Commodities

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COMMODITIES BULLETIN

New ICC rules on forfaiting

In November 2012, the International Chamber of Commerce (ICC) launched new Uniform Rules on Forfaiting (URF). The rules take effect from 1 January 2013. The URF should create standard practice for forfaiting. The credibility this will add to the practice is likely to have a significant effect on the extent of its use.

Forfaiting has grown markedly in recent years. It is a form of trade finance that is well-suited to highly regulated and risk averse markets. Forfaiting involves a trader selling goods to a forfaiter, repurchasing the goods from the forfaiter at a premium, and selling them on to the end buyer.

The proposal for a uniform set of rules was first put forward in 2009. There have inevitably been differences of opinion about it. The leading forfaiting organisations, including the International Forfaiting Association (IFA), are pleased to have a set of rules from such a reputable and trusted institution as the ICC, offering international recognition and acceptance to the practice of forfaiting. Another group, composed mainly of independent forfaiters, believes the rules could expose forfaiters to disputes over payment. The new rules will have to strike a balance between providing regulation and not disrupting the forfaiting process.

Forfaiting traditionally offers greatest benefits in long-term transactions, of up to ten years in duration. However, the current market trend is strongly focussed on the minimum forfaiting term, of around six months. This trend shows the market's need for a more flexible type of financing in the present economic climate. That said, even the most flexible financing processes benefit from having a set of governing rules, as both the ICC and the forfaiting industry are fully aware.

The debt provided for under a forfaiting agreement is enforced in a form of payment obligation, often a documentary letter of credit guaranteed by a bank. The URF rules

are intended to cover the various different payment instruments comprehensively, including promissory notes and bills of exchange. This may lead to an increase in the use of such lesser known payment instruments.

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The effect of Basel III on trade finance

The requirements of the Basel III accord will start to apply from 1 January 2013. The Financial Times and other newspapers have claimed that its impact could be devastating to the trade finance industry. On 19 October 2010, the FT ran an article entitled *"Impact of Basel III: Trade finance may become a casualty"*. A year later, another FT article, on 19 October 2011, incorrectly claimed that the capital requirements for trade finance instruments such as letters of credit have increased from 20% to 100%. It has also been reported that, in response to these stricter regulatory requirements, some of the major players in trade finance are withdrawing from the business.

It is true that some large players are exiting the field. However, this is not necessarily as a consequence of the Basel accords. It is the consequence of the Eurozone crisis, the difficulties of getting funding in US dollars, the general financial crisis, volatility in the banks' share prices and rising commodity prices, among other factors. Several banks are dealing successfully with these challenges. This may be because they are less susceptible to them because of their geographical location, the amount of their available capital reserves, their access to funding, or their business strategy.

It is not the case that trade finance has become unprofitable. The banks who are constrained by factors such as those mentioned above have cut their trade finance departments because they are less profitable. This presents business opportunities for new entrants to the market.

Basel III does not completely re-write the previous Basel accords. It makes amendments to Basel II and adds several features. The way basic capital is calculated remains almost identical. Moreover, because letters of credit are usually collaterised and the value of the collateral can in most circumstances be taken out of the value of the asset to calculate the capital requirements, the actual capital requirements for letters of credit in monetary terms have not changed significantly.

The change introduced by Basel III most likely to affect the trade finance industry is the introduction of the new leverage ratio and credit conversion factors. Basel III requires leverage ratio of at least 3%. This must be fully in place by 2018 and must be monitored by supervisors in the interim, and publicly disclosed from 2015. Technically, the leverage ratio is the ratio of tier 1 capital (as measured under Basel III) to total exposures (being non-risk weighted assets and off-balance sheet exposures). This means that for every US$100 in assets, the bank must have not more than US$97 in liabilities and off-balance sheet exposures. Or, put another way, a bank's commitments will be capped at 33 times tier 1 capital. In calculating the leverage ratio, risk mitigating factors that can be taken into account for calculating off-balance sheet exposures cannot be taken into account when calculating on-balance sheet exposures. In the basic capital calculation outlined above, risk mitigation can still be applied to off-balance sheet exposures such as letters of credit.

Assets for the purpose of calculating the leverage ratio are calculated in the same way as for calculating the basic capital requirements, though the ratio is measured for the whole bank rather than transaction by transaction. However, whereas the credit conversion factor to calculate the basic capital for trade finance instruments such as letters of credit is 20% under Basel III (as it was under Basel II), it is 100% for the purposes of calculating the leverage ratio under Basel III. This has been widely misunderstood and misreported as an increase in risk-weighting for calculating trade finance capital requirements.

The effect of the change in the calculation of the leverage ratio is that on average, the amount of capital that has to be reserved to meet the required leverage ratio for a specific trade finance transaction is larger than what is necessary to meet the basic capital requirements. The difference will depend on how high the tier 1 capital requirement is set. On the other hand, it is still a fraction of a percent of the total exposure after the risk mitigating factors are taken into account. Where a bank's minimum capital is dictated by the leverage ratio rather than by the risk-weighted capital requirements,

it may be that the bank will opt to invest in higher risk assets rather than undertaking lower risk trade finance business.

It is difficult to sustain the argument that the new Basel rules in general, or the leverage ratio in particular, have caused large international banks to retrench from trade finance. Well managed, trade finance remains a highly profitable business.

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Challenging GAFTA jurisdiction: Court clarifies time limit

In a recent judgment, *PEC Limited v Asia Golden Rice Co Limited (17 October 2012)*, the Commercial Court has clarified the time limit for challenging the decision of a first tier GAFTA tribunal that it has jurisdiction to hear a dispute.

Asia Golden Rice Co Limited (AGR) agreed a contract for the sale of 25,000MT of Thai Rice to PEC Limited (PEC). AGR alleged that PEC failed to perform and brought their claim before a GAFTA tribunal earlier this year.

In its award, the tribunal found that the contract of sale incorporated the GAFTA Arbitration Rules (the GAFTA Rules) and so it had jurisdiction to hear the dispute. It found in favour of AGR and ordered PEC to pay damages in the sum of US$6,250,000.

PEC appealed the tribunal's findings on the merits to the GAFTA Board of Appeal. At the same time, PEC challenged the tribunal's jurisdiction. Under the GAFTA Rules, if a GAFTA tribunal decides it does *not* have jurisdiction to hear a dispute, a party can pursue an appeal against that decision to the GAFTA Board of Appeal. Where, as here, a tribunal rules that it *does* have jurisdiction, no appeal to the GAFTA Board is available.

However, under section 67 of the English Arbitration Act 1996 (the "Act"), any party to any arbitration can apply to the English Court to challenge a decision of an arbitral tribunal as to its own jurisdiction. The time limit for making such an application is 28 days, either from the date of the decision on jurisdiction, or from the date of exhaustion of *"... any available process of appeal or review"*.

PEC wanted to make an application under section 67 of the Act. The issue was whether they needed an extension of time to do so. PEC argued that they did not, on the basis that the 28 day time period would only start to run from the date of the GAFTA award on the appeal as to the merits - which was still underway. PEC placed emphasis on the reference to *"any available process of appeal or review"* in the Act and submitted that this had a wide enough meaning to include their outstanding appeal.

Although the parties had by then agreed that the Court should grant PEC an extension of time to make their application under section 67 of the Act, in a short judgment the Court gave a reasoned decision against PEC's arguments.

The Court held that the GAFTA Rules are clear that a first tier tribunal's award that it has jurisdiction is *"conclusive and binding"*. As the only route to challenge such a decision is by way of section 67 application under the Act, the time limit for bringing such a challenge must be 28 days from date of the first tier award. Contrary to PEC's submissions, under the GAFTA Rules there is no *available* arbitral process of appeal or review where the first tier tribunal determines it has jurisdiction. PEC therefore required an extension of time (which they were granted in any event).

For GAFTA practitioners contemplating a section 67 application against a first tier award, the message is clear: time will start to run from the date of the first tier award, irrespective of whether there is an appeal on any other issue to the GAFTA Board of Appeal.

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Conferences & Events

Breaking the oil curse: a guide to US and UK anti-corruption law seminar
HFW Friary Court, London
(10 December 2012)
Diana France, Anthony Woolich, Robert Finney and Nick Hutton

ICC Winter Trade Finance Conference
HFW Friary Court, London
(11 December 2012)
Robert Wilson, Craig Neame and Spencer Gold

International Trading Contracts: Description vs Quality: what recourse does a Buyer have?
Swissotel Geneva
(11 December 2012)
Sarah Hunt

LMA: Bills of Lading
Hotel Pullman, Dubai
(12-13 December 2012)
Simon Cartwright, Sam Wakerley, Yaman Al Hawamdeh and Nejat Tahsin

Capital Link Forum: 4th Annual Global Derivatives Forum
New York City, USA
(17 December 2012)
Brian Perrott and Robert Finney

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