INTERNATIONAL CHAMBER OF COMMERCE

The world business organization

Global Policy Team

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Treatment of trade finance assets under the proposed CRR3: potential adverse consequences for recovery of the real economy from the Covid-19 pandemic

The International Chamber of Commerce ("ICC") – the institutional representative of more than 45 million businesses in over 130 countries – warmly welcomes the objectives of the proposed Capital Requirements Regulation ("CRR3"). As a global organization, we fully recognize that a robust and stable financial system is an essential foundation to enable economic growth, entrepreneurship and opportunity for all.

Based on extensive consultations in recent weeks – with financial institutions, European multinationals and representatives of small and medium-sized enterprises ("SMEs") – we are, however, deeply concerned that two provisions in the draft CRR3 may have severe unintended consequences for the provision of cost-effective trade finance to the real economy.

While trade finance represents only a small proportion of the assets regulated by CRR, the potential impact of the changes contemplated by the draft regulation could have far-reaching consequences for the competitiveness of EU-based companies trading (or seeking to trade) internationally – and, moreover, for the achievement of the laudable targets set out in the European Green Deal.

By way of context: the World Trade Organization (WTO) estimates that over 80% of international trade relies on some form of trade finance.[1] This means that any company – from SMEs to large multinationals – require access to trade finance products whenever they need to import essential components, when they market their products abroad and when they try to secure international contracts.

Given that international trade will be a vital form of relief for many companies – particularly SMEs – in the wake of the Covid-19 pandemic, we encourage EU policymakers to pay careful attention to ensure that trade finance assets are not regulated in a penalizing manner under the final CRR3.

In this connection, we would like to highlight two provisions within the draft regulation which, we firmly believe, deserve revision: (i) the increase in CCF for Technical Guarantees from 20% to 50% and (ii) the effective maturity recognition for Trade Finance. based on the imperative to secure the supply of cost-effective trade finance to the real-economy and the available empirical evidence we encourage the policy makers to review these points. A full elaboration of our views follows below.

[1] World Trade Organization. Trade Finance and SMEs (2016). https://www.wto.org/english/res_e/booksp_e/tradefinsme_e.pdf

INTERNATIONAL CHAMBER OF COMMERCE
33-43 avenue du Président Wilson, 75116 Paris, France
T +33 (0)1 49 53 28 28 **F** +33 (0)1 49 53 29 42
E icc@iccwbo.org www.iccwbo.org

I. Increase in the CCF for "Technical Guarantees" from 20% to 50%.

Technical Guarantees

Referred in CRR3 Annex bucket 2 as performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions and similar transaction-related contingent items. (See: CRR3 Article 111 and Annex 1)

Background[2]

Technical Guarantees are a traditional trade finance product widely used in the real economy. These guarantees are required by any company, large or SME, whenever they aim to secure a commercial contract. Through Technical Guarantees a financial institution guarantees to the buyer that the seller will perform their contractual obligations as agreed. Therefore, this product is essential to facilitate commercial transactions and reduce the execution risk. In this context, it should be noted that Technical Guarantees will play an important enabling role in a wide range of essential infrastructure and energy-transition projects under the European Green Deal.

New CRR Treatment

Increase in the Credit Conversion Factor (CCF) of this product from existing 20% to 50%, through its inclusion in the bucket 2 of the Annex Classification of off Balance Sheet Items.

Impact

ICC considers this new proposed treatment (50% CCF) overly punitive, with a significant negative impact on the corporate business activities for the following reasons:

- **Cost Increase:** we estimate the new treatment will increase the cost of Technical Guarantees by 150%,[3] heavily impacting corporate business, especially SMEs who already have limited access to financial markets. In addition, the new measure will reduce market capacity for this product due to the increase in RWAs for the banks providing the product. This is a particular concern given that the impacts of Covid-19 and the energy transition needed to meet the goals of the Paris Agreement will inevitable increase demand for Technical Guarantees in the coming years.
- **Reduce Competitiveness and economic impact**: linked to the point above, European corporates will lose competitiveness when bidding for commercial contracts, especially in large infrastructure/energy projects, where Technical Guarantees are essential. This will negatively affect the operating margins of affected corporates – foreseeably leading to job destruction in sectors where margins are already extremely tight.
- **Overly Punitive based on historically observed CCF:** ICC and GCD historical data shows that CCF of 20% for Technical Guarantees is adequately conservative[4]. The ICC Trade Register report also shows that it is a low risk product with minimal default rates (0.24%).[5] In addition, ICC is in the process of completing the analysis to prove the adequacy of the current 20% CCF with fully updated data.
- **Uneven playing field:** The increased burden for banks when issuing Technical Guarantees will create an uneven playing field for European Banks, as other institutions

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[2] Please see Annex I for more detail on the Technical Guarantees nature, structure and examples.
[3] Please refer to Annex II for an analysis of the cost increase on Technical Guarantees due to the proposed CCF increase.
[4] International Chamber of Commerce. Performance Guarantees and Claims (2019). https://iccwbo.org/content/uploads/sites/3/2019/10/icc-gcd-performance-guarantee-paper.pdf
[5] International Chamber of Commerce. Trade Register Report (2021): https://iccwbo.org/publication/icc-trade-register-report/

(such as insurance companies) are offering the product without being subject to the same capital requirements.

ICC Proposal
Classification of Off-Balance Sheet Items to be amended so “Technical Guarantees” (as identified in the 2 items below) are included in the bucket 4 – medium low risk, therefore maintaining the 20% CCF.

Bucket 4 – Medium Low Risk – 20% CCF

- *Performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions and similar transaction-related contingent items;*
- *Off-balance sheet items not constituting a credit substitute where not explicitly included in any other category.*

II. Effective Maturity recognition for Trade Finance

Article
Maturity (CRR3 Article 162).

Background
The short-term and self-liquidating nature of Trade Finance has been already recognized in the previous CRR, which allows for Trade Finance products to be exempted from the one-year maturity floor. Therefore, financial institutions can apply the effective residual maturity when calculating capital requirements. This is aligned with the short-term nature of the product, a feature that the ICC Trade Register has recurrently confirmed.

New CRR Treatment
As Article 162.1 sets out, there is a possibility for the competent authorities to allow the use of effective maturity for some or all exposures. But it links its use to the permission referred to in Article 143, i.e., to the permission to use A-IRB. We believe that this proposal does not contemplate the fact that large corporate and financial institutions, due to mandatory application, must be classified under F-IRB.

Impact
By nature, Trade Finance deals have very short maturities (according to ICC Trade Register,[6] LCs, import/export loans and supply chain programs have an average maturity below 130 days), while they do not have automatic rollover as they are linked to commercial transactions.

Applying an average 2.5Y to this kind of transaction will create a significant price increase for European corporates – the main users of Trade Finance – putting EU exporters in a weaker position than their competitors outside the EU, as they will need to pay for a 30- or 90-days Letter Of Credit the equivalent for a 2.5Y dated product.

In addition, this would be contrary to the short-term nature of Trade Finance already recognized in the previous CRR. Based on our initial consultations, we consider that not allowing the use of effective maturity will reduce the risk sensitivity of banks’ models and create a negative incentive to move into longer-dated and riskier assets.

ICC Proposal
Based on the possibility established in article 162.1, allow the use of effective maturity under F-IRB as well, maintaining the permission to break the 1-year floor set in article 162.3.

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[6] Refer to annex III for further detail on the trade finance observed maturity.

III. Conclusions

ICC is aware of the great importance that clear and fair regulation has in order to develop a sound financial system that would allow European companies to prosper. In addition, it is ICC's belief that the regulation should be based on observed empirical evidence and measurement of potential unintended consequences.

In this regard, ICC welcomes the transitory period that has been included before applying the 10% CCF in Unconditionally Cancellable Commitments (UCC) and the application by the EU of the national discretion to exclude some of the contractual arrangements from this requisite. This would also have a prejudice impact on price and availability for Trade Finance products for corporates, especially SMEs, across Europe and therefore it deserves further consideration.

However, it is our belief that in the case of the proposed **CCF increase for Technical Guarantees, the impact on the companies and the historical evidence on the nature of Trade Finance and its products has not been considered.** Therefore, we would take this opportunity to request the EU Parliament and Council to kindly review the proposed treatment, while we urge the regulatory bodies to clarify the application of the trade finance short-term as provided in article 162.

ICC Commerce remains completely available to provide further clarification on the importance of trade finance for the real economy and discuss with the policy makers the impact and the empirical data that support the low risk nature of trade finance as substantiated by the ICC Trade Register report for the past 15 years.

Annex I – Nature of Technical Guarantees and Structure.

A Technical guarantee is an irrevocable undertaking, issued by a Bank upon request of its client (the Seller) in favor of a beneficiary (the Buyer) where such Bank, as Guarantor, agrees to pay the beneficiary in case of **default of the Seller with respect to its technical obligations under the underlying commercial contract**. That is, an obligation that is wholly non-financial in nature (or in which the primary obligation is non-financial in nature).

Technical guarantees are widely used in the real economy, because they are used along with the commercial relationship/contract ("the Underlying Contract"), from the bid offer up to the final receipt of the goods or the project. As such, there are different types of technical guarantee, which common feature is that the potential execution and demand for payment under the instrument is a non-financial feature, which explains their lower drawing rates even in a scenario where the client is in default.

These types of guarantees include:

i ensure the seriousness of the offer (**Bid bond**),

ii cover the reimbursement of the advance payment made by the buyer prior to delivery (**Advance Payment bond**),

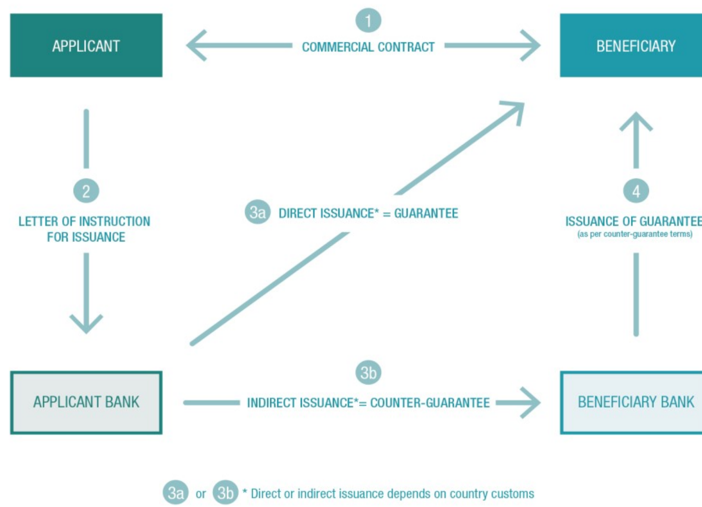
iii cover the good execution by the seller of its contractual obligations and ensures its technical capacity to honor the contract (**Performance bond**),

iv cover the reimbursement of the last payment term in case the equipment delivered turns out to be defective during the warranty period (**Retention / Warranty bond**).

To better understand the involved parties, an example of a workflow for **issuance of a performance guarantee** is detailed below:

1. Signature of a commercial contract between a Seller and a Buyer covering manufacturing and delivery of an equipment.
2. The Buyer requests from the Seller a performance guarantee covering the seller's due fulfillment of his contractual obligations (i.e., manufacturing and delivering the equipment in accordance with the Underlying Contract), the Seller (the Applicant) then instructs its bank to issue such performance guarantee.
3. The guarantee is issued in favor of the buyer (the Beneficiary) enabling the latter to call on the guarantee in case of seller's non fulfilment of its contractual/technical obligations.

A guarantee can be issued directly (direct issuance as scheme above) or through another bank (indirect issuance). In case of indirect issuance, the bank may either request another bank (often the beneficiary's bank) to issue locally the guarantee under its counter-guarantee or issue a guarantee at the request of another bank acting as counter-guarantor.



Source: For more information about the nature of Technical guarantees, find below the source of this annex published by Fédération Bancaire Francaise (FBF).

Trade Finance
UCC_CCF_26.11.2021

Annex II – Impact on the corporate business: Cost increase example.

Following the detailed explanation of Technical Guarantees developed in annex I, it is crucial to understand how the increase of CCF (from 20% to 50%) can affect the real economy. As has been pointed out, Technical Guarantees are widely used in a variety of situations. For example, corporates need them to develop their infrastructure projects (like building a road or an energy station) or participate in a public bid). Therefore, this annex tries to explain how the CCF increase could affect the pricing of this type of instruments.

Think of a simple example included in the letter published by the FBF, it can be showed that the **new 50% CCF proposed could cause a price increase of 150%.**

A company A (assuming here a rating BBB+, a probability of default of 0,08% and a LGD 35% which is the average for guarantee at this level of rating) delivers work to a beneficiary company B (B is in same country, or in a different country). The duration of these works is 1 year and the contract between A and B requires that the good execution of the commercial contract by company A in favor of company B is covered by the delivery by A of a Performance Guarantee for an amount of 100m Eur. Typical pricing range for such duration and rating is 12-17 bps. Let’s take 13 bps for the example.

Amount in kEUR	Before Basle IV impact (CCF20%)	After Basle IV impact (CCF50%)	CCF change's impact
RWA	2,992	7,481	150%

- Required margin to compensate the new CCF at 50% : **33bps (+150%) meaning a cost of 330.000 Eur instead of 130.000 eur for company A.**

A similar example with a BBB- rating, PD of 0,33%, an LGD of 40% and a current margin of 38 bps is showing a financial impact in EUR terms which is even more critical eroding severely the gross margin of the client.

Amount in kEUR	Before Basle IV impact (CCF20%)	After Basle IV impact (CCF50%)	CCF change's impact
RWA	8,713	21,782	150%

- Required margin to compensate the new CCF at 50%: **95bps (+150%) meaning a cost of 950.000 Eur instead of 380.000 Eur for company B.**

Annex III – Trade Finance short term nature – ICC Trade Register evidence.

The current CRR already recognized the short-term nature of Trade Finance. ICC, through its Trade Register report has consistently proved over the years the short-term nature of Trade Finance, which can be observed in the table below. In addition, it is worth considering that trade finance is typically uncommitted and it is also self-liquidating without have automatic rollover, which means that there needs to be new commercial transaction before having a new disbursement.

Figure 17
Average maturity by trade finance products (days), 2008-2020

	Average Maturity	10th Percentile	90th Percentile
Import L/C	107.0	73.0	191.5
Export L/C	126.8	74.8	311.1
Loans for Import/Export	129.1	83.7	337.6
Performance Guarantees (Applying CCF to EAD)	619.3	421.2	1264.4

Source: ICC Trade Register Report 2021

Figure 39
Average maturity of SCF payables finance (days), 2017-2020

	Average Maturity	10th Percentile	90th Percentile
SCF Payables Finance	71.8	60.4	192.0

Source: ICC Trade Register Report 2021

About The International Chamber of Commerce (ICC)

The International Chamber of Commerce (ICC) is the world's largest business organization representing more than 45 million companies in over 100 countries. ICC's core mission is to make business work for everyone, every day, everywhere. Through a unique mix of advocacy, solutions and standard setting, we promote international trade, responsible business conduct and a global approach to regulation, in addition to providing market-leading dispute resolution services. Our members include many of the world's leading companies, SMEs, business associations and local chambers of commerce.

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