Legal and regulatory issues adversely affecting banks in Trade and Supply Chain Finance

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Can non-bank entrants benefit from their less regulated environment to make an impact on the market?

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Banking regulation – where are we?

Following a meeting of the Basel committee in March this year, the Chairman Stefan Ingves, announced that the committee has made further progress towards the finalisation of the Basel III reforms (called by some Basel IV). Amongst the proposed revisions to the Basel III accord are stricter capital rules and restrictions on the use of complex internal models used by banks to assess their risk. Despite the further progress reported by the Basel committee, delays are anticipated.

The expected delays are not helped by the changing attitudes from the US towards global banking regulation. This change in attitude could not only pose further delays to finalisation, but lead to a greater fragmented approach to financial regulation, negatively impacting those institutions wishing to operate on a global scale.

Basel III was implemented in the EU by the Capital Requirements Regulation (CRR) and the Capital Requirements Directive. As will be seen below this has some implications for trade finance which are not positive in some cases.

The proposed Basel reforms do not relate specifically to trade finance. They do not address one of the biggest shortcomings of Basel III for certain trade finance banks. The issue in question is the restriction on the types of assets that banks adopting the Standardised Approach can use as credit risk mitigation under Articles 194 to 217 of the CRR. These banks cannot use either receivables or physical collateral as eligible credit risk mitigants as these are expressly reserved for banks operating under the IRB Approach. This is a significant restriction given that many trade finance structures involve taking security over physical goods that are being financed and/or security over receivables generated by the sale of such goods. The approach taken to credit risk mitigation under the CRR fails to recognise the knowledge and expertise that many smaller trade finance institutions have and places them in a disadvantageous position compared to their counterparts who operate under the IRB Approach. There are more issues to consider which adversely affect trade finance.

Basel IV

There are proposed changes to the risk-weighted asset framework which will impose restrictions on the ability of banks to use an internal model for calculating regulatory capital in favour of a standardised approach. While these changes are intended to reduce differences in the way in which the internal ratings-based model is applied by banks and to reduce regulatory complexity, these do not appear to have been welcomed by market participants. These changes arguably have some effect in levelling the playing field between those banks who are subject to the Standardised Approach and those who are subject to the IRB Approach. They do nothing to help banks generally feel comfortable in the trade finance area.

Other regulatory problems

Earlier this year in the UK the Policing and Crime Act 2017 came into force. The act includes provisions allowing the HM Treasury to hand out fines of up to GBP 1,000,000 for breaches of financial sanctions.

This should be looked at together with requirements on banks to comply with sanctions and anti-money laundering (AML) requirements. All of these lead to tighter requirements in the area of compliance, with provisions being looked at relating to “know your customer” (KYC). All of this leads banks to being very cautious in this area. Taken to an extreme, many banks are de-risking as will be seen below.

> The approach taken to credit risk mitigation under the CRR places many smaller trade finance institutions in a disadvantageous position

Other regulatory issues set to impact financial institutions include minimum levels of total loss absorbing capacity (TLAC), which should be implemented by 1 January 2019 and affect the 30 banks identified by the Basel committee as being globally systematically important. The levels will increase from at least 16% of the group’s risk-weighted assets (RWA’s), to at least 18% from 1 January 2022. There seems to be little good news for banks wishing to conduct trade finance.

Non-banks entering the market

The banking landscape has changed significantly over the past decades. The breadth and scale of regulatory reform has arguably contributed to the rise in “shadow banking”, or market-based finance. The last decade in particular has seen a rise in FinTechs entering the market and partnering with some of the arguably more forward looking traditional financial institutions in a bid to revolutionise traditional finance practices, including trade and supply chain finance.

Market-based finance is not new, the European Commission issued an economic paper in 2012 which assessed the impact of non-bank financial institutions (NBFIs) on the stability of the financial system. The paper considered the range of players present in market based finance, including money market funds, private equity firms, hedge funds, pension funds and insurance undertakings, central counterparties, and UCITS (Undertakings for Collective Investment in Transferable Securities) and exchange traded funds. The European Commission has continued in its efforts which it sees to improve the market and recently published an Action Plan on Building a Capital Markets Union.

More recently, there has also been the rise in "peer-to-peer lending" and "crowd funding". Some of the platforms used in the EU will be subject to MiFID II (Markets in Financial Instruments Directive II), whereas others may not be. However, they will likely be subject to their own nation's laws. These are not banks and are not subject to Basel III as it currently stands.

Levelling the playing field

Non-banks may have been attracted to the market as a result of the comparatively reduced regulation surrounding their activities, but in order to achieve a level playing field, regulation may be exactly what is required by the regulators.

> Non-banks may have been attracted to the market as a result of the comparatively reduced regulation surrounding their activities

The changes brought about by the implementation of the Payment Services Directive mean that traditional banks will undoubtedly incur increased costs related to security for example, since they will be sharing access to their customer's accounts with non-banks. Traditional banks are subjected to a wide range of regulation compared to that of NBFIs. However, it is not the case that NFBIs are not subject to regulation, including, for example, national laws and sanctions provisions. Unless or until this happens, there may be advantages that NBFIs have and should exploit.

Advantages for NBFIs

In light of the above, can and should NBFIs exploit advantages to become more involved in trade finance lending? In looking at this what are the advantages?

The key advantages that NBFIs have relate to their not being required to comply with requirements relating to the whole risk asset framework and restrictions on capital requirements.

This means that making funds available in the market is to a great extent something that NBFIs can achieve by their own fund-raising activities.

As noted above, banks are seeing themselves restricted by internal compliance particularly around KYC. The result of this, in many cases, has been called de-risking. Put simply, banks are not prepared to maintain relationships which they see as being costly from a compliance point of view. They are terminating these relationships. Many of these are in emerging markets and often are local banks who were useful eyes and ears on the ground. Equally, onboarding new relationships are seen to be too expensive and risky. Thus, new lending opportunities particularly in trade finance in the emerging markets are not being taken up. In fact, a paper released by the Financing for Development forum estimated a USD 1.6 trillion shortfall in trade finance funding. The result of this is that there are whole areas of opportunities which NBFIs can exploit.

NBFIs can be more flexible in setting up their own rules to onboard relationships and as to how they set up facilities for these relationships. Where their own fundraising is outside the bank markets this works well. It is an unfortunate effect of new regulation that where funding to a NBFI is dependent on bank finance then restrictions are often put on NBFIs in raising funding.

This is not to say that NBFIs can go into arrangements with their eyes closed. These entities are equally bound by laws relating to sanctions, AML and financial crime. All of this needs checking, but against a background of being satisfied within their own rules. NBFIs can also take advantage of FinTech solutions in the area of compliance and the tracing of goods. This reduces risks in these areas. It allows these institutions to be more fleet of foot.

NBFIs are making an impact in the market. However, they are not the solution but perhaps regulators will look at the opportunities and not restrict NBFIs but perhaps to be flexible for banks more widely.

The future

The future is further complicated by the upcoming exit of the UK from the EU (Brexit). As such, there is uncertainty as to how the UK will adopt measures under Basel III and indeed Basel IV. For the moment, this may be a side issue to the question as to who provides finance for trade. Access to finance is what trade needs. If NBFIs can be a greater part of this then that must be good news.

Editorial Comment: selected strategic and tactical implications

Strategic implications

The global regulatory environment will continue to change and compliance requirements will become more intrusive to the operating environment of banks. The industry will need to continually work to ensure that regulators appreciate and keep in focus the vital role of trade finance, ensure and that it is treated in a manner which aligns with its risk profile. Practitioners must continue to highlight adverse impacts of unintended regulatory consequences upon on SME market participants and the developing world. As more non-banks enter the trade finance business it will be important that regulators take a holistic view of the market and of consequently evolving regulatory requirements.

At the same time, it is critical that industry leaders continue proactively in efforts to develop and earn greater trust from the market, and to support the shared objective of a robust and sustainable global financial system.

Tactical considerations

The industry will need to work with new entrants in the field to ensure that common standards and risk profiles are applied across the globe. It will be essential that existing banks, non-banks and FinTech companies cooperate to the benefit of trade finance as a whole and jointly develop the future environment for trade finance and for fast-growing supply chain finance.