would result in more than double the required RWAs, which would put considerable strain on the EU banking industry's willingness to finance foreign trade.

EBCAM and Afrika-Verein recommend that the current provisions in Basel II / CRR II for banks' foreign trade positions (contingent liabilities) remain unchanged, especially in light of the fact that

[1] EBCAM and Afrika-Verein use the term "Basel IV" to refer to the Basel Committee on Banking Supervision's (BCBS) document "Basel III: Finalising post-crisis reforms". The term "Basel IV" is more widely used in the public domain and for reasons of clarity also used here.

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the International Chamber of Commerce has also determined an industry-wide CFF of 0.24 percent for trade finance.[2] This makes trade finance one of the lowest-risk positions in bank balance sheets.

3. Maturity restrictions (provision of a fixed maturity of 2½ years) on short-term foreign trade financing

The foreign business activities of banks described here (mainly letters of credit and guarantees) have a short-term structure; less than one year, especially with Africa. If, however, a fixed maturity of 2½ years were to be taken into account instead in the calculation of RWAs, this would result in significantly increased RWAs, which would dramatically overstate the actual risks from the effective residual maturity of a transaction. This would also have a considerable negative impact on the financial sector's ability to adequately support EU industry in its trade with Africa.

EBCAM and Afrika-Verein recommend retaining the provisions of the existing CRR II for foreign trade business (i.e., allowing the use of the effective residual maturity for the RWA calculation). This regulation has proven its worth time and again.

4. Disadvantaging companies without external ratings

The application of the Standardised Approach for risk weighting does not reflect the reality of the financing structure of European banks and trade with Africa. In particular, it does not take into account the high proportion of companies without external ratings in Europe (80 percent) as well as in Africa (import/export). As a result, the risk weighting for transactions with these non-externally rated companies increases disproportionally to 100 percent, even if the credit risk is assessed as investment grade by the banks.

EBCAM and Afrika-Verein recommend that banks should retain the option of using individual ratings as a basis for calculating RWA weightings (internal models), at least for foreign trade business.

5. Use of derivatives (e.g., currency hedging transactions) made more difficult

The Standardised Approach also makes it more difficult to use derivatives as hedging instruments (e.g., currency hedging transactions) as it proposes an increased RWA burden in these cases. Particularly in foreign trade, currency hedging transactions are unavoidable, as the USD is the dominant currency of trade invoicing around the world (and in Africa as well). A tightening of restrictions here would represent a clear competitive disadvantage for EU industry.

EBCAM and Afrika-Verein recommend that derivatives under the CRR III (e.g., currency hedges) are not overweighted in RWA calculations, and that transactions with corporate clients are treated equally (in line with the CRR II provisions).

Further accompanying measures

EBCAM and Afrika-Verein also regard the following measures as necessary to facilitate the financing of business activities in Africa and to strengthen the competitiveness of companies in the EU:

- Export credit guarantees: Create a European 'Supra' ECA, especially for large infrastructure investments (within EU Global Gateway Initiative) and natural resources sourcing (UFK-schemes).
- A further and co-ordinated expansion of EU support programmes for exports to Africa

[2] ICC (International Chamber of Commerce). https://iccwbo.org/publication/icc-trade-register-report/

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