INTERNATIONAL CHAMBER OF COMMERCE

Finance for Development
Banking Commission

WORKING GROUP ON IBOR DEMISE AND TRANSITIONING TO NEW BENCHMARKS

TERM REFERENCE RATE FOR TRADE FINANCE AND EXPORT FINANCE SOLUTIONS

INTERNAL

Background

The Interbank Offered Rate (IBOR) is a widely used benchmark for many differing financial arrangements. Of particular note is its use in Trade Finance and Export Finance transactions.

Trade Finance comprises of working capital and risk-mitigating solutions used by corporates and financial institutions. Trade finance exposures are diverse in nature, typically smaller in value, shorter in tenor, self-liquidating and exhibit different behavior and payment patterns from other working capital solutions. Export Finance, which involves risk mitigation from Export Credit Agencies and Multilaterals may be longer in tenor and larger in size, but shares many of the characteristics of the general Trade Finance solutions. In this paper references made to Trade Finance include solutions offered under Export Finance..

It is estimated that 80-90% of global merchandise trade (approx. USD19.48 trillion for the year 2018) is reliant on Trade Finance[1]. The LIBOR term rates (1 week, 1, 2, 3, 6, and 12 months) are commonly used as the reference rate for short term, fixed interest in advance (discounting) or interest in arrears Trade Finance solutions providing transparency of pricing and certainty of interest costs.

With the regulatory call for a market-wide transition away from LIBOR to Risk Free Rates (RFRs), financial institutions need to be prepared for LIBOR's demise by the end of 2021. A Working Group (WG), sponsored by the ICC and represented by some of the leading Trade Finance banks, was set up in Nov'19 to consult and provide market views concerning the IBOR transition to the regulatory preferred Risk Free Rates (RFR) committees specifically from the perspective of the Trade Finance industry.

Working Group Outcome

The WG issued a consultation paper and sought views from member banks of the ICC through its national committees. The member banks have recognised the continued need for a forward-looking term rate for Trade Finance products, across currencies, to support a robust and streamlined transitioning to alternate benchmark rates. These forward-looking term rates would be applied selectively as a trade-off to the puristic Risk Free Rate approach, providing a workable solution for transactions requiring cost certainty and pricing transparency.

Whilst acknowledging the preference of the regulators for the market to adopt a broad-based transition to RFRs compounded in arrears, it is also noted that backward looking RFRs are not suitable for all transactions.

This paper represents the view of the WG as well as the feedback received from the national committees and aims to –

- Define the scope and usage of the forward-looking term rate
- Outline the rationale for trade finance business requiring forward-looking rates
- Express the significance in the selection of the term reference rate publishers

Scope and usage of forward- looking term rates

The WG recognises the critical need for a forward-looking rate to the solutions under Trade Finance product line and recommends its application:

[1] WTO Economic Research , Global Trade Finance Data

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- Where interests are typically recovered in advance and customer receives the discounted proceeds on the first day - examples being Supply Chain Finance solutions (Receivables Discounting, Payables Finance, etc.), Discounting of Letters of Credit or other instruments.
- Where interests are recoverable in arrears and clients need an upfront fixed rate pricing structure - example being Import/ Export Loans, Export Finance transactions supported by export credit agencies, etc)

Why Trade Finance needs forward-looking rates

1. Trade Finance lending is linked to specific, identifiable underlying trade transactions (the purchase / sale of goods or services). Customers will typically require the certainty and upfront visibility on their interest payments for pricing the goods / services, budgeting and cash flow planning. The likely loss of the upfront knowledge of interest costs when using ''backward-looking'' RFRs calculated at the end of the interest period creates a challenge to participants in buying and selling goods or services at competitive margins.
2. Regulators in certain markets require the interest cost to be made available at the time of the loan drawdown for reasons such as giving small business (SME) clients certainity of interest payments, cash flow planning etc. and using a daily compounded rate in arrears does not meet this requirement
3. Users of Trade Finance belong to a wide spectrum of company profiles including smaller companies who may not have the sophistication or access to the treasury solutions to hedge (fix) the interest,
4. Availability of forward-looking term rates helps in calculating coverage ratios for such loans which may be secured against collateral / security.
5. Some key Trade Finance solutions are offered with interest payable in advance. These solutions form a significant portion of the Trade Finance market and cannot be offered without a fixed forward- looking rate.
6. For solutions where interest is recoverable in arrears, further to the challenges outlined in points numbers 1- 4 above, a variable rate may pose other practical challenges. Trade finance customers may have trade facilities with a number of different banks, but generally use only one or two as their cash bank. Interest in arrears at a variable rate may mean the customer has insufficient time to arrange to remit the principal plus interest to the lending bank, as the total interest payable may not be known sufficiently ahead of time. The more diverse range of currencies and higher volume, lower value of trade finance transactions vs traditional lending will make this more problematic for Trade.
7. As agreements and contracts containing LIBOR are revised, the lack of a forward- looking term rate for trade finance transactions may make it challenging to ensure these contracts will continue to function as intended by the parties.
8. While the market will be provided shortly with daily term compounded averages of the new reference rates, these will still not replace the need for forward-looking rates as they are based on backward-looking historical rates.
9. There is a significant secondary market for trade finance, enabling finance providers to deliver solutions to clients where funding capacity constraints may otherwise preclude them from doing so. Availability of term reference rates supports both the origination and distribution of these funded structures.
10. Many of the above points relating to Trade Finance apply equally to solutions under Export Finance , in particular points 1,3, 7, 8 and 9, plus the fact that many Export Finance clients require more notice to make principal and interest payments than envisaged under daily compounding methodologies with some requiring 30 days or more advanced notice. This

necessitates a forward-looking term rate or equivalent to determine interest costs in advance.

Selection of term reference rates publisher(s)

Multiple publishers have entered the market and are planning to publish term reference rates. WG members are of the view that the lenders should reference a common publisher of term reference rates in order to deliver the best outcome to the customers. Regulators may consider identifying a single publisher with a robust calculation methodology to ensure transparency and adoption.

If the market converges on more than one publisher, methodologies may differ and lead to varying term rates. The market (supported by the regulator) may need to ensure that the waterfall for calculation of term rates is consistently deployed across all publishers and the terms rates are available at any given point in time and are on a comparative and competitive basis.

Recommendations

ICC Banking Commision has issued this paper to highlight the importance of forward-looking rates for the Trade Finance and Export Finance industries, as compounding the rate in arrears is not suitable for servicing many of the users of Trade Finance and Export Finance solutions. The paper also recommends that a consistent approach be followed by the market in publishing of term reference rates.

While we are pleased to note the position of the UK Working Group for the Sterling Risk Free Reference Rates acknowledging the need for forward-looking term rates (with limited applications) for trade and working capital and for export Finance and emerging market loans, the view of this working group is to use the forward-looking term rates for trade solutions with interest recovered in advance or, interest recovered in arrears where clients needs to know the rate upfront.

Along with this, it is important that these forward-looking term rates are made available in a timely manner to ensure a smooth transition. This will further support the system and process readiness of all market participants.