Benefits of ADB’s Funded and Unfunded Trade Finance Support

1. Introduction

The Asian Development Bank (ADB), by means of its Trade Finance Program (TFP), promotes trade with and among its Developing Member Countries (DMCs) by offering support with the following products:

- Credit guarantees for funded or unfunded transactions
- A funded revolving credit facility (RCF)
- Refinancing for funded exposures of global banks to DMC banks

The TFP’s credit guarantees — unfunded or in combination with a funded product — mitigate interbank risk. The key leverage for this is the favorable treatment of ADB’s status as a multilateral development bank (MDB) in connection with its AAA credit rating. This allows for higher trade finance volumes with a given risk appetite, and for a more efficient use of a bank’s regulatory capital. Both funded TFP products — the RCF for DMC banks and refinancing for global banks — provide liquidity while the latter is only available in combination with a credit guarantee.

ADB backing is only provided if all of the following criteria are met: i) an agreement and active credit limit for this particular product with the ADB is in place; ii) the goods shipped under these particular transactions qualify for ADB support; iii) at least one of the trading partners is located in one of the ADB’s DMCs; iv) none of the trading partners, their owners or countries, are on a relevant sanctions list.

The TFP refers to DMC-based obligors in inter-bank trade finance as “issuing banks” and their creditors (in or outside DMCs) as “confirming banks”. This terminology is derived from letter of credit (LC) transactions, although the ADB can also support other financial instruments. Upcoming issues of the ‘In Focus’ series will discuss LCs and other unfunded trade finance instruments in more detail. Updated lists of institutions accredited with the ADB as issuing or confirming banks are available on the TFP’s website.

2. Products of the ADB’s Trade Finance Program

Inter-bank credit limits are a scarce resource in trade finance, especially when the obligor is domiciled in a developing or transition country. The credit guarantee products of the ADB’s TFP can add value where demand for trade finance exceeds the available limit, or where a limit is absent in the first place. This enables banks to process larger trade volumes without necessarily taking on more risk.

Figure 1 shows an international trade finance transaction between two banks and an exporter or importer. Credit risk is depicted as red arrows from the creditor’s perspective, i.e. pointing to the obligor: from a confirming bank to a DMC-based issuing bank, and from the latter to its business client. These creditor-obligor relationships are trade-related (as indicated by the caducei) and support the same underlying shipment. For the sake of clarity, the corresponding accounting positions are shown as on-balance sheet assets and liabilities, as would be the case for a funded trade line, e.g. for the purpose of pre-shipment finance to an exporter. However, among the transactions for which banks seek
support from the ADB, off-balance sheet exposures prevail, such as the confirmation of an LC issued on behalf of an importer.

Figure 1. Credit risk in an international trade finance transaction

If approached by either of the banks (dashed grey lines in Figure 2), the ADB can issue a credit guarantee for the principal of a specific transaction favoring the confirming bank (green arrow). The instrument of choice is a stand-by LC (caduceus in a rescue net). The issuing bank becomes the ADB’s obligor for the full transaction amount (new red arrow). It remains obliged to pay the confirming bank, but does not represent a credit risk for the latter any longer (greyed-out arrow) as far as the principal is concerned. In accounting terms, the original exposure remains in the books, but from a risk perspective, the ADB completely absorbs the credit risk of the principal. The confirming bank retains only accrued and future interest as a residual risk (transparent ‘issuing bank’ symbol on the asset side of the confirming bank).

Figure 2. Credit guarantee for individual transactions with stand-by LCs

In addition to this case-by-case approach, the ADB can also guarantee credit exposures in bulk via Risk Participation Agreements (RPAs). Several globally active confirming banks have signed an RPA
with the ADB. They report to the latter monthly their exposures with issuing banks (dashed arrow in Figure 3) for which they want ADB’s support. The ADB can absorb the risk for several transactions (caducei in rescue net), up to 85% of each. The confirming bank remains the creditor for each transaction, but is exposed to only 15% of the risk (predominantly transparent ‘issuing bank’ symbol on asset side of confirming bank). The issuing banks are not actively involved in this transaction and might not even be aware of it.

**Figure 3. Credit guarantee for multiple transactions (funded or unfunded) under RPAs**

Additionally, the ADB can refinance up to 50% of funded transactions guaranteed under RPAs. For instance, for a funded transaction worth USD 1,000,000, the ADB can guarantee USD 850,000 and can also refinance up to USD 500,000. Figure 4 depicts the funding as blue arrows with banknotes, and the ADB as the confirming bank’s creditor on its liability-side.

**Figure 4. Refinancing for funded, guaranteed transactions under RPAs**
In a nutshell, the credit guarantees of the ADB’s TFP mitigate inter-bank risks for the outstanding principal and are occasionally complemented by refinancing for inter-bank lending. These facilities benefit directly confirming banks and indirectly DMC-based issuing banks and their clients.

Separately, the ADB can extend a revolving credit facility (RCF) directly to an issuing bank that on-lends these funds to one or more exporters or importers (Figure 5). As the RCF is funded, the ADB’s risk appetite for this product is significantly lower than for credit guarantees. Therefore, RCF limits are approved more selectively and tend to be for considerably lower amounts (at least initially) and shorter tenors. The RCF is currently available in US dollars, euros, yen, renminbi, New Zealand dollars and Australian dollars. Some countries levy a special tax on foreign borrowings; however, the ADB’s RCF is exempt due to its status as a multilateral development bank (MDB).

Figure 5. Revolving credit facility for funded trade finance to customers

3. Impact on prudential indicators under Basel I — III

A major motive for why confirming banks offload inter-bank credit risk to the ADB is capital management. When determining a bank’s capital adequacy, off-balance sheet exposures (e.g. LCs or stand-by LCs) are converted into credit risk equivalents as to reflect their product-specific risk profiles; an upcoming ‘In Focus’ issue will discuss this important aspect in more detail.\(^2\) Next, on and off-balance sheet exposures are multiplied with risk weights, yielding as a result credit risk-weighted assets (RWA), the capital adequacy ratio’s denominator.\(^3\) Risk weights are essentially proxies for historical default rates of different types of obligors (e.g. sovereigns and central banks, commercial banks, enterprises).\(^4\)

As mentioned, the ADB’s credit guarantees can mitigate confirming banks’ credit risk exposure towards issuing banks (obligors). It is understood that a guarantee represents only a ‘second way out’ for the confirming bank, i.e. it can claim payment from the ADB only if the issuing bank defaults. Regardless of that aspect, all Basel frameworks (I—III) allow the credit risk parameters of certain third-party guarantors (including the ADB) to replace those of the original obligor. Risk weights are the risk parameter relevant for Basel I and the standardized approach to credit risk of Basel II and III. The internal ratings-based (IRB) approaches of Basel II and III use instead the probability of default (PD, foundation and advanced approach) or the loss given default (LGD), only advanced approach.\(^5\) The adoptions of Basel in the US and the EU fully reflect this possibility of credit risk
substitution. Banks are free to choose whether this can improve their internal obligor risk ratings or only the facility risk ratings. Consequently, ADB’s credit guarantees can lower the RWA for an exposure, and it is largely left to each bank whether and how to reflect this credit risk mitigation in its accounting and rating systems.

As mentioned, the ADB’s credit guarantee covers the principal, but not accrued interest; moreover, under RPAs only 85% of the risk can be transferred. In both cases, the Basel rules provide that the covered portion is treated like a secured facility, i.e. the ADB risk weight is applied to 100% of the principal or, under RPAs, only to 85%. The uncovered remainder is treated like an unsecured facility, i.e. accrued interest and 15% of the principal under RPAs are multiplied with the obligor’s risk weight.

Basel I prescribes a risk weight of 20% for all commercial banks, with the exception of non-OECD banks borrowing in foreign currency or for longer than a year (100%). Per Basel II, risk weights for banks depend on their corporate rating or the sovereign rating of their main country of operations (Table 1). Banks need to choose one of these approaches and apply it uniformly to all exposures with other banks.

### Table 1. Risk weights and external ratings for banks under Basel I and II

<table>
<thead>
<tr>
<th>Basel I</th>
<th>Risk Weights</th>
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<tbody>
<tr>
<td>OECD and domestic banks</td>
<td>20%</td>
</tr>
<tr>
<td>Non-OECD banks</td>
<td>borrowing in their own currency or for ≤1 year</td>
</tr>
<tr>
<td></td>
<td>borrowing in FX or for &gt;1 year</td>
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<tr>
<td>Basel II</td>
<td>Risk Weights for Long-Term Issuer Ratings</td>
</tr>
<tr>
<td></td>
<td>Unrated</td>
</tr>
<tr>
<td>Based on Sovereign Rating</td>
<td>100%</td>
</tr>
<tr>
<td>Based on Corporate Rating and Original Maturity (in Months)</td>
<td>50%</td>
</tr>
</tbody>
</table>

Under Basel I, credit exposures guaranteed by MDBs such as the ADB received a 20% risk weight (Annex 2 of Basel I). Therefore, for confirming banks in jurisdictions fully in line with Basel I (where there are only two different risk weights for banks), the ADB can add value where the issuing bank’s risk weight is 100%.

The standardized approach for credit risk of Basel II and III assigns MDBs a zero-risk weight if they are AAA rated. The frameworks explicitly mention the ADB as an eligible third-party guarantor (section II.A.3. of Basel II). Evidence from contemporary rating methodologies, applied to MDBs, suggests that an IRB approach yields PDs below 0.8% for a one-year horizon and less than 2.2% for three years. For confirming banks in Basel II or III jurisdictions, it is therefore attractive to use the ADB’s credit guarantees for any inter-bank transaction.

It is important to note that even in some countries where capital frameworks are largely based on Basel I, the treatment of banks and MDBs is closer to Basel II, such that the ADB can have a zero-risk weight. In case of doubt, a closer look in the national regulations on capital adequacy is advisable.
The following example (Table 2 on the next page) quantifies how the ADB’s credit guarantees can release regulatory capital of confirming banks (assuming that the minimum capital requirement is 10% of RWA and the exposure in question was originated on the same day, i.e. no interest has yet accrued):

- A bank in a Basel II or III jurisdiction has risk-weighted trade finance exposures of USD 100,000
- If it keeps the entire amount on the books, it needs to allocate USD 10,000 in regulatory capital
- ADB’s credit guarantees for individual transactions result in zero RWA and no capital required
- With ADB’s support through an RPA, the bank reduces its RWA up to USD 15,000, requiring only USD 1,500 in capital

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Illustration</th>
<th>RWA Before</th>
<th>Risk Transfer</th>
<th>RWA After</th>
<th>Capital Required*</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Risk Transfer</td>
<td>Figure 1</td>
<td>$100,000</td>
<td>$0</td>
<td>$100,000</td>
<td>$10,000</td>
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<tr>
<td>Credit Guarantee (individual transaction)</td>
<td>Figure 2</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Credit Guarantee (under RPA)</td>
<td>Figure 3</td>
<td>$100,000</td>
<td>$85,000</td>
<td>$15,000</td>
<td>$1,500</td>
</tr>
</tbody>
</table>

* Assumption: Minimum Capital Adequacy Ratio is 10%

Table 2. Risk relief via the ADB’s 0% risk weight (Basel II and III)

With regard to confirming banks’ capital adequacy (Basel II or III), and compared to keeping inter-bank exposure on the books, ADB’s credit guarantees facilitate the financing of trade volumes that are:

- 6.7 times as large when bundling transactions under RPAs ($100 \div [10\% \times 1.5] = 666.7$), and
- Limited only by the ADB’s available credit limit for individual transactions

For confirming banks subject to the full Basel III capital framework, the ADB’s credit guarantees:

- Have no direct effect on the leverage ratio (by definition, it is unaffected by risk weights)
- Lower their profile regarding systemic importance, as transactions with MDBs are excluded from the criteria ‘cross-jurisdictional claims’ and ‘interconnectedness’ for global systemically important banks (SIBs);\(^3\) this can also be relevant for domestic SIB criteria

As for other key Basel III indicators, ADB’s refinancing under RPAs can also improve confirming banks:\(^3\)

- **Liquidity coverage ratio** (LCR), especially if the refinancing is not due within 30 days;\(^2\) and
- **Net stable funding ratio** (NSFR) if the refinancing’s original tenor is at least six months and its residual maturity at least matches that of the underlying trade loan\(^3\)

Issuing banks can benefit from the TFP indirectly via higher business volumes with confirming banks, directly via the liquidity of the RCF, and ultimately from the additional fee and interest income. Passing an ADB due diligence and being listed on the [TFP’s website](#) also sends a strong signal to the market.

The RCF can also help issuing banks to hedge their currency and maturity mismatches. Meanwhile, as with all wholesale funding, its LCR treatment depends on the maturity schedule (of RCF and
underlying loan), and for NSFR purposes, it is considered a less stable funding source than e.g. customer deposits. ADB refinancing under RPAs can have the same benefits for issuing banks as the RCF if the RPA refinancielleads to more funded trade lines from global confirming banks to issuing banks.

4. Summary

The ADB’s TFP supports trade with and among its DMCs. The ADB’s status as a multilateral development bank (MDB), in connection with its AAA credit rating, grants a favorable treatment under the Basel capital frameworks: Basel II and III allow for a risk weight of 0% under the standardized approach for credit risk, and probabilities of default close to zero under the internal ratings-based approaches. Hence, the ADB’s unfunded products (credit guarantees) are a powerful mitigant for inter-bank risk. They are available to all accredited issuing and confirming banks and allow for a more efficient use of confirming banks’ regulatory capital, and thus higher trade finance volumes with issuing banks. Funded products (refinancing under RPAs for confirming banks and the RCF for issuing banks) are provided on a more selective basis due to their higher risk; they provide liquidity and can be beneficial for confirming banks’ Basel III LCR and NSFR, as well as for hedging issuing banks’ currency and maturity mismatches.

This article was written in collaboration with Mr. Andreas Raithelhuber of Business and Finance Consulting.
As the ADB is now the confirming bank’s obligor, the credit risk could be represented separately as a red arrow pointing towards the ADB, to be consistent. However, as a AAA-rated multilateral development bank, the ADB’s probability of default is close to zero. Hence, this unlikely scenario is not considered in the various figures.

It is understood that under the internal ratings-based approaches of Basel II and III, product-specific risk profiles are factored into the probability of default (PD) and exposure at default (EaD).

The capital charges for market risk (Basel I amendment of 1996) and operational risk (Basel II) compute, in principle, also to the denominator; however, for commercial banks, their contribution tends to be marginal.

The Basel II standardized approach for credit risk suggests risk weights for banks and enterprises depending on their corporate rating; however, most DMCs have adopted the simplified standardized approach, without ratings.

Article 480 of Basel II.


Article 485 of Basel II explicitly mentions ‘borrower or facility ratings’, and article 487 ‘borrower grades or LGD ratings’.

Articles 190.c) and 198 of Basel II as well as Article 40 of Basel I.


Given the lack of historical data, these are so-called implied PDs, i.e. they were inferred mainly from the credit spreads paid by MDBs pay on the capital market, compared to those of corporate debt issuers. Perraudin, Powell, and Yang (June 2016). Multilateral Development Bank Ratings and Preferred Creditor Status. IDB Working Paper Series no. IDB-WP-697, Tables 15 and 16. https://publications.iadb.org/en/publication/12481/multilateral-development-bank-ratings-and-preferred-creditor-status

The complete global SIB criteria are: (i) cross-jurisdictional activity, (ii) size, (iii) interconnectedness, (iv) substitutability (i.e. role for financial system infrastructure), and (v) complexity.

The LCR is the relationship between high quality liquid assets (HQLA) and net cash outflows over the next 30 days and should be at least 100%. FRPA loans will always benefit PFIs as long as they are not due within 30 days. The reason is that the additional cash from refinancing increases HQLA in the numerator, while the corresponding repayment obligation (a future cash outflow) in more than 30 days is not included in the denominator. Within the 30-day period, the effect is positive only if the LCR was originally smaller than 100%, because the same FRP amount is added to both numerator and denominator, but impacts the relatively smaller numerator more. PFIs with a FRPA loan due in less than 30 days and an LCR above 100% could improve it further by settling the outstanding amount. BCBS (January 2013). Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, par. 138 and Annex 4. http://www.bis.org/publ/bcbs238.htm

The NSFR is the relationship between available stable funding (ASF) and required stable funding (RSF) and should be at least 100%. A FRPA loan adds to the PFIs’ ASF and frees up cash, e.g. to make more loans to DMC banks. For inter-bank loans with residual maturities of six to 12 months, both the RSF and ASF factors are 15%, and for more than a year, 100%. However, inter-bank loans up to six months have a 15% RSF factor in the denominator (i.e. on the asset side), but are not considered as ASF at all in the numerator (i.e. 0% factor on the liability side). Hence, a FRPA benefits the NSFR only if its original tenor is at least six months. BCBS (October 2014). Basel III: the net stable funding ratio. http://www.bis.org/bcbs/publ/d295.htm.