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The G20 Processes and Reform Agenda: What impacts on corporate and/or trade finance?

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ABSTRACT

This paper provides an evaluation of the 2008 financial crisis and G20 reforms and their impact on trade and corporate finance. In late 2008, a sudden and severe collapse in global trade occurred as demand shocks from advanced economies affected international-supply chains. Similarly, a reassessment of counterparty risk saw a freeze in trade finance, as banks no longer trusted each other. During this period, corporate finance and investment banking services dried up. Notably, the crisis began with and involved investment banks and demonstrated a failure by advanced economies to regulate and adequately supervise financial markets. Major regulatory and policy reforms are therefore expected to include: stronger rules around capital adequacy and liquidity; greater institutional and geographic coverage of regulation; more stringent rules for credit default swaps; policies to control remuneration of bankers; oversight of credit rating agencies; and stronger supervision of large complex financial institutions. Divergent views exist on the future impact of these reforms on access to finance. Some argue that they will constrain new lending by investment banks, with long-term loans and equity-related exposures becoming more expensive. Shifts towards short-term financing, and risk management products and services will limit asset growth. Another group contends that forthcoming changes will negatively impact trade finance. Regulators, however, find that stronger regulation will bring substantial benefits with modest costs. While several studies find either for or against improved regulation, the bottom line is that perceptions will drive how banks react and evaluate their lending priorities. This is bound to affect developing countries, and may exacerbate access to domestic and cross-border finance, especially for development and infrastructure. Key concerns, however, are about financial sector stability and minimising systemic risk, with closer scrutiny on regulated and unregulated financial institutions.

ABOUT THE AUTHOR

Dr Rosalind Thomas has over 20 years experience as a senior executive and advisor on regional infrastructure and public-private partnerships, development finance, private sector development, risk management, governance, trade and investment, and policy and capacity development in Africa. She has extensive knowledge of key regional economic concerns on the continent. She is currently a director of Nova Capital Africa, a joint venture with a New York based investment bank providing investment banking services in South Africa and the rest of the continent. She holds a PhD from the University of the Witwatersrand; an MA in International Economics and Law from the Paul Nitze School of Advanced International Studies, Johns Hopkins University, Washington, DC; has carried out post-graduate studies at Harvard University, Yale Law School, and the University of Cambridge in the United Kingdom, and was awarded six scholarships for educational excellence. She has authored numerous professional publications; guest lectured at several international universities and participated in many consulting studies and conferences.

ABBREVIATIONS AND ACRONYMS

AVC	asset value correlation
BAFT	Bankers' Association for Finance and Trade
bp	basis points
BEE	black economic empowerment
CDO	collateralised debt obligation
EU	European Union
FSA	Financial Services Authority
FSB	Financial Stability Board
GDP	gross domestic product
G20	Group of Twenty
IAIS	International Association of Insurance Supervisors
IFSA	International Financial Services Association
IFI	international financial institution
IIF	Institute of International Finance
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LOC	letter of credit
M&A	merger and acquisition
OECD	Organisation for Economic Co-operation and Development
PIIGS	Portugal, Iceland, Italy, Greece and Spain
S&P	Standard & Poor's
UK	United Kingdom
US	United States
VAR	value at risk
WTO	World Trade Organisation
ZAR	South African rand

INTRODUCTION

This paper provides an evaluation of the recent global financial crisis, and addresses the Group of Twenty (G20) processes in relation to the discussions on trade and corporate finance coming out of the 2008–2009 financial crises.

After explaining the G20's composition, objectives and general procedures, the paper highlights the technical working groups that support policymakers. The effects of the crisis on trade and corporate finance are then examined. This is followed by a review of the discussions about the crisis at the G20, as well as recent market and regulatory developments in this regard, with a specific application to South Africa.

Lastly, the paper touches on and reviews the actual causes of the financial crisis. It evaluates the shape and content of the regulatory responses being developed within the context of the G20 discussions, the Basel Committee on Banking Supervision (Basel Committee), the International Organization of Securities Commissions (IOSCO) and related institutions. Much of the latter is being targeted at addressing systemic weakness, but could, as a by-product, have real economy impacts of a negative kind. The focus here is mainly on capital adequacy and liquidity reforms and their consequences for investment banking going forward.

THE G20 PROCESS

In 1999, following the 1997 Asian financial crisis, the G20 was established, as an informal forum for open and constructive discussion on key issues affecting global economic stability. Its membership is limited to major advanced and emerging market economies, '... of systemic significance for the international financial system'. Initially, only the finance ministers and central bank governors of the constituent countries met annually. However, after the 2008 global financial crisis, a 'Leaders' Summit' was constituted, where heads of state could discuss and co-ordinate policy responses to the crisis.¹ Membership at summit level continued on the basis of the original members. Box 1 on page 6 details the meetings and procedures of the G20.

The G20 process has evolved since the crisis in 2008. Scheduled meetings now emulate the G7/G8 meetings.² Significantly, the G20 membership demonstrates that developed countries recognise the need to engage directly with critical emerging market countries, in order to address the effects of the crisis and to set up rules governing financial markets.

The central fixture of the G20 is the summit, which is preceded by frequent officials-level meetings where positions are negotiated and logistical and technical details for implementing agreements are discussed. Leaders meet at least once a year, while finance ministers and central bank governors meet biannually, and sometimes as frequently as four times a year, to monitor global developments and assess economic policies. The G20 is considered to have replaced the G7 on finance issues.³ Decisions in the G20 are taken by consensus, and participation is restricted to members. All agreements reached are published on the G20 website as communiqués or declarations.

No formal procedure exists for enforcing agreements at the national level. However, the G20 has indirect enforcement capabilities through the huge influence that its members (especially the G7) wield in other forums, such as the Bretton Woods Institutions,

the Financial Stability Board (FSB), the Bank for International Settlements, the Basel Committee, IOSCO, the International Association of Insurance Supervisors (IAIS), and the Joint Forum⁴. The recommendations and/or rules emanating from these institutions permeate to national level via officials from the Ministries of Finance, Central Banks and non-bank financial regulators who attend their meetings.

Similarly, various task forces, working groups and experts groups established to support the work of the G7, provide support to the G20. These include the FSB mentioned above, the Financial Inclusion Experts Group, and the Trade Finance Experts Group.⁵ At the height of the crisis in November 2008, trade was a side issue for the G20, as they were concentrating on stabilising financial systems and kick-starting recovery. However, in April 2009, trade moved to centre stage in London for various reasons.

Box 1: Meetings and procedures of the G20

Since September 2008, several meetings of the G20 summit have taken place. The Washington, DC meeting, in November 2008, focused on immediate crisis management and regulatory reform. The London meeting, in April 2009, addressed crisis management and a concerted financial response by international financial institutions (IFIs). Pledges were made to increase the International Monetary Fund's (IMF) and Multilateral Development Banks funding by \$1.1 trillion; reform these institutions; commit a further \$5 trillion to stimulus packages; set up the Financial Stability Board (FSB); and kick-start the stalled Doha Round at the World Trade Organisation (WTO). The meeting in Pittsburgh took place in September 2009, when the recession was bottoming out. Announcements included a new framework to monitor national economic policies and to correct (and prevent the recurrence of) global imbalances, as well as plans to improve representation of emerging and developing economies in the IFIs. The last meeting was held Toronto in June 2010.

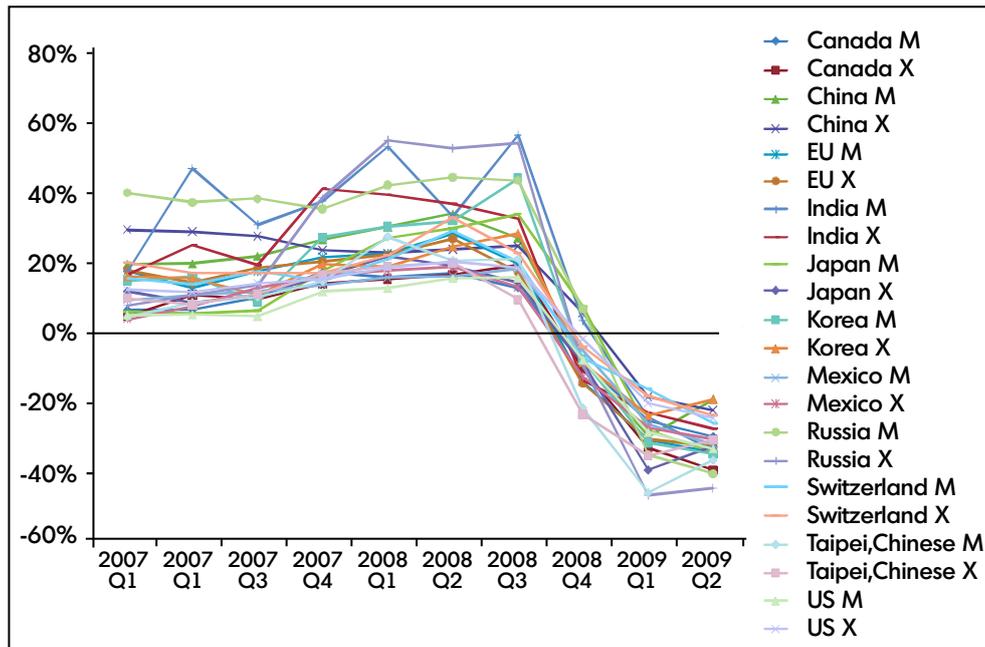
Divisions have begun to emerge among G20 members, whose interests are not always aligned. Concerns include recovery from the ongoing global recession and the European debt crisis: China, India, and the United States (US) support increased stimulus spending to alleviate the recession, while the European Union (EU) countries are clamouring for a reduction and balanced budgets. Taxes on financial institutions are supported by the EU, France and Germany, but opposed by Australia, Canada, South Africa and the US. International development and requests to increase international aid to Africa and the developing world are also on the agenda.

The pre-selected G20 chair rotates each year within a different region. The responsible country sets up temporary secretarial facilities catering for all G20 administrative issues, including the co-ordination of meetings and events and posting of information on the G20 website, and chairs the summit and ministerial meetings for that year. The next meeting was held in South Korea in November 2010. From 2011 onwards, G20 members will meet annually.

THE IMPACT OF THE CRISIS ON TRADE

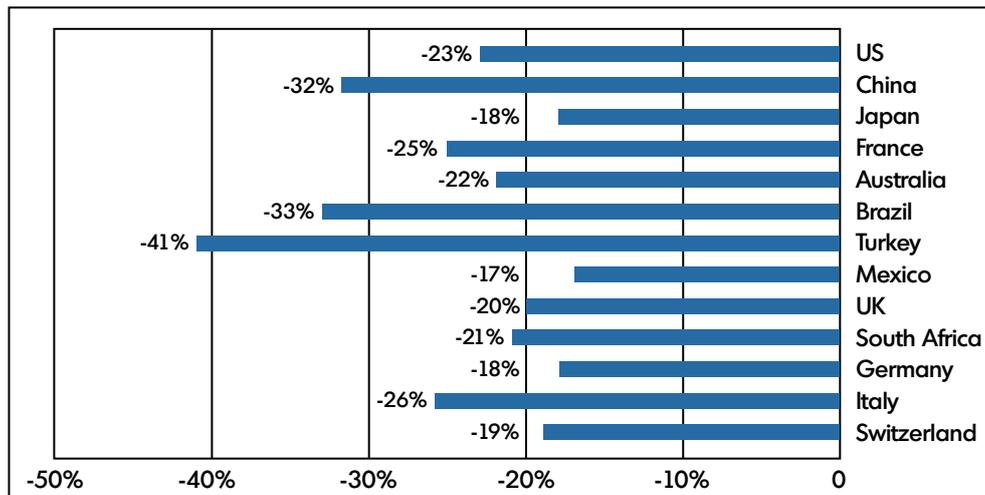
Between October and December 2008, global trade flows – both imports (M) and exports (X) – collapsed suddenly and severely, and were shown to be globally synchronised (see Figures 1 and 2).

Figure 1: The great trade collapse, 2008 Q3 to 2009 Q2



Sources: Eichengreen B & K O'Rourke, in Baldwin R, (ed.) *The Great Trade Collapse: Causes, Consequences and Prospects*. Geneva: Centre for Economic Policy Research, 2009, www.voxeu.org/reports/great_trade_collapse.pdf

Figure 2: Collapse in world trade, October–December 2008



Source: Baldwin R & SJ Evenett, *Introduction & Recommendations for the G20*

Baldwin described the collapse as ‘huge – the steepest fall of world trade in recorded history and the deepest fall since the Great Depression’.⁶ Two primary explanations are proposed for this fall:

1 International supply chains

The widespread use of international supply chains and the just-in-time nature of vertically integrated production networks, which served to rapidly transmit demand shocks.⁷ Thus, the instantaneous, electronic transmission of the drop in demand, by US and European consumers to the entire supply chain in Asia, immediately halted purchases and production. Both imports and exports dropped in tandem. Volumes for trade in goods and services fell by 12% in 2009,⁸ the biggest drop since the Second World War.

2 Short-term trade credit

Short-term trade credit dried up as quickly as trade flows collapsed.⁹ The World Bank estimated that about 10–15% of the total decline in trade since 2008 was due to a decline in trade finance. WTO Director General, Pascal Lamy, called trade finance ‘the oil that keeps the wheels of global trade running’.¹⁰ Despite long-standing practices between banks and traders, and the low risk/high collateral qualities of trade finance, traders found it harder to access finance as banks no longer trusted each other post–Lehman Brothers, and slowed down or stopped issuing letters of credit (LOCs). Widespread fear led to the collapse of open-account trading, which had previously existed, and the insistence instead on LOCs from partners, but on more onerous terms.

THE DECLINE IN TRADE FINANCE

The G20 *Trade Finance Experts Group* report of April 2010, noted a worldwide shrinkage of available financing and, in particular, a decline in trade finance. Approximately 80–90% of international trade is financed through various types of credit instruments, in a market estimated to be about \$10–15 trillion in size. According to the Bankers’ Association for Finance and Trade (BAFT), trade finance flows fell by about 6% year-on-year, probably more than the reduction in trade flows. Surveys by BAFT in collaboration with the IMF and World Bank showed that the lack of trade finance had a severe impact on emerging markets trade.¹¹

The WTO Secretariat calculated that this decline created a market gap of about \$100 billion, and argued that the absence of trade finance would accelerate the slow-down of world trade and output.¹² With liquidity drying up in their markets, developing countries, most of them in Africa, were the hardest hit. Despite recent improvements in the first two quarters of 2010 in developed and emerging economy markets,¹³ liquidity has yet to return to developing country markets.¹⁴

Two reasons are given for the decline in trade finance: (i) general market failure; and (ii) a lack of liquidity due to the implementation of Basel II requirements. The public sector cites the first reason, decrying the ‘herd-like’ behaviour of stronger private sector

banks, which refused to take up, or refinance in secondary markets, any LOCs issued by counterparties from emerging and developing country markets. The latter were considered to be less liquid and thus more risky. All types of financing saw a ‘flight-to-quality’¹⁵, as risk-adverse major banks pulled back to their home bases (although this was where the financial crisis originated).

Private sector banks¹⁶ argue that the implementation of Basel II rules, especially related to capital adequacy, has a pro-cyclical effect on the supply of credit and therefore contributes towards increasing the market gap. A study in late 2009 supports this view. Assessing the effects of bank capital regulation in a dynamic equilibrium model of relationship lending, Repullo *et al.*, found that banks held significant capital reserves, as a precaution against the anticipated shocks to their earnings and the cyclical economy that could harm their future lending capacity. The cyclically varying, risk-based capital requirements (as under Basel II) also meant that banks tended to hold larger buffers during expansions than during recessions. However, in a recession, these buffers were insufficient to prevent a significant contraction in the supply of credit.¹⁷

A BAFT survey, prior to a consultative WTO Expert Group Meeting on 15 September 2009, found that 43% of respondent banks said the Basel II had a negative impact on their ability to provide trade finance, with banks in industrialised countries more likely to cite the negative implications of Basel II, while 60% of respondents citing it as a hindrance. When market conditions tightened, the capital requirements for trade finance instruments became more onerous for developing country banks.¹⁸ The BAFT concluded that a, ‘more rational treatment under Basel II of trade finance, given its fixed, short-term, self-liquidating nature, will ultimately have a positive effect on the trade finance markets’.

Whatever the reasons for the decline, this reassessment of counterparty risk in developing economies had a negative impact on global credit markets and spilled over into the specialised financial instruments that support international trade flows. All types of trade finance instruments were affected, particularly open account trading and LOCs, which rely on a high level of trust between traders and counterparties. For example, spreads on 90-day LOCs issued by emerging and developing economies rose from 10–16 basis points (bp) in the pre-2008 credit crunch period to between 250 and 500 bp. This, despite the fact that trade finance is viewed as among the safest types of finance because of strong receivables and marketable collateral. In a survey of 161 banks in 75 countries, completed in April 2010 by the International Chamber of Commerce, 40% of banks indicated they had cut trade finance in 2009, while a further 27% said they were unable to meet the demand for credit.¹⁹

In response to the trade financing crisis, the April 2009 London Summit committed to make \$250 billion of trade finance available in 2009–2010, within a broader package of fiscal, monetary and financial responses. The G20 also agreed to participate in the FSB and Basel Committee to contribute to and review the new Basel rules and requirements in respect of Tier 1 capital.²⁰ To guard against future financial meltdowns, Basel III would require banks to hold even more capital in reserve and make higher provisions for losses. Given the G20 agenda and influence on the new Basel rules around capital adequacy and liquidity, bank concerns are unlikely to disappear, and new rules are expected to continue to affect the availability of trade finance.

CORPORATE FINANCE

Evidence of the impact of the financial crisis on corporate finance is not readily available. However, drawing from media reports of South African banks (notably Standard Bank), 2009 was a challenging year that saw the near collapse of liquidity and solvency in the global financial system and domestically in South Africa. While largely insulated from the subprime-mortgage crisis, South African banks were heavily impacted by from the second-round effects of the recession on their corporate customers.²¹ The 2008 crisis and subsequent economic downturn continued to affect financial systems around the world, creating a challenging operating environment for corporate finance and investment banking services. The effect on the retail banking sector shifted to corporate customers, requiring risk management interventions, monitoring of corporate clients and rigorous industry-specific analysis and reviews, with proactive debt restructuring solutions required for distressed customers. Notwithstanding their exacting focus on risk management, the full impact of the downturn resulted in banks experiencing increased credit impairments, with some of their customers defaulting.²²

Globally, merger and acquisition (M&A) activity was more resilient in 2009 and conditions are improving in 2010. In 2009, M&A volumes were at their lowest level since 2004, with 5 800 deals totalling \$2.3 trillion announced. However, most of the reduction came about because of a 29% decline in market capitalisation, leading to smaller absolute deal sizes and a sharp decline in private-equity activity because of weak credit markets. There was a significant decline in volumes from 2007 and 2008, which were considerably higher. When adjusted for market capitalisation, the level of deals by corporations in 2009 was on par with that of 2008, only slightly lower than that of 2007, and significantly higher than after the dot-com crisis at the beginning of 2000.²³ The pattern of M&A also changed during 2009. The long-term trend of an increasing number of cross-border deals ended, although in one respect the M&A marketplace turned increasingly global as Asian companies increased their share of international M&A. On a sector-by-sector basis, M&A activity was busiest in strong sectors, such as energy, utilities, health care, and pharmaceuticals, than in more troubled ones, such as financial services, real estate, construction, and basic materials. In South Africa in 2009, Standard Bank played a leading role in M&A activities that involved a South African rand (ZAR) 7.3 billion SABMiller black economic empowerment (BEE) transaction, a ZAR 2.5 billion Tiger Brands BEE transaction and the raising of ZAR 3 billion in equity for Illovo Sugar.²⁴

In sub-Saharan Africa generally, M&A activity doubled in the first half of 2010 boosted by the Bharti Airtel acquisition of Kuwaiti Zain's assets in Africa for \$10.7 billion. The most M&A deals were completed in Nigeria, with South African companies playing a dominant role, responsible for 95% of the deals.²⁵

WHAT REFORMS ON THE HORIZON?

Analysis of the causes and effects of the global financial crisis had revealed a combination of: (i) macroeconomic imbalances due to large current account surpluses in Asian and oil-exporting countries, and fiscal and current account deficits in the US, United Kingdom (UK) and eurozone; (ii) loose monetary policy that led to mispricing of risk and credit,

creating asset price bubbles in housing and consumer credit; (iii) excessive leveraging, facilitated by pro-cyclical regulation and regulatory arbitrage (drawing attention to capital requirements); and (iv) intemperate and unmanaged growth of the financial sector, as new complex derivative instruments magnified rather than diversified risks.²⁶ Notably, this crisis began with, and involved the main investment banks.

The Turner Report²⁷ highlighted the disproportionate growth in financial sector debt compared to that of both households and corporates. Once the latter two were removed as a percentage of gross domestic product (GDP), the huge size of intra-financial claims, especially securitised credit activities, became clear and increased the influence of the financial system instability on the real economy. Much of this activity was not aimed at delivering credit intermediation efficiently, but at ‘rent extraction’, which was made possible by, ‘the opacity of margins... [and] the asymmetry of information and knowledge’.²⁸ The demand for ‘yield uplift’, stimulated by the above-mentioned macro-imbalances (particularly the excessively expansionary monetary policy), produced an explosion in the origination, packaging, trading and distribution of securitised credit instruments (collateralised debt obligations or CDOs), which led to the collapse of the financial system in 2008. Investment banks thought that by ‘slicing, structuring and hedging’ these CDOs, they could create value at more attractive terms for investors.

Nkosana Mashiya at the South African Department of National Treasury puts this even more plainly:²⁹

... in many countries the growth of the financial sector is significantly higher than the growth of the economy as a whole. Between 1996 and 2006 the financial sector grew faster at an average of 7% while the economy grew at 5%. The question is what do you normally need money for? Goods and services? So why was there a difference of 2% between economic growth and growth in the financial sector? This was due to growth in derivatives and other financial instruments, including futures and forwards. What, therefore, was it needed for? Finance on finance? This is what needs to be taxed as it is not needed to grow the economy. This was the source of financial instability in the US. These instruments are not on the banks’ balance sheets and therefore are not transparent.

With hindsight, a substantial part of the blame for the crisis, starting with the ‘subprime’ fiasco, and ending with the current euro crisis in the ‘PIIGS’³⁰ countries, can also be attributed to failure by OECD³¹ governments to adequately regulate and supervise domestic and global financial markets. Accordingly, discussions on regulatory and supervisory reform have been a central feature of the G20 summits to date, with proposals emphasising the need for new international standards and the implementation of national reforms. The major commitments expected to influence the future regulatory and policy agenda are:

- capital adequacy and liquidity;
- institutional and geographic coverage of regulation;
- deposit insurance;
- credit default swap market infrastructure;
- remuneration of bankers;
- credit rating agencies; and
- regulation and supervisory responsibility of large complex banks and cross-border banks.

At the Pittsburgh G20 Summit in 2009, leaders announced several deadlines for achievement of these regulatory reforms, including the following:

- developing new standards under Basel III for bank capital by the end of 2010;
- implementing new capital standards by the end of 2012;
- strengthening regulation of over-the-counter derivatives markets by end of 2012;
- addressing cross-border resolutions and systemically important financial institutions by the end of 2010;
- converging on new global accounting standards by June 2011;
- implementing countermeasures against tax havens from March 2010; and
- initiating a peer review process of non-co-operative jurisdictions by February 2010.

However, at the June 2010 meeting of finance ministers and central bank governors in South Korea, the UK, US and Canada backed down over (a) reforms, and (b) against strong pressure from Germany, France and Japan. The latter argued that forcing banks to hold more capital to guard against financial system meltdown would negatively affect companies and individuals seeking finance, and would plunge the global economy into a double-dip recession. Canada's finance minister told the media, 'Implementation is a variable. Some would like a shorter period some ... a longer period. I think that can be worked out over time', and it seems unlikely that the original deadline for implementation at the end of 2012 will be met. Attempts will be made to conclude negotiations by the end of 2010, and flexible implementation is being considered, provided (according to George Osborne, the UK's chancellor of the exchequer) no attempts are made to dilute the Accords. Basel III is intended to do away with 'hybrid capital' – the debt-equity mix used by many European banks in favour of pure equity or retained earnings.³² Establishing a minimum level of capital lies at the very heart of bank regulation: banks with too little capital (excessive leverage) are at risk of insolvency if they suffer even small losses on loans or other assets. However, for banks that manage to remain solvent, higher leverage also increases the return rate on shareholder capital. Capital standards are thus a key element of the trade-off between risk and rate of return for banks and other financial institutions.³³

As far as (c) is concerned, G20 members recognise the importance of securitisation methods for taking risk off banks' balance sheets, by placing them with a variety of end investors, thus creating more space for lending.³⁴ In this manner, securitised credit intermediation should help reduce systemic risks, and yet the opposite occurred in 2008 with the subprime mortgage crisis, when these securitised debt instruments created the worst financial crisis for a century.³⁵ Poor regulation, including inadequately low capital requirements against trading books, resulted in these off-balance sheet 'shadow banking' activities involving extremely complex, structured credit instruments (referred to as an 'alphabet soup of structured credit products' because of the complex use of credit ratings in their design).³⁶

As a consequence, while not banning these instruments, regulators are seeking to design a framework for safer securitised instruments involving less complexity, more transparency, less packaging and trading through multiple layers of balance sheets, more true distribution to end investors and better and real risk diversification. As South Africa's Department of National Treasury notes: 'credit derivatives and hedge funds, etc, were off-

balance sheet. But we want them back on the balance sheet as the state has contingent liability, as we saw recently in the bailouts, and so as regulators we need to know all there is to know about them. So all exotic instruments must go back onto the balance sheet and the banks must hold capital against them'.³⁷ Regulators are also looking at controlling and regulating the role of credit rating agencies in the structuring of these products.

CAPITAL ADEQUACY AND LIQUIDITY

Not surprisingly, capital adequacy and liquidity issues are treated as paramount. Thus the proposed changes to Basel II include increased capital and liquidity requirements for banks, with the capital proposals encompassing four key elements:

- 1 Raising the quality, consistency and transparency of the capital base.
- 2 Strengthening the risk coverage of the capital framework, particularly with respect to counterparty credit risk exposures arising from derivatives, repos and securities financing activities.
- 3 Introducing a leverage ratio requirement as an international standard. The leverage ratio is generally expressed as: Tier 1 capital as a proportion of total adjusted assets, and is considered a non-risk based capital measure. It can thus be thought of as a measure of the quality of the balance sheet, or, to the extent that it also includes off-balance-sheet exposures, economic leverage.³⁸ However, as a result of differences in accounting regimes, balance sheet presentation, and domestic regulatory adjustments, the measurement of leverage ratios varies across jurisdictions and banks. The US and Canada have maintained a leverage ratio alongside risk-based capital adequacy requirements, while Switzerland has announced the introduction of a leverage ratio that will become effective in 2013.³⁹ An explicit leverage ratio is not a component of the current Basel I or II rules.
- 4 Introducing a countercyclical component that promotes the build-up in good times of capital buffers that can be drawn upon during periods of stress, thus addressing the concern that existing capital requirements are pro-cyclical. This would encourage reducing capital buffers in good times, when capital can be raised more easily, and increasing capital buffers in times of distress, when access to the capital markets may be limited or may effectively be closed.⁴⁰

Figure 3: Calculation of leverage ratio

<p>Equity + reserves – intangible assest = tier 1 capital</p> <p>Total assets – intangible assest = adjusted assets</p> <hr style="width: 80%; margin: 0 auto;"/> <p>Tier 1 capital / adjusted assets = leverage ratio</p> <p>Note: Intangible assets include goodwill, software expenses and deferred tax assets</p>
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Source: D'Hulster K, World Bank, December 2009

The amendments to Basel II address the components of capital. Tier 1 capital is defined as having just two components: ‘common equity’ (i.e. a higher quality capital – thus ensuring greater shareholder responsibility and capital retention against risk-weighted assets), and ‘Tier 1 additional going concern capital’, each of which are defined by or must satisfy 14 separate criteria (not addressed in this paper).⁴¹

Major changes are also anticipated to trading book risk, which is the risk involved in taking market positions in assets or contracts held within the designated trading book. Putting aside the deficiencies of Basel I and II in respect of the present treatment of the trading book and of value at risk (VAR) (i.e. estimates of the probability of losses which could be incurred before a position is closed), the following changes are being mooted. They have already been adopted by the Basel Committee, are strongly supported by the UK Financial Services Authority (FSA) as essential, and are being planned for implementation by the end of 2010:

- requirements for stressed VAR calculations;
- an incremental capital charge to cover default and credit risk mitigation; and
- increased charges for securitisation, particularly re-securitisations.

These changes will more than triple the capital requirements for some bank trading books.⁴² However, the FSA has also proposed an even more radical review of trading book risk measurement and capital adequacy requirements, to cover the following:

- the definition of assets appropriately booked in trading and banking books;
- the use of VAR, stressed VAR and other measures of risk;
- the extent to which approaches should vary by trading book activity, to reflect, for example, different liquidity characteristics; and
- the FSA international review is expected to be completed within 2010.

The proposals on liquidity have three key elements:

- 1 A ‘liquidity coverage ratio’ designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets that can be converted into cash to meet its liquidity needs for a 30-day time horizon, under an acute liquidity stress scenario specified by supervisors.
- 2 A ‘net stable funding ratio’ designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon.
- 3 A set of common metrics – referred to as ‘monitoring tools’ – that the Basel Committee indicates should be considered as the minimum types of information that banks should report to supervisors, as applicable, and supervisors should use to monitor the liquidity risk profiles of supervised entities.

While compliance with the liquidity coverage ratio, the net stable funding ratio and the monitoring tools will be mandatory for all internationally active banks, the proposals note that these ratios and monitoring tools may also be used for other banks and for any subset of subsidiaries of internationally active banks that supervisors may choose. Regulatory sanctions to be applied for non-compliance are not however addressed.⁴³

Commenting on the above changes, Bernard de Longevialle, credit analyst at Standard & Poor's (S&P), said recently, 'In our opinion, the Basel III proposals address many of the weaknesses in Basel II and should lead to stronger, more stable banks worldwide. However, they are also likely to affect parts of the financial sector in ways that regulators may not have envisaged.'⁴⁴

S&P believes that Basel III will result in some banks having to change their balance sheet structures or business models. Smaller, deposit-funded retail banks will find it easier to comply with Basel III's more stringent liquidity and capital requirements than the larger wholesale-funded institutions, which have extensive trading operations or large loan books and securities holdings. According to S&P, Basel III could have a major effect on the capital requirements of investment banks, whose counterparty risk already accounts for more than 20% of total regulatory risk-weighted assets. The unintended consequences could include constraining banks' lending activities and their ability to trade on derivative markets, hampering the inter-bank lending market, causing displacements in markets for high-quality liquid securities, and encouraging banks to shift to short-term lending.

However, Enrico Perotti offers an alternative argument, contending that measures such as 'liquidity buffers' are necessary to contain 'liquidity risk' (i.e. the inability of financial institutions to refinance their positions in times of distress), which was a major flaw in Basel II.⁴⁵ He says that the heavy lobbying by banks, in early July 2010, against the amendments proposed by the Basel Committee 'undermined G20 support for the proposals to plug a major gap in banking regulation'. For Perotti, 'the banks won but financial stability lost'. The costs to the banks of these liquidity buffers are justified by social economic losses. For Perotti, it is critical that such costs be born in good times, to produce proper incentives and avoid socialising losses, where losses are pushed onto society (via government), in bad times.

According to Perotti, at the heart of the problem is the regulators' inability to keep up with the banks. 'Many large banks changed the way they did business, regulators did not'. Whereas in the past banks relied on stable funding sources, such as bonds and bank deposits that benefited from deposit insurance, in recent times the trend was for incentives to expand short-term funding in the wholesale credit market, reducing risk bearing for many investors.⁴⁶ The net result, when added to the decline in capital ratios, was an accelerated collapse in funding maturity and, more generally, in stable funding sources. He points to the example of Bear Stearns, which had an average funding maturity of seven days prior to collapse (and a loans-to-capital leverage ratio of 30). Lehman Brothers, for its part, had funded its immense proprietary trading with an average maturity of three days.

Two recent studies,⁴⁷ released in mid-August 2010, argue that stronger capital and liquidity requirements will bring substantial benefits with modest costs. The Basel Committee study looks at the long-term effect of stronger capital and liquidity requirements, while the FSB Macroeconomic Assessment Group examines the economic impact as the new standards are phased in. Both institutions have made substantial progress in preparing their detailed internationally agreed financial reforms.⁴⁸ The premise of their reforms is that banks, if left to their own devices, will hold too little capital and liquidity. While a lower level of capital may result in higher returns for their shareholders, the buffer to deal with loan defaults and investment losses will be smaller. Less liquidity implies that a higher portion of long-term assets are funded with short-term debt, thus raising interest rate margins and profits. It also makes banks more vulnerable to sudden withdrawals and

thus difficulties in rolling over debt. The two regulators state clearly that the upside of these risks belong to shareholders and managers at the banks, while the size of capital and liquidity cushions determines how much of the downside risk is borne by the public.

There is an assumption that these higher capital requirements will be phased in over a period of four years, and that the impact on GDP could be large and untimely if the implementation is brought forward by two years.⁴⁹

Michael Pomerleano has a different problem with the capital adequacy proposals in the new Basel III. He says that the new accord may look sensible and create more robust capital standards, but it does not address one of the glaring problems evident in both Basel I and II: under Basel III, sovereign debt will continue to be treated in the same manner as before. The risk weighting for sovereign debt denominated in foreign currency is based on a sovereign credit rating. Thus, the risk weight is 0% for AAA to AA, 20% for A+ to A-, 50% for BBB+ to BBB-, and 100% for BB+ to B-. Given the scepticism regarding credit rating agencies, he wonders if there might not be doubts about sovereign ratings.

However, more importantly, countries assign a zero-risk weight to domestic currency debt. Pomerleano points out that warped incentives are implicit in such an approach, creating the illusion that such debt is risk free, which encourages investors to purchase sovereign bonds. In view of the recent history of sovereign defaults on local currency debt (Mexico, 1994–95; Russia, 1988; Argentina, 2001; and most recently, Greece 2010), he emphasises that a Greek sovereign default would lead to contagion and affect other vulnerable eurozone countries. The impact on the vulnerable economies of Portugal, Ireland, Italy and Spain, have already been noted earlier.⁵⁰ Despite this obvious weakness, no objections to, or comments on, this problem have been tabled with the Basel Committee, which Pomerleano describes as ‘a reflection of resignation and apathy’.⁵¹

Encouraging banks to accumulate local currency sovereign debt in emerging and developing countries can have several negative consequences. First, it exacerbates the shortage of bank capital, as banks not willing to lend in what is considered a riskier market, such as in trade, corporate or infrastructure financing (all productive parts of the economy), would take refuge in huge amounts of government debt. Second, banks would simply borrow from liquidity lines and invest in government debt, so the zero interest rate policies in effect transfer large sums of money risk-free from the public purse to the bank’s coffers. Seduced by the safe profits from intermediating government debt, banks lose the institutional capacity and motivation to look for suitable credit risks in the real economy. Thus in developing countries, Africa and India being cases in point, ‘lazy banks’ arise which intermediate mostly public debt, and are some of the most profitable in the world. The definitive macroeconomic outcome of portfolios that are full of government debt is a slowdown in credit intermediation and growth. Pomerleano notes that regulatory authorities are encouraging banks to take refuge in government debt, and wonders why the Basel Committee insists on calling local-currency denominated sovereign debt ‘risk free’.⁵²

IMPACTS ON BALANCE SHEET AND OFF-BALANCE SHEET LENDING

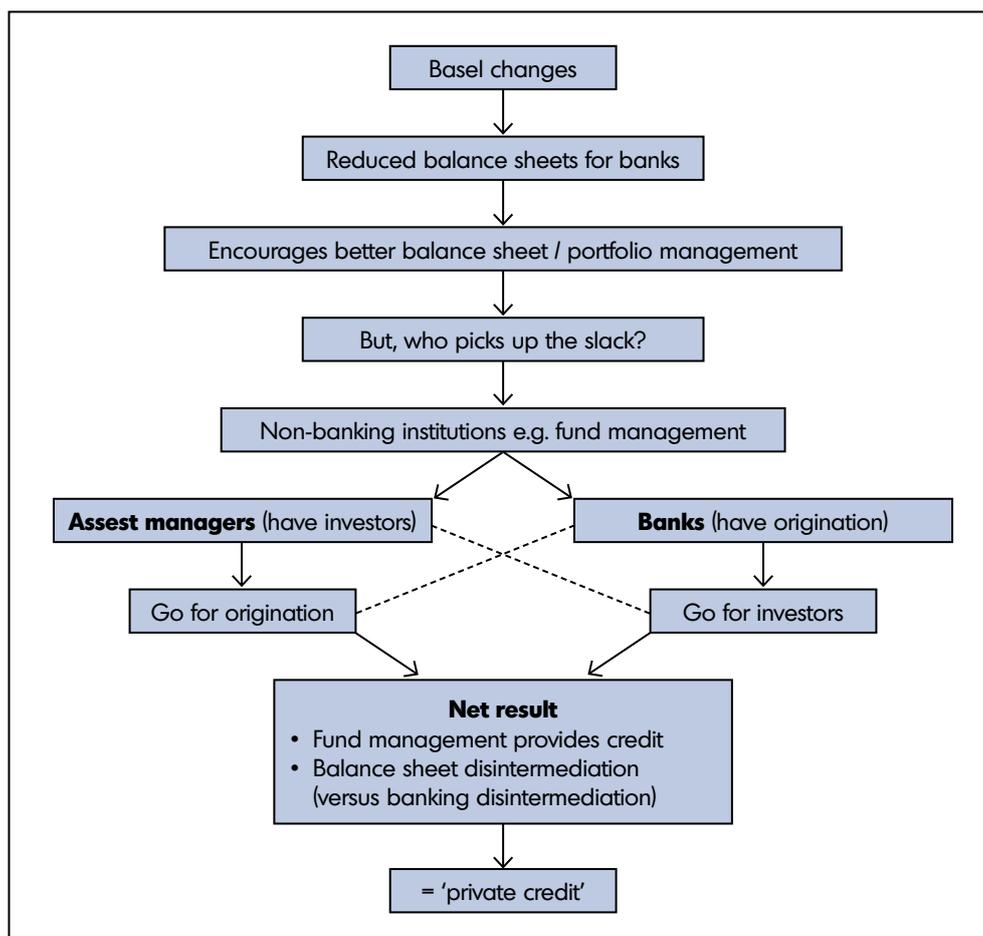
Many share the view that the above-mentioned regulatory changes would affect mainly investment banks engaged in structured and corporate finance, project financing, and trade finance, rather than retail banking.⁵³

Structured, corporate and project finance impacts

In an internal white paper, Pieter Van der Merwe of South Africa’s Absa Capital, argues that two types of assets will become more expensive for banks to hold on balance sheet: (i) long-term loans (necessary for infrastructure and mortgage financing), and (ii) equity-related exposures.⁵⁴

Long-term loans have a bearing on the net stable funding ratio and the maturity mismatch of a bank, while equity exposures affect the capital leverage ratio requirement. As a result, asset growth would be constrained, as investment banks shift their focus to providing shorter-term finance and risk management products and services. This will affect all forms of longer-term finance, including M&A. In this case, the term – not the type – of finance will be a problem. He asks, ‘who will pick up the slack with the void left by the banks?’, and suggests that long-term asset investors are likely to become more active in the fund management industry (see Figure 4). Given the huge infrastructure and other needs in Africa, if banks do pull out of long-term funding, will the asset management industry be sufficient to fill the gap?

Figure 4: Banks and asset managers meet in the credit extension environment



Source: Van der Merwe P, July 2010

The International Project Finance Association's Anthony Sykes supports the concerns raised by Van der Merwe. In a presentation at the Project Finance Conference 2010, in Johannesburg on 17 August, he advised participants that 'the net stable funding ratio' (a likely feature of the new Basel III) 'could emerge as a material impediment, owing to the fact that it would seek to balance the liquidity profiles of the assets funded and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations'.⁵⁵ Policymakers need to take into account these new regulatory restrictions when preparing and marketing projects that require private finance.

As balance sheet capacity becomes increasingly constrained, banks would be challenged to maintain profitability in the 'client franchise'⁵⁶ through relatively less-balance-sheet-intensive activities, i.e. risk management and fee income. The term 'client franchise' is important because of the trend towards proprietary trading.⁵⁷ However, as the business becomes more speculative, the risk increases. Investment banks will therefore have to increase their loan pricing or re-focus on non-margin income sources,⁵⁸ i.e., an increase in the income to asset ratios, as a smaller balance sheet must produce the same revenue numbers.⁵⁹ As investment banks will have to ensure that their asset base can produce more, they will become more selective in their investments. This calls for much closer scrutiny in asset selection through a more pro-active portfolio management approach. Apart from the usual credit tests that a new asset must pass, much more emphasis will be placed on the ancillary revenues (business case) attached to a new exposure.⁶⁰

Van der Merwe further notes that portfolio management⁶¹ in banking will require stringent balance sheet management through:

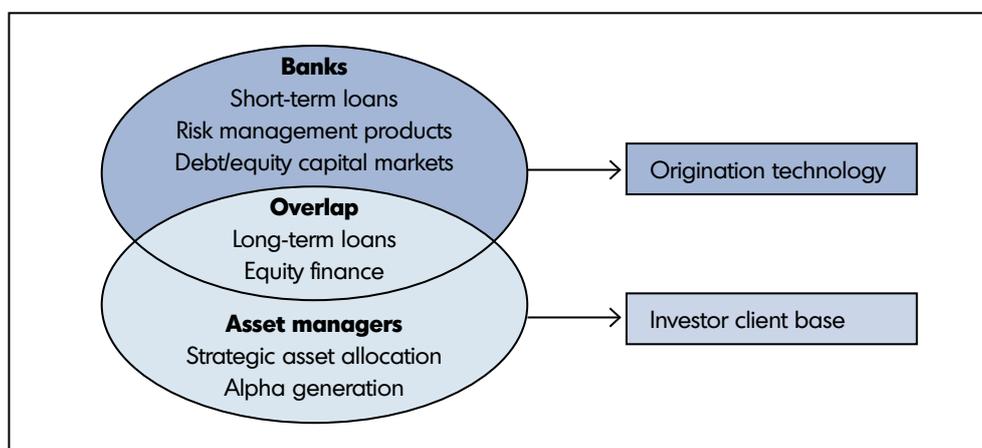
- Increased focus on return/risk ratios and concentration risk,⁶² and less emphasis on pure asset growth.
- Greater pipeline management.⁶³
- Portfolio management mandate that must be inclusive of all long-term exposures to ensure enterprise-wide return/risk management.
- Balance sheet space creation, i.e. reduce balance sheet usage through asset reduction strategies,⁶⁴ credit risk mitigation, process efficiencies and product design.

Like banking, traditional asset management has also experienced industry shifts and challenges. It is significant for investment banking because of the development of a business model, which mirrors the 'bank assurance' model. In the 'bank assurance' model, the overlap was found to be the distribution channels in banking and insurance, while in the 'banking asset management' model, the overlap is product (see Figure 5). In other words, while they may use different instruments, asset managers and banks provide the same fundamental product, i.e. finance. Banks give loans, while asset managers provide bonds and commercial paper to borrowers.

If long-term loans and equity become less attractive to banks, this could provide an opportunity to the asset management industry, where banks might remain in these asset types, but through off-balance sheet asset management vehicles. In turn, asset managers might gear up on the technology necessary to originate these asset classes for their investment clients. Asset managers have, by virtue of their client base, access to the long-term liabilities which create the natural fit for long-term assets.⁶⁵ Currently, banks have

the upper-hand in asset origination, but the asset managers ‘own’ the investment clients that buy into these asset classes.

Figure 5: The banking asset management model



Source: Van der Merwe P, Absa Capital, July 2010

Trade finance impacts

Several banks lobbying the G20 members have argued that the new capital adequacy requirements would worsen the global economic situation, and starve companies and individuals of finance. Trade finance would be sorely affected. The heads of trade and structured finance of Deutsche Bank, HSBC, Standard Chartered, and JP Morgan in the US and Europe, and Standard Bank and Absa Capital in South Africa, all echoed the sentiment that tougher capital and liquidity standards backed by the G20, would increase pricing, thus constraining trade finance.⁶⁶

In respect of the leverage ratio proposal, the BAFT–IFSA⁶⁷ analysis, informed by several member-level surveys carried out in collaboration with the IMF, supports the view that Basel II changes will negatively affect trade finance. BAFT–IFSA quotes the Basel consultative document, ‘... off-balance sheet items, including trade finance instruments, are a potential source of significant leverage’, and proposes including these items using a 100% credit conversion factor to impose a leverage ratio constraint. BAFT–IFSA argues that this fails to take into consideration the intrinsically safe nature of trade finance instruments given that they are underpinned by goods and services. Second, trade assets should not be included in the calculation of a financial institution’s asset size when determining whether asset value correlation (AVC)⁶⁸ should be applied, due to the short-term, self-liquidating nature of trade finance.

Third, the one-year maturity floor applied under Basel II is excessive for trade finance transactions, as they are short term in nature (i.e. 180 days duration) and self-liquidating. As a consequence, they argue that Basel should provide an exemption in this respect. Finally, evidence from their members suggests that applying minimum date requirements (5–7 years) to calculate default is inappropriate for trade finance credits.

According to BAFT–IFSA, the inability to meet this data requirement would result in capital requirements that would not reflect the nature of the trade finance business. Basel II provides for national regulators to allow national dispensations based on local circumstances. In line with this dispensation, one of the South African banks noted that the FSA in the UK has consented, ‘to treat trade finance transactions more favourably than Basel II.’ However, in South Africa, the South African Reserve Bank, the national regulator, has declined to provide this dispensation, which means that the playing field is not level for local banks.

CONCLUDING REMARKS

The latest financial crisis, and its aftermath, is remarkable for several reasons. For the first time, developed countries in the G7 have recognised that the global financial system cannot be fixed without the involvement of emerging market economies. A recalibration of global relationships has reconfigured the international financial regulatory and supervisory architecture to include systemically significant economies, whether developed or emerging, beyond the G7, so the G20 is now considered to have replaced the G7 on financial issues.

Second, this crisis clearly emanated from the developed economies largely because of (i) macroeconomic imbalances due to large current account surpluses in Asian and oil-exporting countries, and fiscal and current account deficits in the US, UK and Europe; (ii) highly expansionary monetary policy, resulting in mispriced risk and credit and the creation of asset price bubbles; (iii) excessive leveraging, facilitated by pro-cyclical regulation and regulatory arbitrage; and (iv) the unregulated and unsupervised growth of the financial sector, with complex and non-transparent (off-balance sheet) derivative instruments that magnified risks. There was a clear failure in OECD countries to regulate and supervise properly their financial markets domestically and internationally. This ‘perfect storm’ affected the real economy, with global trade the earliest casualty, as trade, corporate and project financing dried up for most economies.

Third, the crisis began with and involved mainly investment banks, whose activities were not aimed at delivering credit intermediation efficiently, but rather on ‘rent extraction’. As a result, the above-mentioned macro-conditions facilitated an explosion in securitised credit instruments, which led to the collapse of the financial system in 2008. Even though they recognise that these instruments can play a useful credit management role, by allowing banks to create more space on their balance sheets through securitising CDOs, regulators are now seeking safer ways of structuring these derivative products that involve less complexity, more transparency, and better and real risk diversification.

Fourth, all jurisdictions across the world have recognised that establishing a minimum level of capital is at the very heart of banking regulation today. Banks with too little capital (or excessive leverage) risk insolvency if they suffer even small losses on loans or other assets. However, recognising that higher leverage also increases the rate of return on shareholder equity for banks that manage to remain solvent, it is accepted that capital standards are a key element of the trade-off between risk and rate of return for banks and other financial institutions.

Lastly, the Basel III proposals on capital adequacy and liquidity are expected to have

a major impact on, in particular, the wholesale funded institutions with their significant trading operations, large loan books and securities holdings. Policymakers view these reforms as key to the stability of the global financial system (together with other measures not considered in this paper). Supported by studies and surveys, such as those carried out by BAFT and the Institute for International Finance⁶⁹ (IIF), the banks believe Basel III's new capital requirements will have negative (unintended) consequences for their lending activities.

Not everyone agrees with this analysis. The FSB and Basel Committee have both released alternative studies showing that the effects are not as dire as predicted by the private sector, and would in fact be good for the economy. The larger banks, on the other hand, maintain their positions and have lobbied the G20 members, arguing that new capital adequacy requirements would worsen the global economic situation, and starve companies and individuals of finance. They assert therefore that long-term financing (e.g. for mortgage and infrastructure financing); and short-term trade finance are likely to be affected. As a consequence, even more innovation in structuring is anticipated as banks begin to grapple with ways to improve their profitability in this constrained environment, through relatively less-balance-sheet-intensive activities.

What is of paramount concern is the banks' perceptions of how much capital they will be required to hold against risk-weighted assets under Basel III, and the effect on their bottom line. Whatever the findings of regulators and policymakers, banks' lending decisions may not favour taking on activities that require them to hold increased capital on their balance sheet. Even where excellent prospects for financing exist, banks are likely to become more choosy about the projects they finance. Under these conditions, governments and private sector sponsors and operators will find it more difficult to access funding for projects. For developing countries with a large presence of international banks, this re-evaluation by banks of their lending priorities could exacerbate access to domestic and cross-border finance for much needed economic development.

In the final analysis, however, the key issues are financial sector stability and minimising systemic risk. The scope of the proposed regulation will be debated even after the ink has dried on the Accords. Unregulated institutions will be brought under supervision, while off-balance sheet vehicles will be put under stronger 'microscopes' and require greater balance sheet consolidation. In the meantime, efforts will also need to be accelerated to find ways to address concerns about pro-cyclical regulation and other such related policies.⁷⁰

While many more effects emanating from the G20 regulatory changes are looming on the horizon for the financial sector, this paper is not intended to review all of these consequences. Its purpose is to highlight and draw attention to the G20 processes on regulatory reform especially around capital adequacy and liquidity, to show how they might evolve over time, and to demonstrate the possible effects on trade and corporate finance.

ANNEXURE 1
G20 MEMBERS

Region	Member	Leader	Finance minister		Central Bank governor	GDP (nominal PPP) USD\$ million		Population
Africa	South Africa	President	Jacob Zuma	Minister of Finance	Pravin Gordhan	Gill Marcus	287,219	49 320 500
				Minister of Finance	Jim Fiherty	Mark Carney	1,336,427	34 088 000
North America	Mexico	President	Felipe Calderón	Secretary of Finance	Ernesto Cordero Arroyo	Agustín Carstens	874,903	111 211 789
				Secretary of Treasury	Timothy Geithner	Ben Bernanke	14,256,275	309 173 000
South America	Argentina	President	Cristina Fernández de Kirchner	Minister of Economy	Amado Boudou	Mercedes Marcó del Pont	310,065	40 134 425
				Minister of Finance	Guido Mantega	Henrique Meirelles	1,574,039	193 088 765
East Asia	China	President	Hu Jintao	Minister of Finance	Xie Xuren	Zhou Xiaochuan	4,908,982	1 338 612 968
				Minister of Finance	Yoshihiko Noda	Masaaki Shirakawa	5,068,059	127 390 000
South Asia	India	Prime Minister	Naoto Kan	Minister of Strategy & Finance	Yoon Jeung-hyun	Kim Joong-soo	832,512	50 060 000
				Minister of Finance	Pranab Mukherjee	Duvvuri Subbarao	1,235,975	1 180 251 000
South-East Asia	Indonesia	President	Susilo Bambang Yudhoyono	Minister of Finance	Agus Martowardojo	Darmin Nasution	539,337	231 369 500

Region	Member	Leader	Finance minister	Central Bank governor	GDP (nominal PPP) USD\$ million	Population
Western Asia	Saudi Arabia	King	Minister of Finance	Ibrahim Abdulaziz Al-Assaf	369,671	25 721 000
		President	Minister of Finance	Alexei Leonidovich Kudrin	1,229,227	141 927 297
Eurasia	Russia	Prime Minister	Minister of Finance	Mehmet Simsek	615,329	75 561 312
		President	Minister of Finance	Olli Rehn	16,447,259	501 259 840
Europe	EU	E. Council President	Commissioner for Economic & Monetary Affairs	Jean-Claude Trichet	2,108,228	65 447 374
		Commission President	Minister of Economy, Industry & Employment	Christine Lagarde	3,352,742	81 757 600
	France	President	Minister of Finance	Wolfgang Schäuble	2,118,264	60 325 805
		Chancellor	Minister of Economy & Finance	Giulio Tremonti	2,183,706	62 041 708
	Germany	Prime Minister	Chancellor of the Exchequer	George Osborne	997,201	22 328 632
		Prime Minister	Treasurer	Wayne Swan		
Oceania	Australia	Prime Minister				
		Prime Minister				

Netherlands and Spain have been observers since 2009. In addition, the following institutions participate in G20 meetings: Association of Southeast Asian Nations; European Commission and European Council; Financial Stability Board; International Monetary Fund; New Partnership for Africa's Development; United Nations; World Bank and World Trade Organisation.

ANNEXURE 2
G20 SCHEDULED MEETINGS FROM 1999 TO 2011

Year	Chair	Summits	MOF & CBG	Location
1999	Canada	–	✓	Berlin
2000	Canada	–	✓	Montreal
2001	Canada	–	✓	Ottawa
2002	India	–	✓	New Delhi
2003	Mexico	–	✓	Morelia
2004	Germany	–	✓	Berlin
2005	China	–	✓	Beijing
2006	Australia	–	✓	Melbourne
2007	South Africa	–	✓	Cape Town
2008	Brazil	–	✓	Sao Paulo
	Brazil	November	–	Washington, DC
2009	UK	–	March	Horsham
	UK	April	–	London
	UK	September	–	Pittsburgh
		–	September	London
	UK	–	November	St Andrews
2010	South Korea	–	February	Incheon
		–	April	Washington, DC
	South Korea	–	June	Busan
	South Korea	June	–	Toronto
	South Korea	–	October	Gyeongju
	South Korea	November	–	Seoul
2011	France	TBD	–	TBD

Source: G20 website, <http://www.g20.org>

ENDNOTES

- 1 See Annexure 1 for a list of members and observers.
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- 12 Auboin M, *op. cit.*
- 13 The WTO expects an increase in trade of 9.5%.
- 14 Bacchus J, *op. cit.*
- 15 A flight-to-quality is a stock market phenomenon occurring when investors sell what they perceive to be higher-risk investments and purchase safer investments, such as US Treasuries, gold or land. This is considered a sign of fear in the marketplace, as investors seek less risk in exchange for lower profits. See <http://en.wikipedia.org/wiki/Flight-to-quality>.
- 16 See interviews with, *inter alia*, Standard Bank, First Rand and Absa Capital in South Africa; and with First National Bank of South Africa, Standard Chartered Bank, African Banking Corporation and Stanbic in Botswana.
- 17 Repullo R & J Suarez, 'The procyclical effects of bank capital regulation', European Banking Centre Discussion Paper 2010-05S, 31 October 2009.

- 18 Banks anticipated that shocks to their earnings as well as the cyclical position of the economy could harm their capacity to lend in the future and, as a precaution, held significant capital reserves. (Repullo R, *op. cit.*). According to Marc Auboin, 'The Basel II accord, finalised in June 2004, sets out a framework for banks to determine their minimum capital set-aside requirements in order to ensure that sufficient capital is on hand in times of stress. The agreement sets different weightings for various forms of credit risk, with riskier forms of exposure subject to higher set-aside requirements. In the case of trade finance, the credit conversion factor has been determined at the level of 20%, the same as in the Basle I framework. The difference, though, is in the application of such ratios. The Basle II framework is a risk-based, asset-weighted system of capitalisation. Should the inherent risk of doing cross-border business increase with the instability of the international financial environment, the capitalisation requirements are also set to increase – both with the re-assessment of the banks' internal ratings, but also with the assessment of the counter-party risk. This double weighting tends to increase capitalisation for cross-border lending relative to domestic lending.' Auboin, M, 'Restoring trade finance during a period of financial crisis: Stock-taking of recent initiatives', Staff Working Paper ERSD-2009-16, WTO, December 2009. See http://www.wto.org/english/res_e/reser_e/ersd200916_e.pdf.
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- 25 Reuters, 'Africa M&A doubles to US\$25 billion in H1, fees squeezed', 14 July 2010.
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- 49 *Ibid*.
- 50 See section 'What Reforms on the Horizon?'
- 51 Pomerleano M, 'The Basel II concept leads to a false sense of security', The World Bank, 5 February 2010. See <http://www.voxeu.org/index.php?q=node/4561>.
- 52 *Ibid*, p. 2.
- 53 See comments of the chief director at the South African Department of National Treasury, Nkosana Mashiya, and also comments from interviewees from the three major banks – Standard Bank; Absa Capital and FirstRand. Cf, also works cited from BAFT–IFSA, ICC, and IIF.
- 54 Van der Merwe P, 'The effect of the newly proposed changes to Basel II on balance sheet extension for investment banks', internal white paper, Absa Capital, South Africa, July 2010.
- 55 Creamer T, 'New bank curbs may crimp capital for Africa's US\$93 billion/y infrastructure needs', *Engineering News*, 17 August 2010. See <http://www.engineeringnews.co.za/article/new-bank-curbs-may-crimp-capital-for-africa-93bny-infrastructure-needs-2010-08-17>.

- 56 'Client franchise' refers to that portion of the bank's business that is purely due to client relationships and related business flowing from such clients. Bank revenue per client may typically consist of (i) margin (through assets on balance sheet); (ii) risk management income (trading room products, e.g. interest rate swaps and currency forwards); and (iii) fees (e.g. for arranging finance). The opposite of client franchise is proprietary trading, i.e. the bank does not rely on clients for income but on pure speculative trading activities (taking positions in the market, i.e., taking on pure market risk). The most 'balance sheet intensive' activity is (i) above, so if banks are forced to do less of (i) then they must make more out of (ii) and (iii) to compensate. If this does not work, the temptation might be to go for more risky speculative trading activities. So if they cannot generate more of (ii) and (iii), they will simply have less income or be tempted towards more risky proprietary trading.
- 57 Proprietary trading is where a bank or financial institution trades securities and other financial instruments with its own money rather than for its customers. See http://freerisk.org/wiki/index.php/Capital_adequacy.
- 58 *Ibid*, n.51. In the explanation above, this refers to income sources described in (ii) and (iii).
- 59 If the bank has less capacity to do (i) above, this means a smaller balance sheet, but if they want to generate the same revenue numbers as before, it would translate into more expensive loans (i.e. (i) above) plus a lot more of (ii) and (iii) above. If the bank is not able to do any of this, then it will have to cut costs to maintain profitability.
- 60 Van der Merwe P, *op. cit.*
- 61 Portfolio management is about determining the mix of assets to hold in a portfolio. A fundamental aspect of portfolio management is choosing assets which are consistent with the portfolio holder's investment objectives and risk tolerance. The ultimate goal of portfolio management is to achieve the optimum return for a given level of risk. See investor glossary, <http://www.investorglossary.com/portfolio-management.htm>.
- 62 Concentration risk is the risk of loss because of the concentration of exposure to a specific instrument, sector, individual transaction, industry, or country. See <http://www.oag.govt.nz/2007/nzdmo/glossary.htm>.
- 63 'Pipeline management' is about determining whether and how a set of projects in the portfolio can be executed in a specified time, given finite development resources. This appears to be the best definition of pipeline management. See http://en.wikipedia.org/wiki/Project_portfolio_management.
- 64 There are two ways in which a bank can increase its capital ratio: (i) by maintaining the current asset levels but raise more share capital; or (ii) by maintaining the current share capital levels, but reducing asset levels. If the bank wants to continue doing more asset-based business but is already at its capital adequacy ratio, then it will need to resort to 'balance sheet space creation'. In other words, it will sell assets to make space for new assets. If it does not do this, its capital adequacy ratio will be negatively affected.
- 65 Pension funds through asset managers have a natural appetite for longer-term assets which can be matched with their long-term liabilities. If they simply match these two, then there is no need to subject them to the same rules as banks. Mostly because banks do not have long-term liabilities as deposits are mostly short-term. Banks perform maturity transformation – i.e. they match long-term assets – loans against short-term liabilities (deposits) – and this mismatch requires rules. The re-allocation of credit risk from banks to asset managers is a by-product of Basel III and has been recognised as such by the Basel Committee. This development is driving banking balance sheet disintermediation and the acceleration of 'private credit' (i.e.

the provision of loans by non-bank institutions). This results in a more natural fit between long-term assets and long-term liabilities. Van der Merwe P, *op. cit.*

- 66 MacInnis L, 'Bank regulation seen hurting commodity exports', *Reuters*, (AFX UK Focus) 10 June 2010; and interviews held with Standard Bank and Absa Capital, July 2010.
- 67 BAFT-IFSA is the global financial services association formed by the merger of the Bankers' Association for Finance and Trade (BAFT) and the International Financial Services Association (IFSA) in April 2010.
- 68 AVC – when this is calculated for a financial institution, it is an attempt to determine to what extent the valuation of one asset class or type will be influenced by another. The higher the likelihood of this cross-influence, the higher the correlation (and the AVC) and the riskier the asset base is deemed. High AVC means that if one asset class goes down, there is a high probability that other asset classes on the same balance sheet might also go down and cause massive losses. Van der Merwe P, *op. cit.*
- 69 Institute of International Finance (IIF) is the world's only global association of financial institutions. Created in 1983 in response to the international debt crisis, the IIF has evolved to meet the changing needs of the financial community. Members include most of the world's largest commercial banks and investment banks, as well as a growing number of insurance companies and investment management firms. See <http://www.iif.com> for additional information.
- 70 Klein MU, 'The international financial crisis: What next for emerging markets', p. 6. See <http://www.worldbank.org/financialcrisis/pdf/UnfoldingCrisis1.pdf>.

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