

# THE REGULATORY FRAMEWORK OF TRADE FINANCE: FROM BASEL I TO BASEL III

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## **Abstract**

*The global crisis revealed several weaknesses in the international framework of banking regulation. Consequently, the Basel Committee on Banking Supervision (BCBS) proposed a package of measures to strengthen the resilience of the banking sector. Besides the positive effects they have on financial stability, the new regulatory provisions affect the ability of banks to provide trade finance. Therefore, the banking industry considers that regulators have not taken into account the low-risk profile of activity. Starting from this premise, the paper consists of three parts. In the first part, the role and objectives of the BCBS are presented; the second part is designed to review the most important trade instruments and to underline the tendencies in trade finance; finally, the last part highlights the regulation of trade finance under the Basel I, Basel II and Basel III regimes, and some unintended consequences of the Basel III framework.*

**Key words:** *Basel III, trade finance, global crisis, regulatory framework of trade finance, international trade*

**JEL Classification:** G<sub>21</sub>, G<sub>28</sub>, F<sub>10</sub>

## **Introduction**

Under the current conditions of intense competition in the international market, trade finance represents a significant tool that contributes to the development of international trade.

Due to evolution of information technology and increased globalization, open-account arrangements became more and more important. However, bank-intermediated trade finance still covers a great part of global trade. Moreover, the global financial crisis has strengthened the position of traditional trade finance instruments compared to open-account payments.

But the regulatory measures proposed by the Basel III have some negative implications for trade finance, which due to increased costs of capital and liquidity has become more onerous for foreign trade companies. At the same time, banks are not anymore stimulated to provide trade finance, as long as with the same capital cost, they can invest in more risky but more profitable assets.

In order to avoid these adverse consequences, the International Chamber of Commerce in Paris (ICC), the banking industry and the trade community recommend a more favourable regulatory treatment of trade finance. Their argument is based on the historical low-risk profile of the activity.

## Literature review

The international regulatory treatment of trade finance regime was developed within the BCBS (1988, 2004 and 2010) under the Basel I, Basel II and recently Basel III framework.

Asmundson and others (2011) highlight the role of bank-intermediated trade and the shares of global trade covered by the various forms of trade finance. Negruş (2008) and Lewis (1988) cited by Howells and Bain (2008) provide some classifications of off-balance sheet operations.

The provisions regarding regulation of trade finance gave birth in the speciality literature to numerous debates. For example, the ICC (2009), the ICC Banking Commissions (2009), Auboin (2010) argued that under the internal-ratings based system of Basel II, the regulatory treatment of trade finance has worsened. Consistent with its role of promoting international trade, the ICC (September 2010, 2011) has developed several documents that argue for low-risk profile of trade finance operations, highlighting the adverse effects that the new regulatory framework of Basel III has on trade finance. Finally, the ICC (2011) recommends regulators a revision of the proposals on trade finance.

### 1. The role and objectives of the Basel Committee on Banking Supervision

The Basel Committee on Banking Supervision (henceforth named the Basel Committee or the Committee) was created in 1974 following the triggering of three banking crises, which generated consequences at the international level (Herstatt Bank crisis, Germany; Franklin National Bank crisis, the U.S. and the British Israel Bank subsidiary crisis in London). These crises have revealed that the development of international banking and increasing interconnections between banks in different countries require international action to coordinate banking regulations. The main objective of the Committee is to prevent banking crises with international impact, thereby strengthening international financial stability. According to this objective, the Committee has developed several documents that form the basis for establishing rules of banking regulation and supervision in many countries throughout the world.

Although initially the Committee was composed of representatives of the G10, Luxembourg and Switzerland, the composition of the Committee was later expanded with the development of banking globalization, now comprising 27 members from both developed countries and emerging economies.

The Committee's work focuses on three main areas.

(1.1.) The first area is related to the *adoption of general principles for the supervision of banks' foreign establishments*. Essentially, these agreements established two fundamental principles:

- no foreign banking establishment should escape supervision; and
- the supervision should be adequate.

In order to fulfill these objectives, the foreign establishments of banks were classified into three major groups: branches, subsidiaries and joint ventures or consortia. Also, sharing the responsibilities between authorities from the origin country and those in the host country has been achieved taking into account the following aspects: liquidity, solvency and foreign exchange operations and positions.

The documents adopted emphasize the importance of permanent cooperation between supervision authorities from the origin countries and those from the host countries. At the same time, within the supervision of international banking, one can notice the tendency to reinforce the principle of supervision from the origin country. Also, an adequate supervision imposes adopting the principle of consolidated supervision. According to this principle, the supervisors from the origin country must monitor the exposure risk of the banks under their responsibility for all operations, no matter the territory where they are located. These principles are reflected in the document adopted in May 1983, entitled „Principles for the supervision of banks’ foreign establishments”. Improving the rules regarding the supervision of banks’ foreign establishments was realized in 1990 (the document „Information flows between banking supervisory authorities”), 1992 (the document „Minimum Standards for the supervision of international banking groups and their cross-border establishments”), 1996 (the document „The supervision of cross-border banking”).

(1.2.) The Committee’s second area of interest, and the most important achievement, is *the establishment of minimum capital requirements* for internationally active banks. This action was motivated by the fact that, seeking to improve their profits, at the beginning of the 1980’s, international banks were engaging in risky activities that were not correlated with their capital. Taking into account that the level of international credit had risen, and the interdependencies between banks situated in different countries were becoming more important, it was recognized that the crisis of one bank could affect the stability of the whole international banking system. After many consultations that started in the 1980’s, the Basel Committee published a document in July 1988 regarding the bank capital measurement and the capital standards, entitled “International Convergence of Capital Measurement and Capital Standards”, which is known in the literature as the 1988 Basel Capital Accord, or simply, the Basel I. According to this document, banks have to hold capital equal to at least 8% of their risk-weighted assets.

The limitations of the 1988 Accord, the evolution of international banking, the increasing complexity of banking risks and progress in banking risks assessment have determined the Basel Committee to bring a series of improvements to the capital adequacy requirements of banks. As a result, in June 2004 the final form of a new accord was published: “International Convergence of Capital Measurement and Capital Standards – a revised framework”, a document known as the Basel II.

Starting from the premises that the stability of the financial system can be ensured through the coordinated action of three elements – efficient risk management, activity of the supervision authorities and the transparency of information regarding the bank activity -, the Basel II Accord is based on three pillars:

- *minimum capital requirements;*
- *a prudent supervisory review process;*
- *market discipline.*

In accordance with Basel II, the basic principles regarding the calculation of the minimum capital requirements, as well as the definition of capital, remain the same as in the previous version. However, the calculation methodology of risk exposure has been radically modified. Moreover, operational risk was introduced when calculating the capital adequacy ratio. To measure risk, banks may choose between two options: a standardized approach, similar to the Basel I methodology, and an internal rating approach, approved in advance by national supervisors. This method allows assessment of the risks in a diversified manner, enabling better correlation of minimum capital requirements with risks taken.

More recently, the global financial crisis has risen for the regulatory and supervisory authorities around the world a series of concerns on regulatory framework of financial and banking activity. The main *limitations of the Basel II Accord* that were revealed in the context of the crisis, which began in 2007, are<sup>1</sup>:

- the minimum Tier 1 capital requirement ratio to risk-weighted assets of 4% was inadequate to absorb the credit losses (Tier 1 capital is core capital);
- the ratings agencies that had the responsibility to assign risk-weighting of banks' assets proved to be vulnerable to potential conflicts of interest;
- the capital requirements are pro-cyclical;
- the Basel II Accord stimulated the process of securitization, which in turn, enabled banks to reduce their capital requirements and increase their leverage.

Besides, the Basel II Accord did not give attention to liquidity, and therefore, many banks did not hold sufficient liquidity buffers.

Consistent with its mission, the Basel Committee has developed a set of measures for reforming the banking regulation, known as the Basel III framework. The main *reform measures* comprised in these documents have in view:

- raising the quality, consistency and transparency of the capital base;
- better risk capture (especially the risks concerning the capital markets activities);
- the introduction of a leverage ratio;
- the introduction of measures meant to build up capital buffers during good times, which are to be drawn from in periods of stress;
- the introduction of a global minimum liquidity standard for internationally active banks.

According to the provisions established by the Basel Committee, these standards will be gradually introduced, over a long period of time until the year 2018.

(1.3.) The third major contribution of the Basel Committee was a set of *principles, considered to be fundamental to ensure an efficient banking supervision*. The document which includes these standards, called „Core Principles for Effective Banking Supervision”, was published in 1997, following a close cooperation with authorities from outside the member states of the Committee. The document was revised in 2006.

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<sup>1</sup> Fabiani, Riccardo, *The Business Impact of “Basel III”*, A D & B Special Report, October 2010.

## 2. Trade finance instruments. Tendencies in trade finance

In the specialty literature, there is no consensus on the definition of trade finance. According to the ICC<sup>2</sup>, trade finance refers to short-term sources of financing aimed to fill the time-lag between the production of goods and the receipt of payment. By supplying trade finance, banks contribute to the expansion of international trade.

Trade finance covers several payment arrangements between importers and exporters: open account payments, cash-in-advance and bank-intermediated trade finance. These payments vary from arrangements strictly between importers and exporters (open account, cash-in-advance) to insurance services, to credit from banks (bank-intermediated trade finance). Bank-intermediated trade finance allows exporters and importers to use banking system to: (i) verify delivery of goods; (ii) guarantee payment for goods; and (iii) provide liquidity for the transaction. The most familiar form of bank-intermediated trade finance is the letter of credit<sup>3</sup>.

Unlike domestic trade, a number of issues arise in international trade because the importer and the exporter come from different countries, and often, they do not know each other very well. In addition, others difficulties are related to the fact that in the two countries involved in international trade relations, there may be different regulations, customary and local traditions, as well as cultural and language differences. International trade transactions also mean taking new risks, including currency risk and country risk.

(2.1.) The traditional way to overcome the lack of trust between the importer and the exporter is through the use of *letter of credit* as a means of settlement. The letter of credit is the operation by which a bank undertakes, in accordance with instructions received from its importer customer, to make payments to the exporter upon the presentation of documents meeting the terms and conditions of the letter of credit. A letter of credit provides safety to all parties involved:

- the *exporter* is certain that he receives payment provided that he delivers the goods and submits shipping documents, in strict compliance with the terms and conditions of the letter of credit;
- the *importer* is certain that payment is made for a good, which at least formally, is in accordance with contractual requirements;
- the *bank* that undertakes to pay – the issuing bank – retains a pledge on documents, which gives it control over the underlying goods, and sometimes, its also guaranteed by a deposit made by the importer.

In addition to the advantages they present, the letters of credit have a number of disadvantages related mainly to the high costs involved and the cumbersome procedure to cash. As a result, the dominance of letters of credit in all international

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<sup>2</sup> International Chamber of Commerce, *Report on Findings of ICC-ADB Register on Trade & Finance*, Document No. 470/147 (Rev), Paris, 21 September 2010, p. 7.

<sup>3</sup> Asmundson, Irena, Thomas Dorsey, Armine Khachatryan, Ioana Niculcea, and Mika Saito, *Trade and trade Finance in the 2008-09 Financial Crisis*, IMF Working Paper WP/11/16, International Monetary Fund, January 2011, pp. 54-55.

payments began to erode over time in favour of open account payments, which are more flexible and adapt better to the current conditions of international trade.

(2.2.) An *open account arrangement* means that the importer pays the value of the goods delivered by the exporter at a specified time from delivery. Usually, this term is 30, 60 or 90 days from the date of the transport document. From a technical standpoint, open account payments do not raise any problems, being characterized by simplicity and low costs. The entire risk of operation is borne by the seller, who also provides liquidity in the transaction. Therefore, open account arrangements are used in international trade relations based on trust and transactions developed over a long period of time.

The development of open account payments was due to an increased trust between importers and exporters, as a result of strengthened traditional trade relations between the European Union (EU) and North America, the EU enlargement, the intensifying financial globalization process and the increased trust between partners in developed countries and partners in less-developed country. Last but not least, intense competition in the international market requires exporters to show flexibility in choosing the method of payment. Consequently, as the importer is able to pay for goods after delivery, open account became an important marketing tool used by exporters to maintain customers and promote sales. The evolution of information technology also had an important role because it allowed the development of fast and safe transfers between different parts of the world.

However, the global financial crisis has strengthened the position of the letter of credit, given the comfort which it offers to both exporters and importers. At the same time, during the crisis, open account payments have decreased in importance due to increasing risks.

(2.3.) *Cash in advance* requires the importer to pay before delivery of the good. Unlike open account payments, in this case, all risks are borne by importer, who provides the liquidity. Often, payments in advance allow buyers to obtain some discounts on the traded goods.

According to estimations made within the International Monetary Fund by Asmundson and others (2011, p. 54), in 2008, the shares of global trade covered by the various forms of trade finance were:

- cash in advance – 19%-22%;
- bank trade finance – 35% -40%;
- open account – 38%-45%.

Another trade finance instrument is a *bank guarantee*. Conducting international trade requires risk-taking by both importers and exporters. To cover against these risks, importers and exporters often resort to various techniques, among which, bank guarantees are very important. By providing a guarantee, a bank makes a commitment to pay on behalf of one of its customers – the importer or the exporter – to the guarantee's beneficiary in case its customer fails to fulfill its payment obligations towards the beneficiary.

### 3. The international regulatory framework of trade finance. Adverse consequences of the Basel III regime on trade finance

Many of the trade finance-related activities are circumscribed to traditional off-balance sheet items, which are an extension of the bank's basic operations (e.g., opening and confirming letters of credit, issuance of letters of credit stand-by, issuance of bank guarantees). Historically, these operations have been performed for a long time; for example, the letter of credit was widely used after World War I, when unlike previous periods, the share of transactions carried out between partners who do not know each other personally increased.

As a result of tougher competition, disintermediation, development of information technology, increasing volatility in financial markets, and a change in investment preferences after the 1980s, off-balance sheet operations have acquired new dimensions, both quantitative and qualitative. In quantitative terms, the volume of these operations has greatly increased and extended to new financial markets (first in developed countries and later in other countries), and in terms of quality, off-balance sheet operations have been diversified and refined.

Therefore, off-balance sheet transactions occurring after 1980 are a manifestation of the financial innovation process. One of the most important reasons for off-balance sheet growth was the increased competition for deposits and credits, which decreased the income from interest. As a result, banks were forced to find new solutions to maintain and improve profitability. In this context, they turned attention to off-balance operations, which allowed them to obtain fee income. Negruş (2008, p. 462) classified off-balance sheet operations into three groups:

- operations on a commission basis (i.e., sale and purchase of securities);
- operations on future payment commitments;
- trade related off-balance sheet transactions (i.e. letters of credit, foreign exchange operations).

Another classification of off-balance sheet operations distinguishes between financial services and those giving rise to contingent claims (Lewis, 1988, cited by Howells and Bain, 2008, p. 533). The first category includes services such as investment advice, portfolio management, insurance broking or credit/debit card services. The second category includes guarantees, securities underwriting, hedging transaction, etc.

Initially, regulatory and supervisory authorities did not give due attention to risks related to off-balance sheet operations. Until adopting the 1988 Basel Accord, an important role in the development of off-balance sheet operations played the fact that, under many national regulations, off-balance sheet transactions did not involve capital allocation. Later, as the authorities became aware of the risks borne by off-balance sheet operations, these were included in the calculation of the capital adequacy ratio, by using conversion factors. Use of the conversion factors constitutes recognition of the fact that not all balance-sheet operations necessarily convert to on-balance sheet exposures.

(3.1.) According to the *Basel I regulations* (paragraph 42), all off-balance sheet commitments are converted into credit risk equivalents by multiplying the

nominal principal amounts by conversion factors, the amounts obtained then being weighted according to the nature of the counterparties.

Short-term engagements such as documentary letters of credit collateralized by the underlying shipments received a conversion factor of 20%. The low value of this conversion factor was seen as recognition of the fact that a letter of credit involves low risk for both the issuing bank and the confirming bank. Other off-balance sheet trade products, like performance bonds or standby letters of credit, received a 50% credit conversion factor.

(3.2.) Under the standardized approach of the *Basel II regime*, the regulatory treatment of off-balance sheet items in trade finance is similar to the Basel I framework. However, under the internal-ratings based system of Basel II, the regulatory treatment of trade finance has worsened<sup>4</sup>:

- one of the issues raised by banking community was the fact that Basel II regime focuses on counterparty risk rather than product or performance risks. This approach disadvantages trade finance, which is treated as any form of unsecured lending, such as overdrafts;
- another issue was the rigidity in the maturity cycle applied to short-term trade lending. According to Basel II, a one-year maturity floor will be applied for all lending facilities. As trade finance lending is generally short-term in nature (between 0 and 180 days maturity) and capital requirements increase with maturity length, the capital cost of trade finance is artificially inflated;
- finally, a difficulty faced by banks was the lack of historical and performance data to assist in validating risk attributes.

(3.3.) Starting from the premise that off-balance sheet items are a source of potentially significant leverage, the package of measures adopted by the *Basel III regime* establishes that all off-balance sheet transactions are to be included in the calculation of the leverage ratio. This measure was taken because in the context of global crisis, the securitization process had negative effects on financial stability. Initially, securitization was seen as a way to improve financial stability, as it allowed spreading the risk over a large number of investors. However, after the sub-prime mortgage crisis, securitization was seen as a way to hide the risks, being considered one of the factors that triggered the global financial crisis. By securitization, banks turn loans into financial instruments (asset-backed securities) that move off balance sheet. This practice allowed them to reduce the capital costs established by the Basel II rules and also to originate new loans and get additional incomes. At the same time, securitization enabled banks to take on growing risks.

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<sup>4</sup> International Chamber of Commerce, *ICC Banking Commission Recommendations on the Impact of Basel II on Trade Finance*, Document 470/1119, Paris, 24 March 2009; ICC Banking Commission, *Rethinking Trade Finance 2009: An ICC Global Survey*, Document No. 470-1120 TS/WJ, Paris, 31 March 2009; Auboin, Marc, *International Regulation and Treatment of Trade Finance: What Are the Issues?*, Staff Working Paper ERSD-2010-09, The World Trade Organization, Geneva, February 2010.

In order to calculate the leverage ratio, all off-balance sheet commitments, including those related to trade finance, received a uniform 100% credit conversion factor. In concrete terms, in contrast to Basel II, the new regulations provide banks to set aside five times more capital for letter of credit (from 20% to 100%). In other words, letter of credit received the same treatment as "toxic" off-balance sheet financial instruments, even if there is no evidence that these exposures have ever been used as a source of leverage. The argument used is based on the fact that the exposures are supported by transactions involving either movement of goods or the provision of services<sup>5</sup>.

Considering that the regulatory treatment of trade finance under the Basel III framework is not correlated with the low-risk of this activity, the banking community, foreign trade companies and other stakeholders have expressed concern about the negative unintended effects the new provisions may have on international trade. Arguments in favour of low-risk of trade finance exposures are the short tenor of transactions and the fact that, unlike other credits, the goods underlying the transactions are guarantees for bank.

In supporting the low-risk profile of trade finance, the ICC conducted an analysis that includes data on 5,223,357 transactions provided by nine international banks with operations covering a wide range of jurisdictions. Data are provided for a period of 5 years (2005-2009) and for five product types: (1) import letters of credit, (2) export confirmed letters of credit, (3) guarantees and standby letters of credit, (4) import loans and (5) export loans. The findings of this study are:

- *short tenor of trade finance transactions*. The average tenor of all products is 115 days. Moreover, off-balance sheet products (import letters of credit, export confirmed letter of credits, standby letters of credit and guarantees) exhibit average tenors of less than 80 days;
- *low defaults across all trade finance transactions considered* – i.e. 1,140 cases out of 5,223,357 transactions. This value is lower for off-balance sheet trade products – only 110 cases of defaults from a total of 2,392,257 transactions;
- *low level of defaults throughout the downturn period* – in 2008-2009, only 445 defaults were reported from a total of more than 2.8 million transactions;
- *good recovery rates for all product types*;
- *limited credit conversion from off-to on-balance sheet* (due to high rates of discrepant documentary presentations in case of letters of credit, high rates of expiry without payment, and non-payments after default, in case of guarantees and letters of credit)<sup>6</sup>.

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<sup>5</sup> Auboin, Marc, *International Regulation and Treatment of Trade Finance: What Are the Issues?*, Staff Working Paper ERSD-2010-09, The World Trade Organization, Geneva, February 2010, p. 17.

<sup>6</sup> International Chamber of Commerce, *Report on findings of ICC-ADB Register on Trade & Finance*, Document No. 470/147 (Rev), Paris, 21 September 2010.

One of the most serious *consequences* of the new regulatory framework for trade finance and hence for the development of international trade is the increased costs that customers have to pay to obtain such products. According to estimates made by the International Chamber of Commerce (2011, p. 66), the new provisions adopted by the Basel Committee could lead to an increase in trade finance pricing of between 15% and 37%. Consequently, this pricing increase could lead to a 6% reduction in the volume of trade finance. Foreign trade companies that rely on traditional methods of financing represent the most affected segment; these are small and medium enterprises and traders who have partners in developing countries, where the letter of credit continues to be used predominantly. As a result of the more stringent capital requirements, the banks involved in trade finance could adopt several strategies that could range from a reduction in trade finance volume to orientation toward riskier activities that, while requiring the same capital allocation, could be more profitable.

Because of these unintended effects on international trade and hence economic growth, the ICC recommends regulators a *revision of the proposals on trade finance*, as follows<sup>7</sup>:

- use for off-balance sheet trade products of the same conversion factors assigned by the Basel II Accord;
- key risk attributes to be determined on the basis of industry benchmarking (since many banks faced difficulties obtaining data to produce validated estimates of risk for trade lending). For this purpose, ICC proposes the use of the ICC Register;
- exemption of trade finance products from the one-year maturity floor applied to lending facilities.

### **Conclusions**

The global financial crisis determined the Basel Committee to propose a new regulatory framework for banking activity, designed to strengthen financial stability. Measures adopted by the regulatory regime Basel III introduce several improvements compared to the old regulations.

However, regulatory measures proposed by the Basel III have some negative implications for trade finance. One of the main concerns of the banking community is the fact that off-balance sheet trade products received a 100% credit conversion factor in calculating the leverage ratio, like all other off-balance sheet operations. This treatment does not distinguish between off-balance sheet trade products, characterized by low-risk, and other more risky operations. The provision regarding the application of a one-year maturity floor for all lending facilities is another issue, because banks have to set aside more capital for trade finance lending.

Under these conditions, banks may choose to restrict their trade finance activity in favour of other activities that, while involving the same regulatory cost,

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<sup>7</sup> International Chamber of Commerce, *Rethinking Trade and Finance: Global Survey 2011*, ICC Publication no. 710E, Paris, March 2011, pp. 70-71.

may lead to higher profits. Because trade finance is particularly important for international trade development, restricting trade finance implies negative effects on international trade flows. The strongest impact will be felt by commercial partners that conduct operations with firms in developing countries because these transactions are based on traditional methods of financing, such as letters of credit. Small and medium enterprises will be also affected because traditional financing instruments support their activities on foreign markets. To avoid an increase in the costs of letters of credit, foreign trade companies are encouraged more and more to use open account payments. But this practice can lead to increased defaults if the counterparty and country risk have not been properly evaluated. In order to avoid these adverse consequences, trade finance has to receive a more favourable regulatory treatment.

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