

Transaction Banking: Respecting its role in the real economy

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Abstract

This paper sketches the main features and issues related to recent market developments in global transaction banking (GTB), particularly in trade finance, cash management and correspondent banking. It describes the basic functioning of the GTB, its interaction with global financial markets and related implications of global regulatory developments such as Basel III. The interest in GTB has recently increased, since its low-risk profile, tendency to follow growth rates worldwide and relative independence from other financial instruments became an interesting diversification opportunity both for banks' business models and for investors. Transaction banking has been a resilient business during the crisis, despite the reduction in world trade figures. In the post crisis period, GTB must cope with new challenges related to increased local and global regulation and the risk of inconsistency in regulatory approaches, which could negatively impact the global network and increased competition by new market entrants. Increased sophistication of corporate clients, as well as the pressure to develop and adopt technological innovations more quickly than other areas of banking continues to impact the business. The future of the industry closely depends on its ability to adjust to complex regulatory developments while at the same time being able to operate a global and efficient network.

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Introduction

- Purpose of global transaction banking** The task of global transaction networks is to facilitate the move of money in support of physical and financial transactions globally. Generally defined as a composition of trade finance, payments, cash management, correspondent banking and securities clearing and settlement, global transaction banking (GTB) forms an interface for global trade and helps companies to cope with the ever-more complex challenge of managing their cash and transactions for their customers and suppliers. It operates millions of transactions between corporate counterparties and – within companies – between their different sectors and with banking institutions.
- Importance for the real economy** Although the reputation of banking in general has been damaged during the recent financial crisis, GTB remains an operationally stable business, fairly invisible to the public behind other more exposed banking businesses. It continues to operate soundly and as a key building block for commerce, trade and the global economic system in general, even in difficult times.
- To be hit by regulatory reaction to other banking activities** Banking business has been faced with a raft of regulatory changes at global, regional and local level. Despite the fact that transaction banking is a business that is not displaying increased levels of risk given the absence of financial leverage, regulatory changes – primarily developed to reduce risks in other areas of banking – are likely to have unintended consequences for GTB.
- Purpose of this policy brief** The purpose of this policy brief is to present the basic functioning of trade finance and payment services (including corporate cash management and correspondent banking) as the main lines of GTB and to illustrate the challenges that it continues to face. It will explain the role of GTB in theory and in practice and demonstrate how it supports economic activity. It will also discuss how the views on GTB have changed during the financial crisis and what are its future perspectives as well as opportunities, risks and challenges, in particular in relation to key regulatory changes brought about by Basel III.

Transaction Banking – Challenges and transformations

- A non-core position of GTB before the crisis** Before the crisis, GTB had been widely considered as an operational activity – rather unexciting business – that supports business, government and banking needs. This particular, but stable, position of transaction banking can be explained by the fact that returns and margins are lower overall than in other banking business lines. Investment banking attracted the most attention of high-return seekers and witnessed the largest business development in the pre-crisis period. The reason for the relatively secondary position of GTB, however, has become one of its most distinct advantages and reasons for its survival during the crisis and increased attention to it after the crisis.

GTB and the financial and economic crisis

Although transaction banking did not go through a similar internally induced bust as other banking activities, the effects of the financial crisis on GTB have not been benign. The shortage of credit and liquidity combined with the increased stress in the inter-bank sector led to complications across all banking business lines. As GTB depends mainly on sources of finance from corporate deposits, the overall economic climate had an impact. In addition, global trade witnessed a significant fall, given the economic challenges experienced by trading counterparties. The European sovereign debt crisis also left its mark on the European banking sector, which had to partially withdraw from this business.

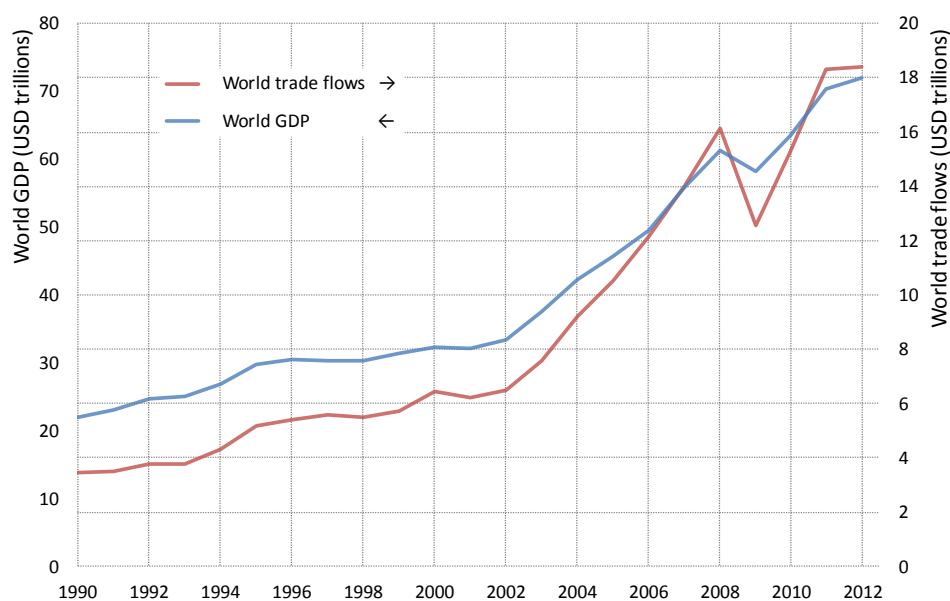
Invisible during the crisis

When the credit markets froze after the fall of Lehman Brothers, transactions nevertheless had to be processed in order to allow the financial system and the real economy to function and hence prevent a potential complete meltdown of the global economy. Given the stable nature of GTB, which continued to provide a stable revenue source for banks, the financial crisis became a turning point for this business. Suddenly banks started to reconsider the position of GTB within the remainder of the banking business.

Specifics of transaction banking

Despite the drop in global GDP and trade in 2009 (see *Figure 1* below) as illustrated by the volumes of trade-related transactions (see *Figure 2* and *Figure 3* below), GTB managed to continue its operations as the sources of its business are less reliant on wholesale financial markets than other banking business lines. Its lower sensitivity to stock markets and the global nature of this business – in general a lower dependence on western financial centres – have become a distinct advantage after the worst of the credit crunch has passed, transforming transaction banking into a field with high growth potential and low risks.

Figure 1. World GDP and global trade flows in current USD



Sources: WTO and IMF.

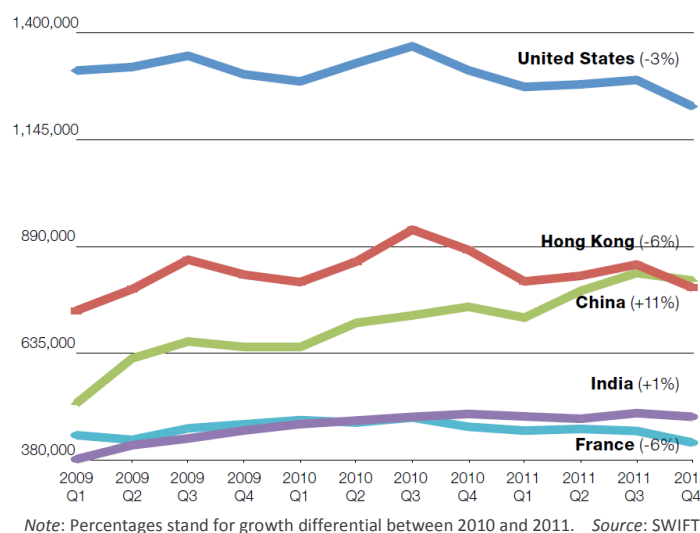
Its low margins as a new advantage

Global transaction banking has therefore been at the centre of the rethinking of financial services from a business point of view worldwide, as an example of banks serving the real economy and not hoarding risk for which other banking business lines have been criticised. Its relatively low but stable margins presented a good opportunity for predictable revenue after the turmoil, but also to show a constructive face of finance oriented towards supporting the real economy including emerging and developing markets. In addition, GTB provides a way to counterbalance potential volatility in other areas of banking such as investment banking and represents thus an investment-diversification opportunity.

Transformation of GTB in a more demanding environment

Whilst financial services have undergone comparatively greater upheavals and transformation in the recent past, GTB has also been transformed, most importantly in technological, geographical and business terms. In order to gain or keep its market share in an increasingly competitive environment, GTB divisions of banks had to cope with a changing environment due to increased pressures for technological innovation. GTB managers have also repeatedly undertaken to become more client-centric as the scope of technological individualisation became higher, and, thirdly, they have been forging strategies to increase GTB's relevance to the new global growth centres.

Figure 2. Top 5 countries in flows of documentary collections, guarantees and standby letters of credit



More competition and innovation

New regulatory requirements and the demanding technological character of transaction banking make it difficult for some players – especially smaller ones – to adjust and to stay profitable, but it also presents an opportunity to recreate the business models, look for new regions with high future growth potential and to re-centre transaction activities on specific customer types.

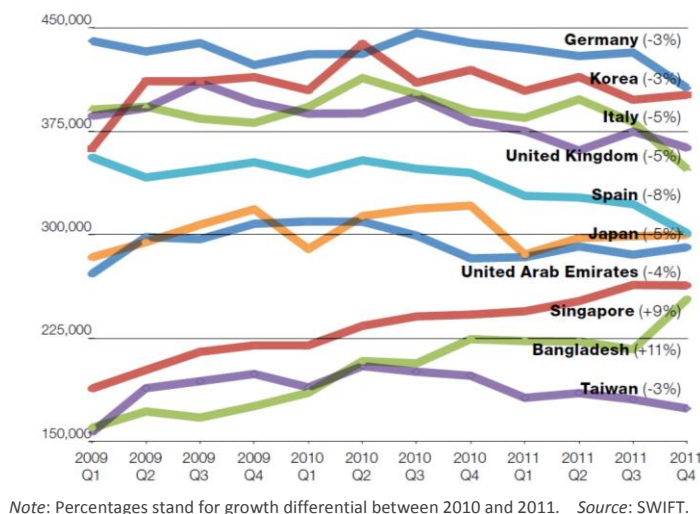
GTB under the strain of the recent economic crises

Considering the clear linkage of GTB to the volume and value of transactions in the economy and therefore its correlation with world gross domestic product, the recent crisis of economic output and the lower-than-expected recovery has, nonetheless, been challenging for GTB, most notably in the Euro-Atlantic space.

Changing the geographic focus

This change has encouraged the move of its expanding activities towards emerging and developing markets, most notably to the Asia-Pacific region, Middle East and Latin America. As the contribution of these regions to the world GDP growth increases, trade finance follows the trends and has increasingly shifted its growth focus from the Euro-Atlantic space. Such trends are not only due to global GDP-growth trends, but also to substantial liberalisation trends, such as the increasing internationalisation of the renminbi, and to – in some instances – lower entry barriers.

Figure 3. Top 6-15 countries in flows of documentary collections, guarantees and standby LCs



GTB and emerging markets

Economic development in emerging markets has thus become increasingly attractive for the provision of GTB service providers. This shift enables a better risk diversification, away from focusing only on Europe or the US and has a double dividend in providing a better growth environment for developing countries in their attempts to catch-up with developed countries.

Increasing competition

As GTB became a more attractive business due to its stability, reputation and the potential to shift easily to new growth centres, new players announced their intention to enter the market, including non-banks and third-party providers. Some existing transaction banks increase their focus on technological innovations and are widening at the same time their geographic focus, which equates for increased competition.

Possibly decreasing margins and supply

Whilst on the one hand, higher competition is squeezing pricing; regulatory adjustments of the banks are potentially increasing liquidity costs and therefore increasing the cost of transaction banking. This would lead to decreased margins and therefore less investment to this type of finance products and potentially a lower availability – most notably in cases where economies of scale become difficult or where risks increase supply volatility, e.g. for SMEs and in the developing countries respectively. In the case of trade products, this would also lead to lower supply and therefore to higher costs on trade, having detrimental effect on volumes and of trade flows and on economic development through trade.

Transaction banking idiosyncrasies

The global-local approach and future market consolidation	Transaction banking needs to be able to operate a global network, connecting other banks and customers worldwide to enable the processing of money flows into even the most remote corners of the world. Clients can range from local businesses to multinationals, and services need to be able to respond to an increasingly complex demand from clients for tailor-made solutions or standardised services. In order to be efficient in this area, economies of scale are needed. In addition, higher regulatory requirements create higher barriers to entry. Despite the increasing competition, it is therefore likely that the consolidation in the area of GTB would proceed in medium to long term.
Importance of level-playing field	Due to this global-network needs, transaction banking and especially trade finance is global almost by definition, therefore it has to deal with different jurisdictions even more than other banking areas. A global level-playing field is not in place but should develop over time in order for this global service to operate efficiently across countries and not to experience inconsistencies between jurisdictions due to their different regulatory and requirements, which could have a negative impact on the GTB business. A sound and consistent implementation of global regulatory initiatives is therefore important for GTB even more than for other banking business lines.
Technological innovations key for future growth	Technological innovations are booming across the transaction banking industry, for example in payments where mobile and real time transactions are becoming the new standard. This is due both to the expansion of mobile technologies and the increased competition. Corporate treasurers increase their technological needs and expectations both for convenience and to increase profits. More available data on transactions and the ability to follow them conveniently are becoming an integral part of GTB's tasks.
Challenges of regulation	As mentioned above, while the sector has not been singled out for special regulatory attention due to its low-risk profile, a set of different pieces of banking regulation is influencing the functioning of GTB. In addition to the many changes imposed by Basel III, transaction banking operators have to tackle both old and newly arising differences between jurisdictions as national governments are setting country-specific regulatory requirements, limits and supervisory structures. In Europe, many additional Regulations and Directives impact GTB ranging from the Single European Payment Area (SEPA), Payment Services Directive (PSD I and II) to AIFMD, CSDR and ring-fencing rules (Liikanen and Vickers).
Adverse risk effects of regulation	There is a good case for increased capital requirements in many sectors of finance as many banking business lines have displayed high risks, which – during the recent crisis – were not handled well by the banking industry. Since GTB is a business line with generally very low margins, there is a risk that if additional capital and liquidity requirements were to be imposed on it, this could lead banks to focus on more profitable, but potentially also to more risky transactions with possibly less of a direct link to the real economy. Imposing similar requirements on low-risk products, such as transaction banking, could therefore paradoxically increase the relative risk in the banking sector.

Trade finance

A business with a long history in a more complex environment

Banks have a long history of facilitating international trade. Although the underlying rationale of trade has not changed, global trade has become more complex today, as different sellers and buyers require different assurances and risk-mitigation techniques. In other words, the substance remains, but the methods and the requirements of counterparties have increased substantially.

What is trade finance?

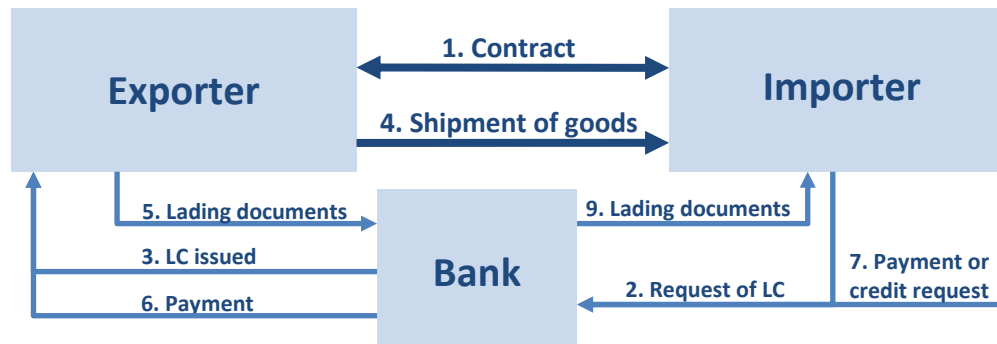
Although approaches to trade finance differ depending on the type of company and region, the underlying logic also remains largely the same across the globe. Trade finance in its simplest form is composed of borrowing from a banking institution with a trade contract or a good as a collateral, often combined with an implicit or an explicit insurance against the defaults of the trade counterparty. The main purpose of trade finance is to decrease the risk of a transaction and to reduce the period of the payment float.

Letter of credit – the most basic example of a trade-finance product

The most basic trade-finance product is the so-called import letter of credit (LC). Under this arrangement, the risk of non-payment by the importer is mitigated by the trade bank, which ensures that the exporter receives payment (e.g. subject to the presentation of correct documents in a documentary LC) whilst the importer is able to pay once he has received the goods, rather than earlier. The basic functioning of an import LC is described below in

Figure 4.

Figure 4. Illustration of an import letter of credit as defined by the ICC



Purpose of trade finance

The purpose of trade finance in increasing profitability

Letters of credit together with more sophisticated trade-finance products enable exporters to receive their payments virtually at the moment of signing the contract and avoiding the risks of counterparty default or operational errors. It is essential for exporters to receive early payment in order to ensure that production can continue. Waiting for funds for a period as long as 90 or more days of shipping will challenge the exporter's ability to continue operating.

Special importance for international trade

In international trade, the periods during which the goods have to travel are on average longer than in domestic transactions. The need for an early payment is therefore important for the exporter as otherwise he would, for example, risk running out of funds needed to invest in on-going production.

Mitigating international risks

International trade is also generally more risky due to different legislative systems, enforcement or political risks. In addition, trade parties are often not known to each other and counterparty default risk can be high. This needs to be mitigated by a third party that intermediates the transaction – a trade finance provider. Trade finance is therefore more important in international trade than for domestic trade transactions.¹

Increasing the likelihood of a trade transaction

In addition to decreasing or even eliminating payment delays, trade finance has a positive effect on the likelihood that a trade transaction occurs. In the absence of a trade finance provider in the middle, the information asymmetry would very likely lead to a situation where the transaction would simply not happen. In this respect, trade finance is a crucial contributor to the number and volume of trade transactions ensuring that trading partners can focus on the actual commercial transaction rather than having to focus on risk mitigation in relation to the creditworthiness or liquidity of the respective counterparty.

Importance of trade finance for global trade and growth

Trade finance has thus a direct impact on trade flows. If trade finance works, as it should, it is virtually invisible both to many trade professionals and to wholesale financial markets. Its malfunctioning or a significant increase in costs could however pose threats to global trade. During the financial crisis, trade did indeed suffer as the provision of trade finance solutions was reduced and as commercial counterparties struggled with the economic environment. Reduced trade flows have the consequence of reducing GDP and undermine future free trade projects across the globe.

Renewed interest of investors in trade finance

Investors are increasingly looking at new asset classes in order to diversify their portfolios and increase yields. Trade finance assets, due to their low-risk profile and stable returns, have attracted more attention from these market participants. In addition to this diversifying quality, trade finance assets are largely bought by risk-averse investors also thanks to their high liquidity.²

The crisis and challenges to trade finance

The financial and economic crisis

Trade finance has recently gone through difficult times. The financial crisis has hit many trade-finance providers, some of which became unable to continue their operations and serve their clients under the same conditions as before the credit crunch, leaving a market gap as high as \$20 billion out of overall amounts of trade finance assessed at \$10 trillion.³ The difficulties that trade finance encountered during the crisis had some explanatory effect on the higher-than-expected elasticity of world trade to GDP,⁴ raising concerns over the possible impact of regulation (in particular Basel III), which would raise costs and therefore further impact the supply.

¹ Ahn, J., Amity, M., & Weinstein, D. (2011). Trade finance and the great trade collapse. *The American Economic Review*, 101(3).

² Tavan, D. (2013). Basel III reshapes trade finance. *Banker*, 2013/03/01.

³ World Trade Organisation. (2013). Supply of trade finance. Retrieved from http://www.wto.org/english/thewto_e/coher_e/whatis_situation_e.htm

⁴ Auboin, M. (2013). Testing the Trade Credit and Trade Link: Evidence from Data on Export Credit Insurance. *World Trade Organization Economic Research and Statistics Division*.

Surviving the crisis Despite the drop of world commerce by 12% in 2009, the losses of world trade volumes have recovered fully in 2010 and continued to grow at a similar pace as the one observed before the crisis (see *Figure 1* above). According to statistics published by the International Chamber of Commerce,⁵ trade finance products on average display a significantly lower probability of default than other financial products and business lines even after controlling for exposure and loss given default. The default rate of surveyed transaction products in 2011 was 0.21% or roughly one per 4,700 transactions. These results also vary relatively little across banks and do not exceed 1% or one per 1,000 transactions.

Table 1. Default rates on trade finance products, 2008-11

Product	Transactions	Defaults	% Default	Transactions per default
Import LCs	1 492 447	299	0.20‰	4 991
Export LCs	293 313	47	0.16‰	6 241
Loans for import	1 912 118	299	0.16‰	6 395
Loans for export	3 825 233	893	0.23‰	4 284
Performance guarantees	609 920	208	0.34‰	2 932
Total	8 133 031	1 746	0.21‰	4 658

Source: ICC.

Short-term transactions with low risk Trade finance is an area of finance that deals by definition with rather short-term liabilities, which have an average tenure of between 80 and 147 days.⁶ In addition, these transactions tend to be self-liquidating. Both its default rates even during the crisis and its character, which is intrinsically interconnected with real-economy activities with a viable and always-present collateral, reflect the low-risk nature of these transactions.

Reasons for low risks The causes for such low risks are various. Most importantly collateral exists in the form of the contract and the good that is being traded. In case of a default, the collateral can be used to generate cash in order to repay a liability arising from the transaction. Trade-finance providers themselves have further reduced any potential risks of trade transactions by improving the technologies of monitoring and tracking, therefore being able to evaluate the risks and price them accordingly.

Trade finance and Basel III

The attempts to reduce reliance on short-term liabilities

In the aftermath of the financial crisis, regulators focused specifically on defining rules that would increase financial stability and reduce the financial sector's reliance on short-term funding. The Basel Committee on Banking Supervision's (BCBS) Basel III accord specifies a number of key recommendations, which focus on the increase of capital quantity and quality, the establishment of liquidity buffers and the limitation of bank leverage. When designing these recommendations, the BCBS did not specifically take into account the business of trade finance because the Basel III regime looks at the bank as a whole. Given that capital requirements are based on the amount of assets a bank holds, trade finance assets are impacted by the increase in capital requirements as well as other elements of the regime, e.g. the leverage ratio.

⁵ International Chamber of Commerce. (2013). Global Risks – Trade Finance Report.

⁶ Idem. (2011).

Systematically important financial institutions

Higher capital ratios will apply for Globally Systemically Important Financial Institutions (GSIFIs). By virtue of their status as GSIFIs, these banks are expected to hold more capital to counteract the concern that their size might introduce moral hazard, in other words making them too big to fail. This is a sound policy in itself, but it could translate into a general increase of pricing levels in the global trade finance space, as size is a condition for efficient network effect of trade finance. And therefore eight of the world's top ten trade finance banks are categorised as GSIFIs. What is more, other financial firms that incur trade finance exposures to GSIFIs will find it more expensive to deal with them because there is a supplementary capital cost to them for such exposures (the so-called 'asset value correlation'-related capital charge).

Basel III leverage ratio and trade finance

One of the most important issues for trade finance is the Basel III leverage ratio. The proposed Basel III leverage ratio will have some unintended side effects on trade finance. The leverage ratio follows the concept of a universal Credit Conversion Factor (CCF) for off-balance sheet exposures in order to act as a non-risk adjusted back-stop to a bank's leverage. Therefore, it requires all exposures, including all off-balance-sheet items to be converted onto the balance sheet in full (a 100% CCF) for the purposes of measuring the bank's leverage. Basel II used 0%-50% CCFs in order to reflect the small portion of exposures that convert into on-balance sheet exposures in the context of trade finance assets. To protect trade finance, it would be appropriate to apply the CCFs that the industry followed under Basel II. Otherwise, further cost increases will have to be absorbed by the market, despite the actual limited risk of highly documented, short-term and self-liquidating trade instruments.

Risk of an uneven playing field

Also due to its global operations, it is essential for trade finance to operate across jurisdictions. If Basel III recommendations are implemented inconsistently, this could trigger a migration of trade finance to providers located in jurisdictions with a more favourable regime or not applied Basel III at all. These banks may therefore not be equipped to comply with the higher standards of Basel III. This would create competitive imbalances, which would disadvantage those providers, both local and global, that are regulated by a country that strictly enforces Basel III rules (or even stricter ones).

The re-adjustment of regulation in view of trade-finance specificities

With a view to limiting unnecessary implications for trade finance, the Basel Committee issued its revised Liquidity Coverage Ratio (LCR) in January 2013. For trade finance-related deposits, the run-off rate has been reduced to 0-5%, subject to national discretion. This change will already support this business to a certain extent as liquidity that stems from trade finance is rightly seen as more stable and sticky, even during periods of 30-day stress, which means that banks have to hold less extra liquidity against those deposits. National discretion should, however, be exercised within the 0-5% range and not beyond.

CRD IV looking at trade transactions differently

One of the goals of the Capital Requirements Directive IV (CRD IV) was also to limit the unintended consequences of Basel III on areas of business with low risks. Trade finance was one of them. The European Union recognised the importance of the appropriate regulatory treatment of trade finance in their calibration of the leverage ratio.⁷ The EU applied credit conversion factors of 20% for medium-to-low risk trade finance products and 50% for medium-risk trade finance products rather than a flat 100% CCF (credit conversion factor) for all transactions. These sensible, pro-growth and pro-trade changes to the leverage ratio should be supported by the Basel Committee on Banking Supervision (BCBS) itself as well as all jurisdictions that are implementing Basel III.

Payments and Correspondent Banking

Main role and purpose of payment services

Another key area of transaction banking, arguably the core of financial markets, concerns payments. Innovative payment services, which comprise cash management and correspondent banking clearing services, are an important business that supports corporations, SMEs, governments and other banks. Similar to trade finance, it represents a low-margin but stable line of banking business, which is built on economies of scale.

The role and purpose of cash management

Cash management in its broadest definition deals with the management of cash for companies, ensuring payments and receivables are managed efficiently and liquidity is optimised by for example pooling it and investing excess amounts overnight or for longer periods. Appropriate cash management has the potential to substantially improve the economics of a company by providing the most efficient use of the company's cash flow.

Correspondent banking explained

Correspondent banking services are services where one bank (correspondent) holds an account for another bank (respondent) for the purposes of payment services. These services can be broad and include for example on-line and real-time access to account and payment information to support underlying services, reconciliation and investigation activities and liquidity management; FX conversion services facilitated through the account to other currencies; settlement of Continuous Linked Settlement (CLS) and payments or receipts to clearing houses and exchanges;⁸ receivable services; trade services and business continuity services to facilitate payment activity through alternate means.

Importance of payments and correspondent banking

Such activities directly support the client banks' proprietary activity and that with third parties and more importantly the activity of their underlying clients who have a dependency upon the client bank and thus in turn on their correspondent bank provider. This is increasingly important as many businesses across the globe, not only large multinationals, are expanding commerce and trade across global borders. In order to do that they require banking partners who in turn rely upon their correspondent banking providers.

⁷ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (CRDIV/CRR): Article 429, Para 10 (b) and (c) and Annex 1.

⁸ Such as the LCH.Clearnet or the Depository Trust in Europe or the Clearing Corporation (DTCC) and the Commodity Futures Trading Commission (CFTC) in the US.

Importance of cash management in an economically constrained environment

Cash management is crucial not only in order to handle cash efficiently – to make sure that cash is not idle – but also to ensure that payments are made and received on time and that the overall cash flow is optimised. Cash management improves the profitability of the company and reduces risks related to transactions. The more a company expands its offerings internationally, the more important it is that its payables and receivables operate efficiently across borders. At the same time, visibility of flows and the ability to aggregate them for the purposes of liquidity optimisation will become more important.

Liquidity visibility and optimisation

A key task of cash management is to optimise the cash of a company by centralising or pooling the liquidity and providing solutions for investing this liquidity in the short term. The liquidity strength of a company is an important criterion and so the focus of the corporate treasurer is on making sure that the corporate cash is visible in real time across the various countries of operation. This facilitates the ability to rely on internal funding, especially at times when credit is scarce, but also supports the ability to centralise liquidity for the purposes of investing it.

Increasing cash velocity and efficiency by centralisation

Furthermore, an end-to-end process from collections to investments helps increase the velocity of cash flow and the corporations' ability to net surpluses and deficits across regions. A transaction bank provides the operational tools and services to do so. Cash pooling helps a corporation to optimise and use surplus funds of all companies that are part of its group, reducing external debt and increasing liquidity. In such a structure all balances of companies belonging to the group are physically swept into one main account – or cash pool – on a daily basis in order to perform overnight investments, or just as a safe harbour (increasingly important as the probability of capital-control interventions has recently increased). The transaction bank performs so-called 'intercompany payments' to move clients' money into the country and account of choice, enabling efficient management of liquidity for the company in question and allows significant flexibility if for example there is country risk that requires such a move.

Extracting liquidity from working capital

Here the objective is to have an efficient financial supply chain in place. Accelerating the cycle from order to cash and purchase to pay with a view to protecting themselves is important. In addition, mitigating any risks that could arise from their counterparties in the supply chain is key. In parallel, the idea is to generate value for both the company and its suppliers in the value chain. To mitigate risk and create value, supply-chain financing is for example an increasingly popular transaction banking solution that helps achieve those goals.

Importance of correspondent banking for international trade

Correspondent banking solutions, on the other hand, enable domestic and cross-border payments, collections, foreign-exchange settlements or processing of standing orders. Correspondent banking processes the flow of funds between emerging and developed markets, thus contributing to trade interactions between the regions. This is particularly the case given the growth in cross-border trade flows, as commerce expands across the globe. SWIFT statistics highlight the increase in trade flows across various country corridors, specifically across developing and developed economies.

Correspondent and multilateral development banks	Correspondent banks provide direct support for participation in multilateral development bank programmes, e.g. the World Bank, the European Investment bank or the Inter-American Development Bank, which enable international trade flows, and the underlying commercial trade activity in emerging markets. This activity directly helps end user companies that engage in trade activity.
The role in developing economies	Correspondent activity also provides assistance to developing economies' financial sectors and a mechanism through which access to trade and capital market flows between global markets is being facilitated. Without access to such flows and foreign markets, the growth of developing economies would be restricted.
Cash management and Basel III	<p>Cash management and correspondent banking under Basel III</p> <p>When we examine Basel III in relation to cash management, a key change to existing practices is brought about by the liquidity coverage ratio (LCR), which assigns various run-off rates depending on the type of depositor (as explained above). Deposits from corporations that are of an operational nature, for example due to cash management services that are provided by the bank, receive a run-off rate of 25%. This means that deposits from corporations are less valuable than in the past as it is not possible to include the full deposit as part of the bank's liquidity. In addition, non-operational deposits of corporations – i.e. deposits that are left for other reasons than operational services such as cash management – receive an even-larger run-off rate than that initially set at 75%, but reduced to 40% by the BCBS in its revised LCR of January 2013. This implies that corporations will find it increasingly difficult to obtain interest earnings from these balances as the bank will need to put up extra liquidity for those balances, which increases the bank's cost. Paradoxically therefore the deposit with a bank could almost cost the company money rather than earn it money (a similar phenomenon can be seen with banks' central bank deposits at negative interest rates).</p>
Correspondent banking and Basel III	Correspondent banking also receives specific treatment under the Basel III liquidity coverage ratio. As explained above, correspondent banking solutions enable domestic and cross-border payments, collections, foreign-exchange settlements or processing of standing orders. These services can support the respondent bank that holds a correspondent bank account with the transaction banking provider but also the clients of the respondent bank, such as corporations, consumers and governments.
Definition issues in Basel III in respect to correspondent banking	The proposed Basel III definition of this business is too narrow to include it all its aspects. The definition limits itself to the provision of "payment and other services in order to settle foreign currency transactions" on behalf of the respondent bank only. Furthermore, correspondent banking activity is not considered as operational business (to which a 25% run-off rate would be attributed for both corporate and financial institution liquidity). Instead, correspondent banking balances are treated as highly volatile and unreliable, expected to result in a 100% outflow of such liquidity over a 30-day period of stress.

Higher Basel III asset requirements for correspondent banking	Under this proposed treatment of correspondent banking liquidity, every euro deposited in a correspondent bank account would require the correspondent bank to hold 4 times more liquid assets to support these deposits against stress outflow, compared to the same euro deposited in a corporate operational account. The proposal also discourages correspondent banks from attracting the kind of client bank deposits that are reliable even in times of specific stress, which runs contrary to what the new regulation is trying to achieve (i.e. lower liquidity risk).
Possibly detrimental substitution	As a consequence, these types of bank deposits are likely to become uneconomical and service offerings would be reduced. Reliable funding from this business would be substituted with wholesale debt, which in turn would increase liquidity risk in the banking sector. With uneven implementation across the globe, transactional flows may be diverted to banks that may not be equipped to comply with the higher standards of Basel III to support cross-border settlements. With the resulting price increase for these services, banks may also try to pass on costs to their users, impacting the real economy.
Clarification of outflow factors needed	Therefore, it would be more beneficial to clarify the outflow factors applied to correspondent banking. In practice, correspondent accounts are operating accounts where the underlying activities are generated largely by transactions relating to commercial operations – incoming receipts and outgoing payments – supporting account holders and account holders’ clients in their operational activities. Some treasury settlements and inter-bank transactions may also be part of these activities given the banks’ operational requirements. The activities on these accounts behave in a similar fashion to those of corporate operational relationship accounts and thus could qualify for the 25% outflow factor. This would ensure the continuation of these services in a cost-effective and proportionate manner to their risk profile.

Conclusions

Purpose of global transaction banking	The financial sector as a whole has suffered large losses during the crisis, not only in financial terms but also in reputation. Excessive risk-taking and high leverage had made the financial sector critically fragile before the crisis, which has triggered the biggest regulatory overhaul in the history of finance.
There is a need for prudential requirements, but not to the same extent everywhere	Tighter prudential requirements for banks are a good way to increase the robustness of the financial sector. In some areas, the prudential adjustments have, nonetheless, been out of proportion to the risk posed by these transactions, making them more expensive than their risk-profile would allow. This could trigger a run after higher margins and higher risk and ultimately increase the relative risk of the system and, at the same time, reduce the access of companies to basic financial services that are crucial for the functioning of the world economy.
Transaction banking and the economy	More than any other banking activities, transaction banking works in close relations to real economic activities and tries to render the workings of the economy as smooth and swift as possible. Transaction banking is a modest branch of banking, attracting only marginal interest, until recently, from wholesale financial markets, politicians or the fastest-growing divisions of global banks. Its problems, however, would be felt immediately and would render the more economically stressed companies unable to operate, particularly those in less stable countries.
Take into account all financial activities in regulation	The changes that are implemented in the new global regulatory paradigm should therefore not only prevent a replication of the main causes of the crisis, but they should also respect the financial activities with a low risk profile in order not to reduce unnecessarily the workings of the economy. In other words, sound and fairly implemented financial regulation is urgently needed to reduce the risks in the financial sector, but it should also avoid hitting bystanders in the effort to prevent similar excesses as developed during the crisis.

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