Business & Finance Consulting

Benefits of Trade Finance Instruments for Risk Mitigation and Capital Adequacy

Tashkent, June 17, 2019

Andreas Raithelhuber, Senior Bank Advisor

Session Outline

Credit risk in trade finance and the Basel capital frameworks

I. **Credit risk distribution and mitigation in trade finance**

II. **Basel treatment of funded and unfunded credit exposures**

Benefits of unfunded trade finance instruments and ADB support

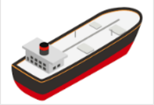
III. **Efficient capital allocation with unfunded trade finance**

IV. **ADB‘s funded and unfunded trade facilitation**

Annex I: Introduction to the Basel capital frameworks

Annex II: Capital adequacy calculation in five steps per Basel I

I. Credit Risk Distribution and Mitigation in Trade Finance

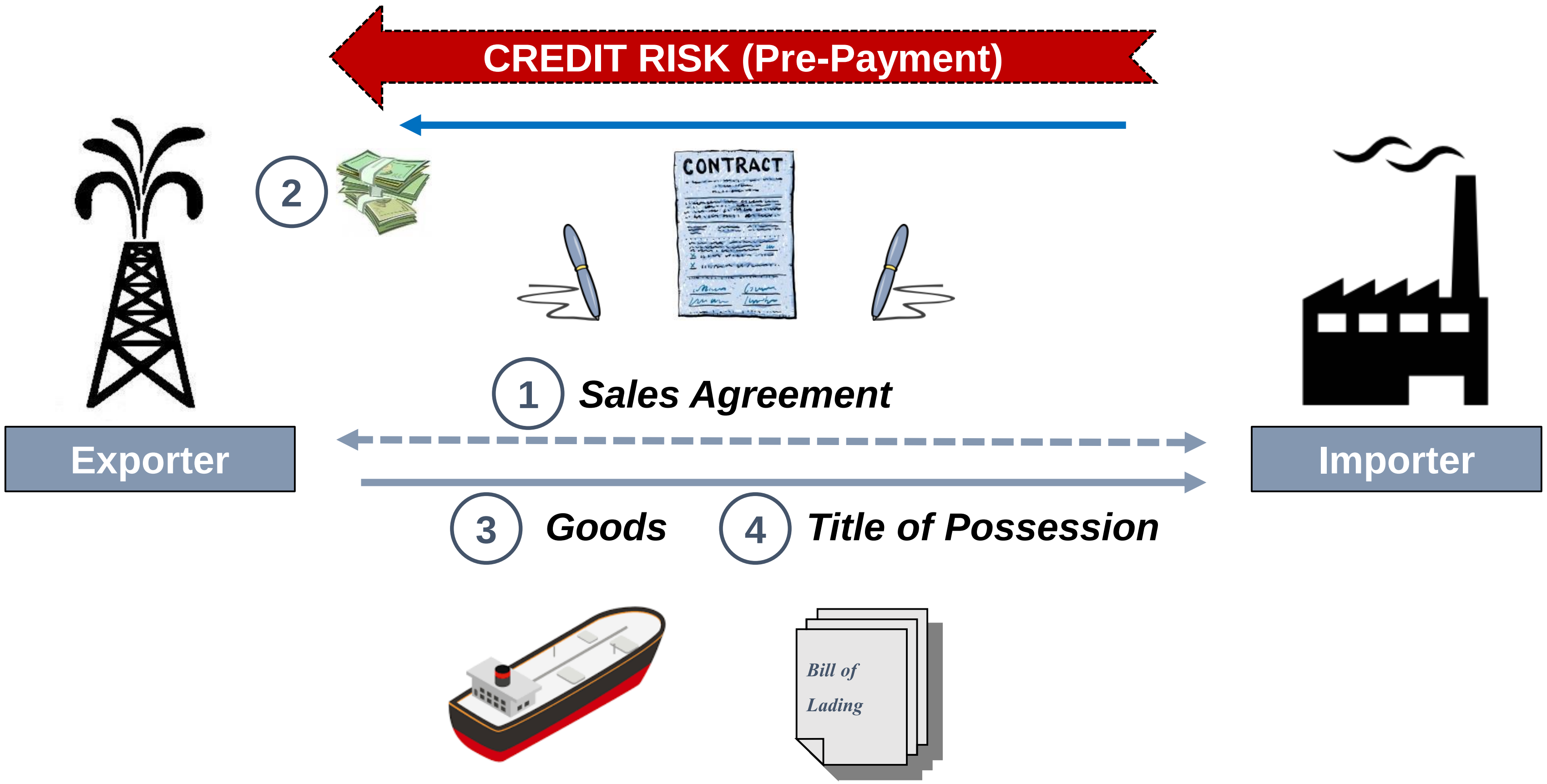


- Banks as intermediaries between contracting parties
- Clean payments
- Documentary collections
- Documentary credit
- Credit risk mitigation: Documentary collections vs. documentary credit
- Funded trade finance: Liquidity, no risk mitigation
- Banks’ default rates of trade-related LCs, loans and guarantees

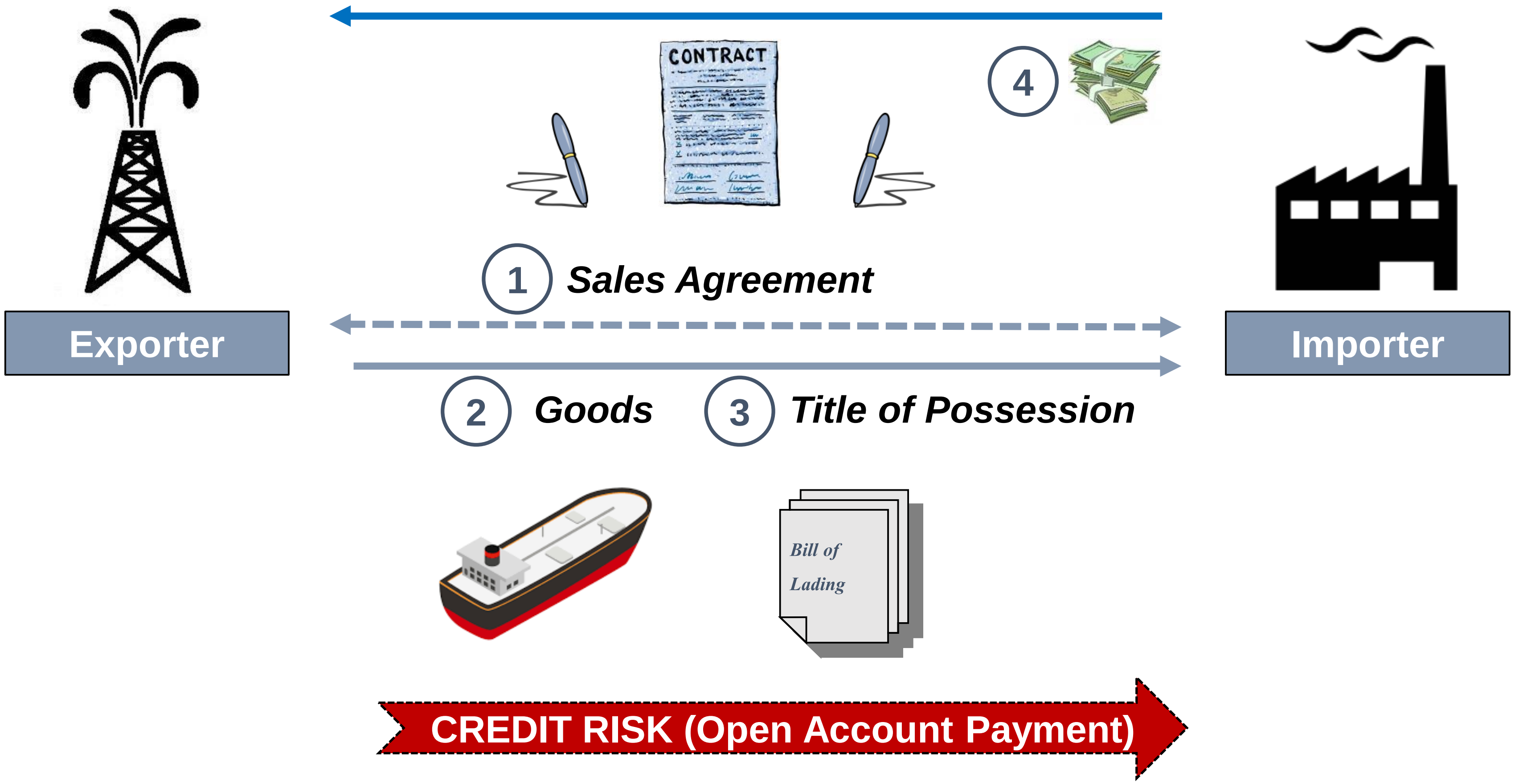
Banks as Intermediaries Between Contracting Parties

Transaction type	Examples	Routing Payments	Presenting/ Releasing Documents	Assuming Commercial/ Credit Risk
Clean payments	Open account, Pre-payment	✓	✗	✗
Documentary collections	Documents against Payment (DP) or Acceptance (DA)	✓	✓	✗
Documentary credit; Guarantees	Letter of credit (LC), Standy-by LC; Performance bond, General guarantee	✓	✓	✓

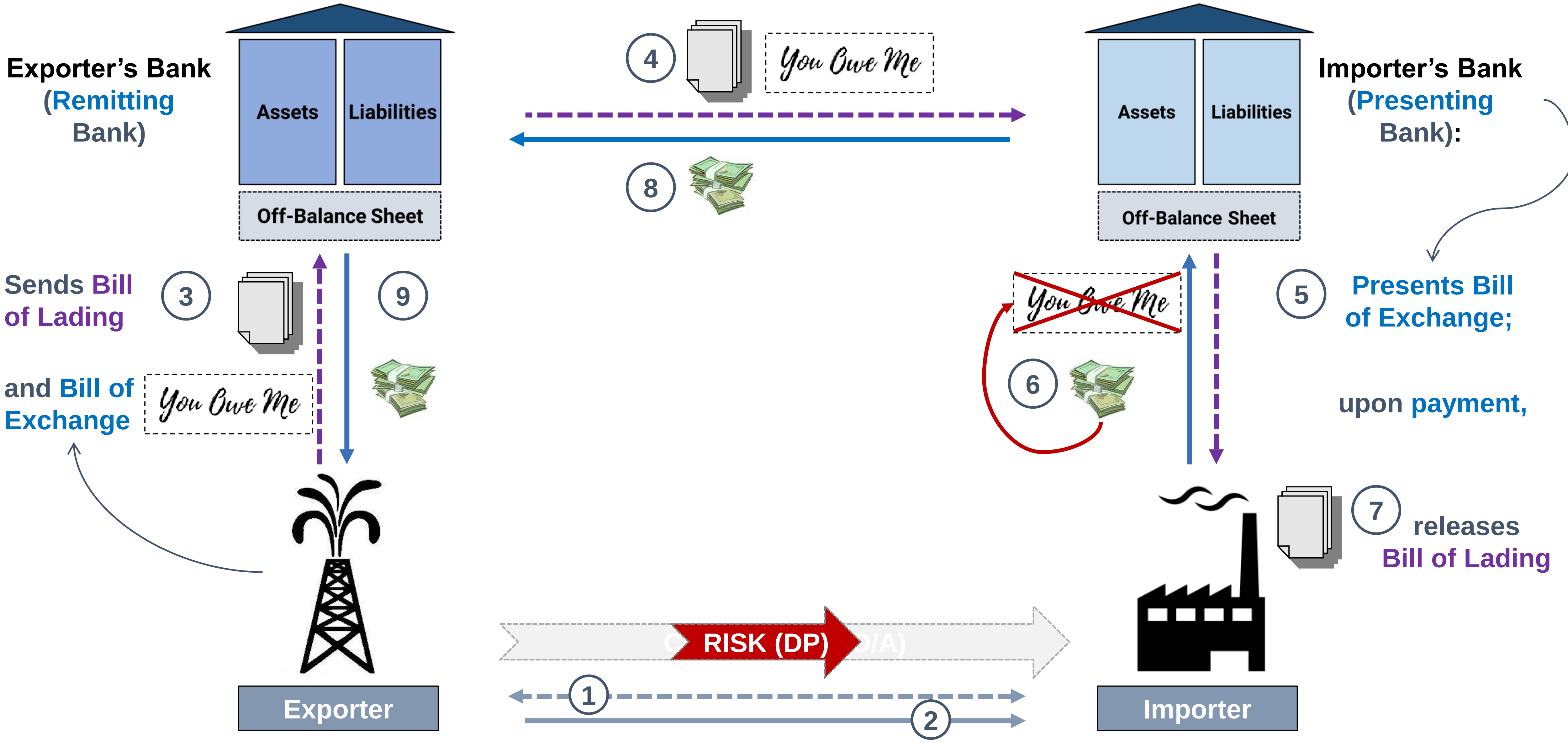
Clean Payments (1 of 2): Pre-Payment



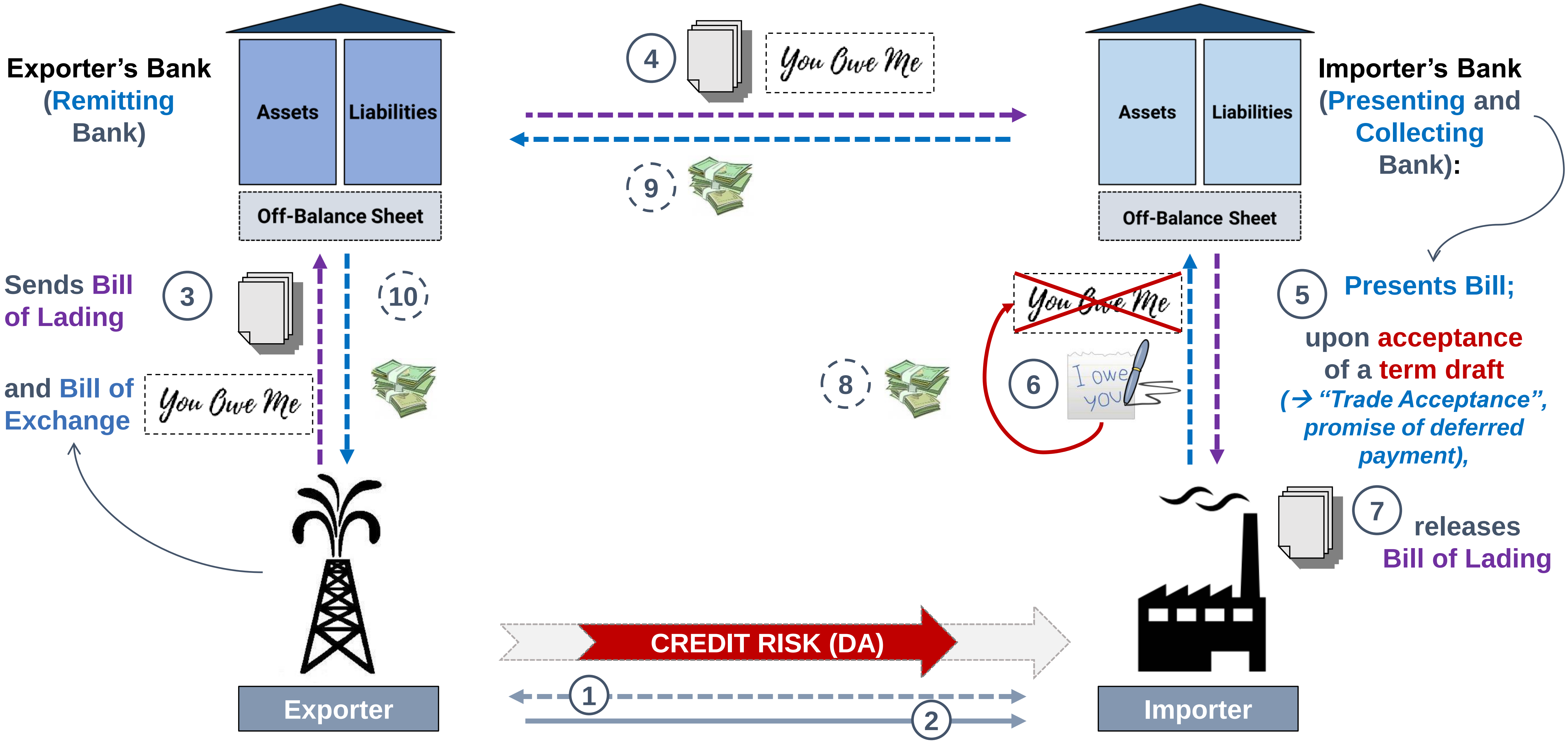
Clean Payments (2 of 2): Open Account (O/A)



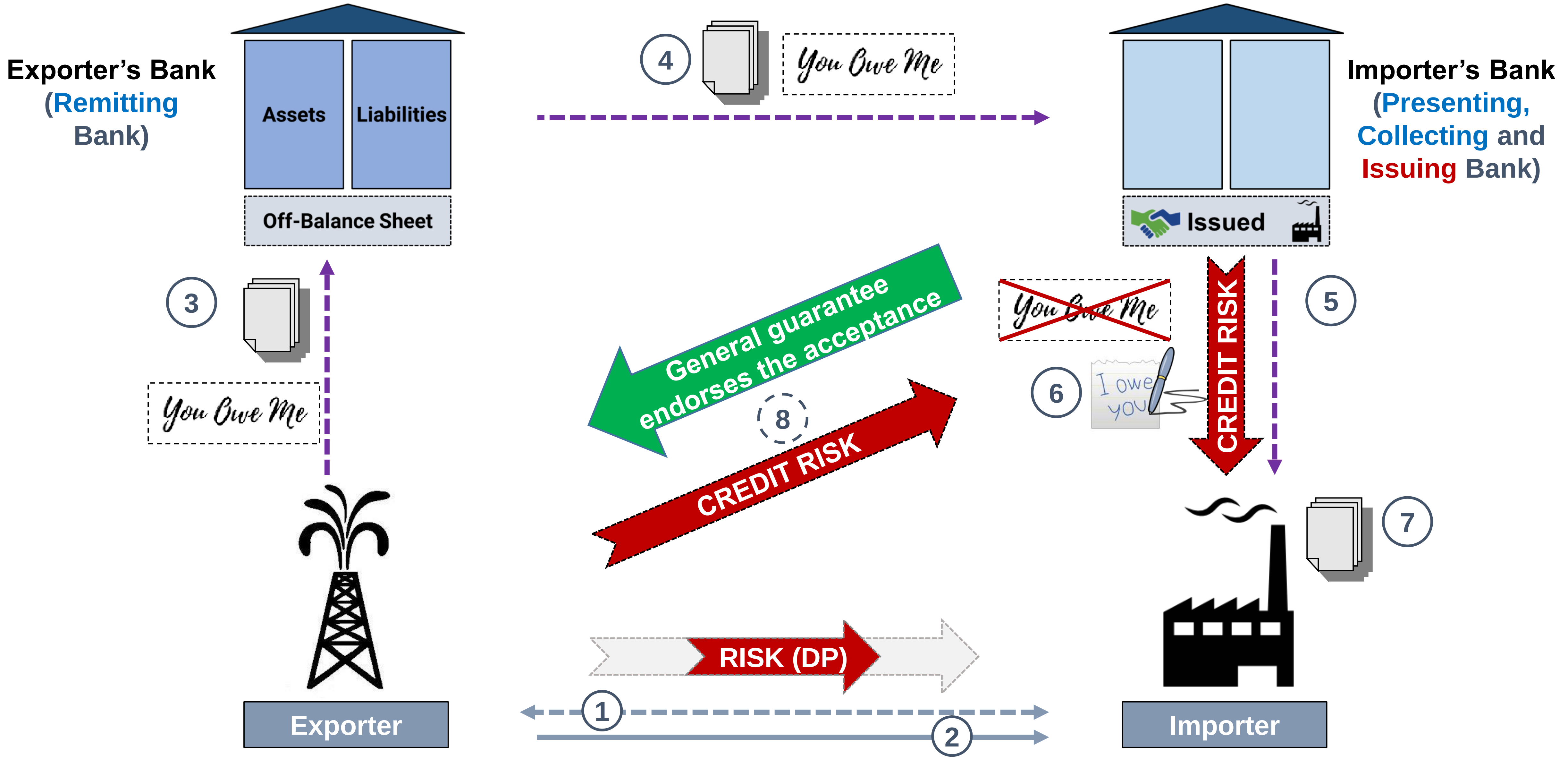
Documentary Collections (1 of 3): D. against Payment



Documentary Collections (2 of 3): D. against Acceptance



Documentary collections (3 of 3): Guaranteed Draft



Credit Risk Mitigation with Documentary Collections

Counterparty	Importer		Issuing Bank
Type of Incident	*Rejects Goods*	*Defaults*	*Defaults*
Risk type	**Commercial** (Credit, Country, Legal)		**Credit, Country**
Open Account	✘	✘✘	*n/a*
DP	✘	✔✔	*n/a*
DA	✘	✘*	*n/a*
Guaranteed DA	✘	✔	✘✘

Exporter

Importer

- Compared to **O/A, DA** reduces the **legal risk** associated to enforcing the payment.
- **Guarantees** facilitate credit from the *Exporter* to the *Importer* by **substituting** the latter's **credit risk**
- **DP** is the **safest form of collection** for the *Exporter*, while the *Importer* can still **reject the goods**

* *International standards on bills of exchange are recognized in most countries, facilitating the legal enforcement of dishonored trade acceptances*

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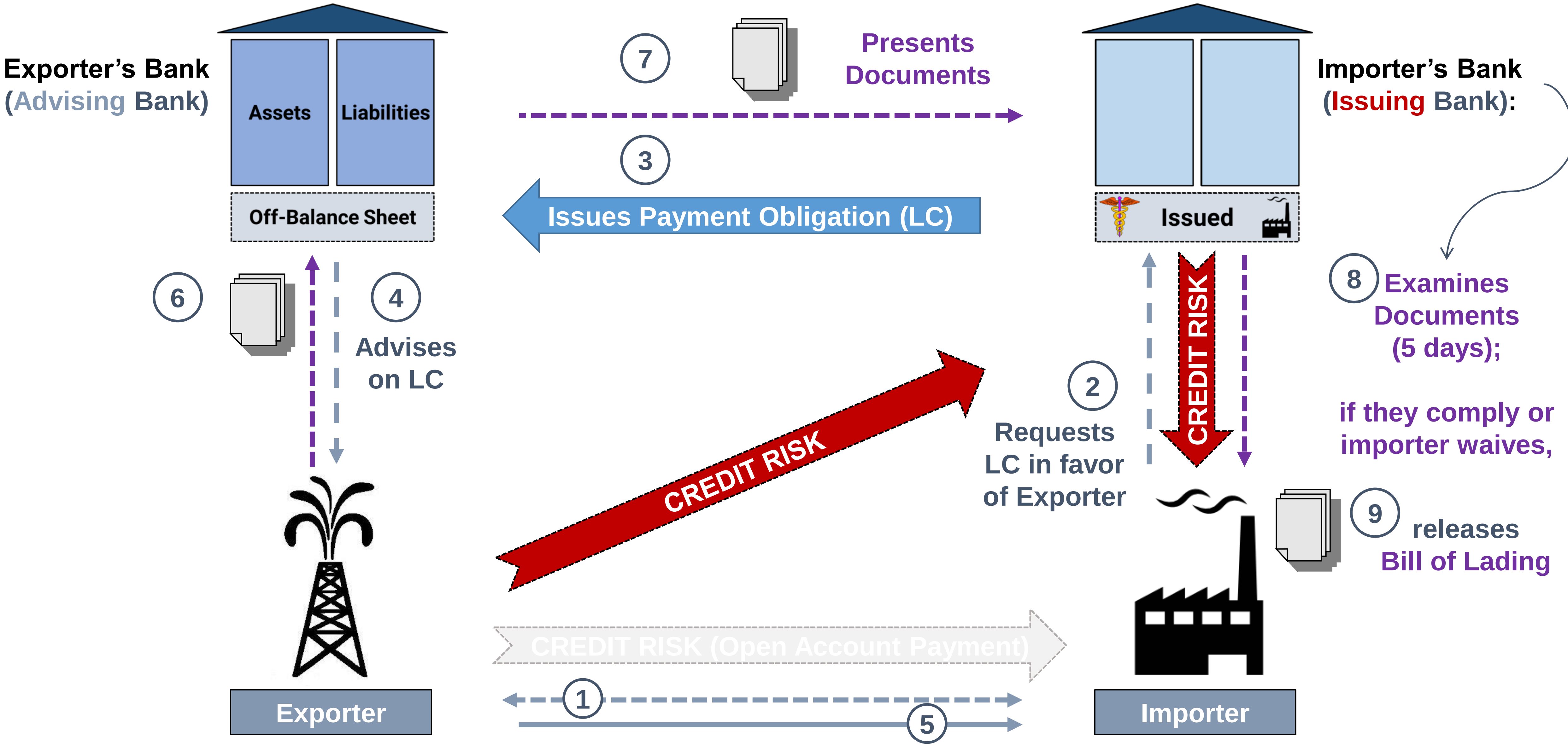
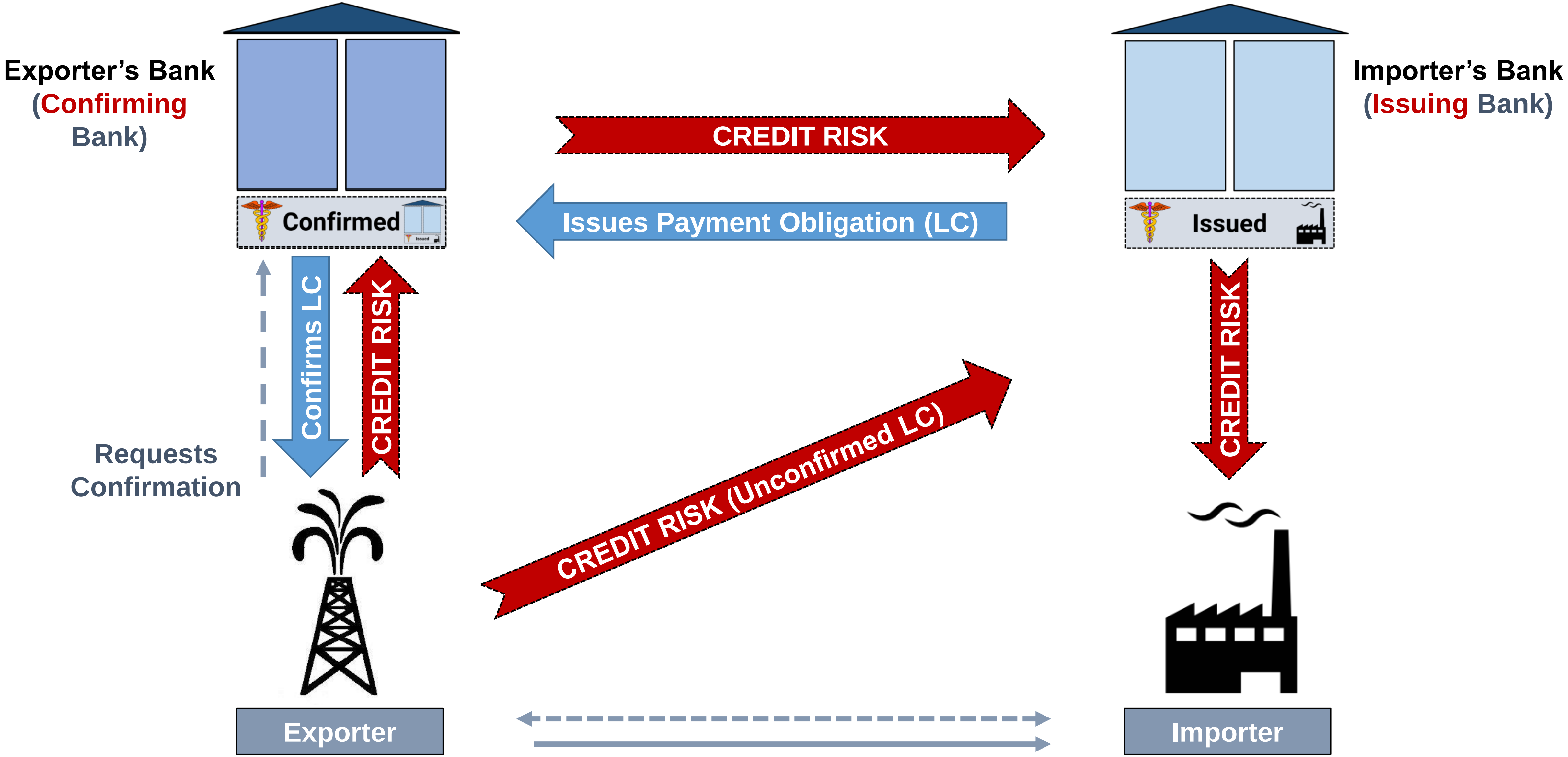
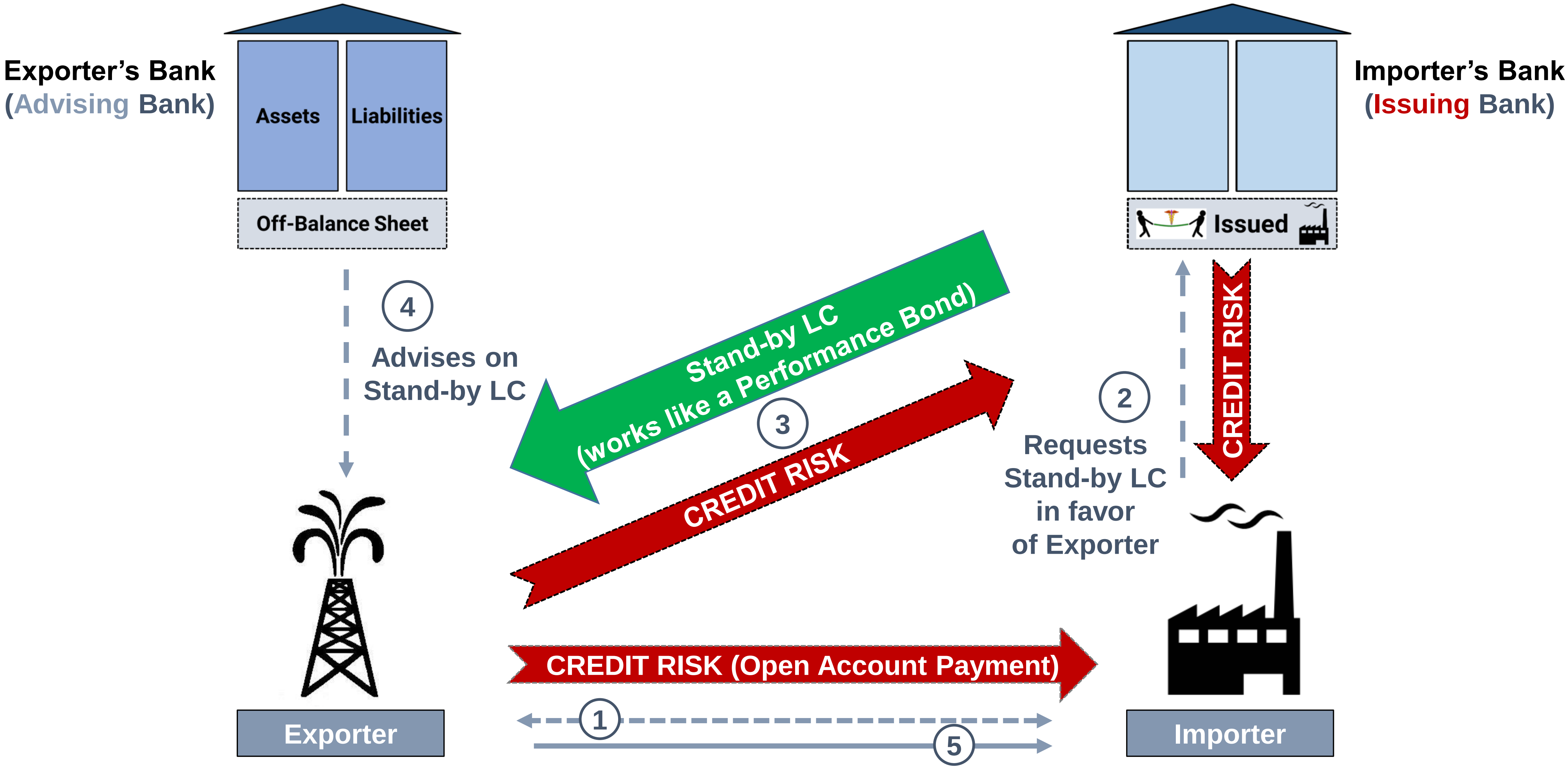
Documentary credit (1 of 3): Unconfirmed Letter of Credit



Documentary credit (2 of 3): Confirmed Letter of Credit



Documentary credit (3 of 3): Stand-by Letter of Credit



Credit Risk Mitigation with Documentary Credit

Exporter

Counterparty	Importer		Issuing Bank	Confirming Bank	
Type of Incident	*Rejects Goods*	*Defaults*	*Defaults*	*Finds Discrepancies*	*Defaults*
Risk type	**Commercial** (Credit, Country, Legal)		**Credit, Country**	**Operational**	**Credit**
Unconfirmed LC	✔	✔✔	✘✘	✘✘	*n/a*
Confirmed LC	✔	✔✔	✔	✘✘	✘
Stand-by LC	✔	✔✔	*depends***	✘***	*depends***

Importer

- The probability that **discrepancies** are found (→ possible **loss of credit risk protection**) increases with the number and complexity of documents examined by bank(s) → **higher** for **commercial LC**
- A **Stand-by LC** **minimizes this risk** for the Exporter → **less defense options** for importer.

*** Stand-by LCs can be confirmed with little paperwork and, in that case, presented to confirming or issuing bank - a key benefit over (counter) guarantees*

**** Documents for stand-by LCs are rarely discrepant, as the beneficiary only needs to state the buyer's default and present a copy of the invoice*

Credit Risk Mitigation: D. Collections vs. D. Credit

Exporter

Counterparty	Importer		Issuing Bank	Confirming Bank	
Type of Incident	***Rejects Goods***	***Defaults***	***Defaults***	***Finds Discrepancies***	***Defaults***
Risk type	**Commercial** (Credit, Country, Legal)		**Credit, Country**	**Operational**	**Credit**
Open Account	✘	✘✘	*n/a*	*n/a*	*n/a*
DP	✘	✔✔	*n/a*	*n/a*	*n/a*
DA	✘	✘*	*n/a*	*n/a*	*n/a*
Guaranteed DA	✘	✔	✘✘	*n/a*	*n/a*
Unconfirmed LC	✔	✔✔	✘✘	✘✘	*n/a*
Confirmed LC	✔	✔✔	✔	✘✘	✘
Stand-by LC	✔	✔✔	*depends***	✘***	✘

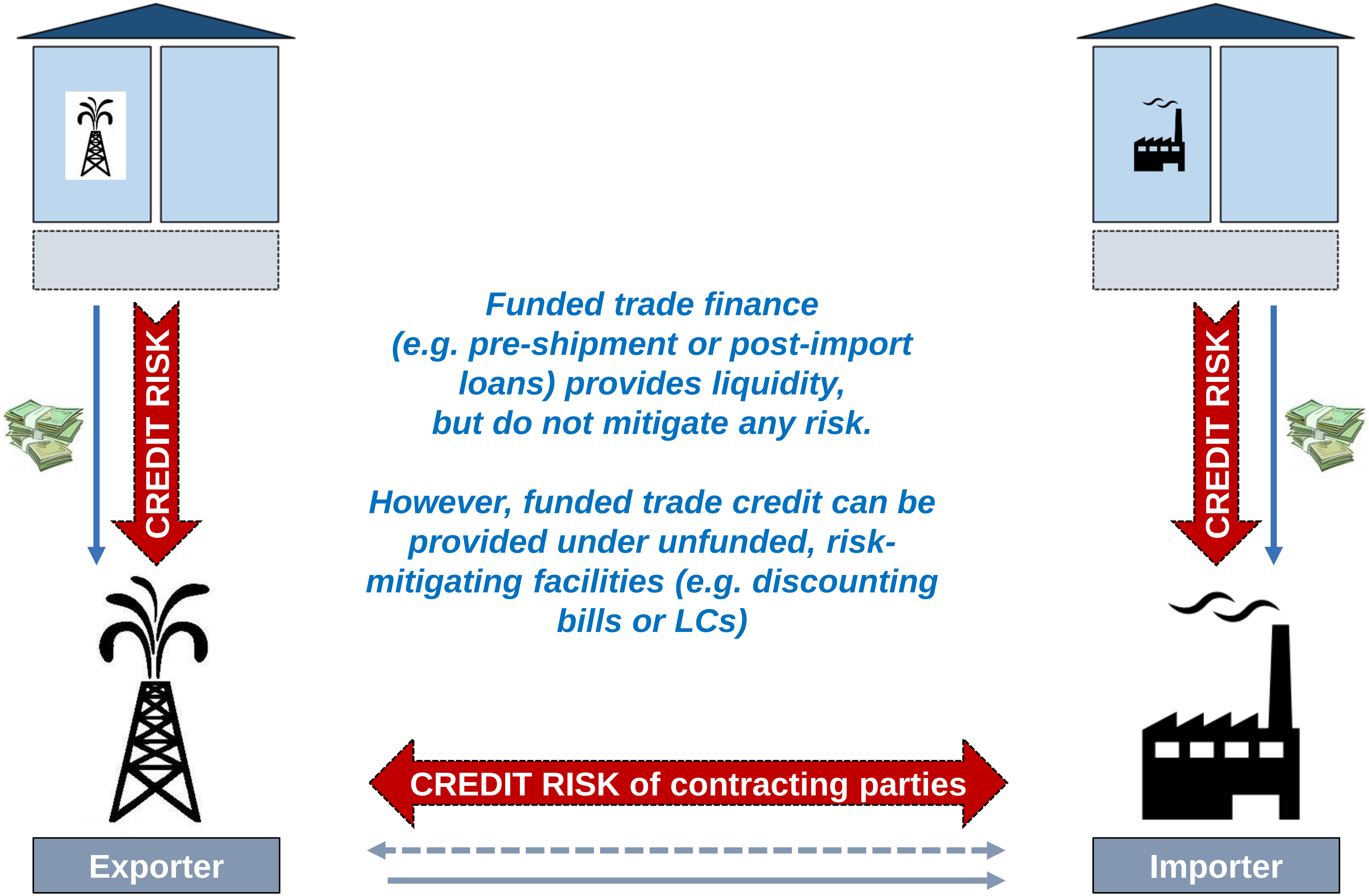
Importer

** International standards on bills of exchange are recognized in most countries, facilitating the legal enforcement of dishonored trade acceptances*

*** Stand-by LCs can be confirmed with little paperwork and, in that case, presented to confirming or issuing bank - a key benefit over (counter) guarantees*

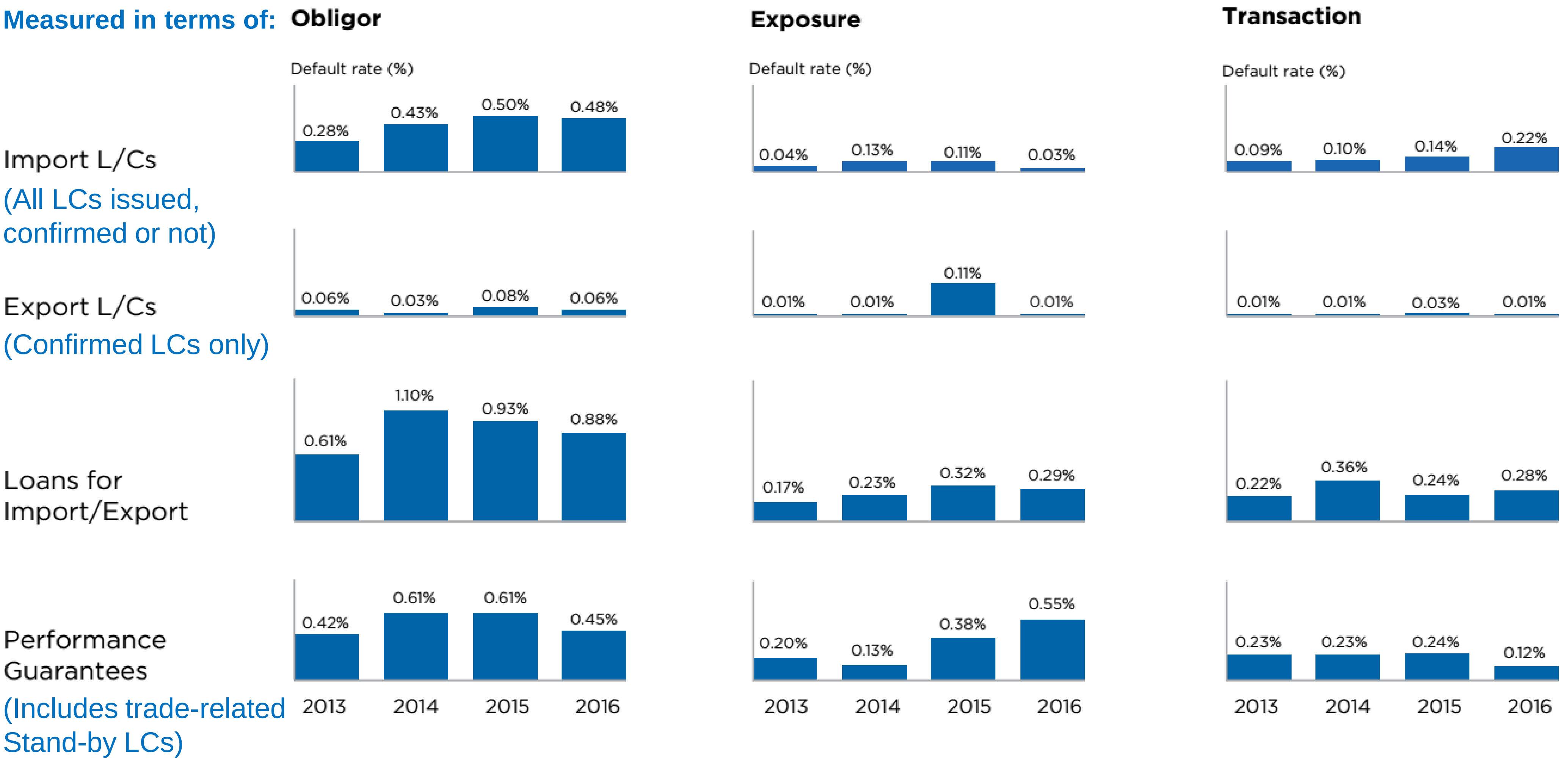
**** Documents for stand-by LCs are rarely discrepant, as the beneficiary only needs to state the buyer's default and present a copy of the invoice*

Funded Trade Finance: Liquidity, No Risk Mitigation

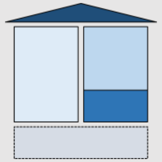


Banks' Historical Default Rates of LCs, Loans and Guarantees

Trade Finance, 2013–2016



Source: ICC Trade Register 2017.

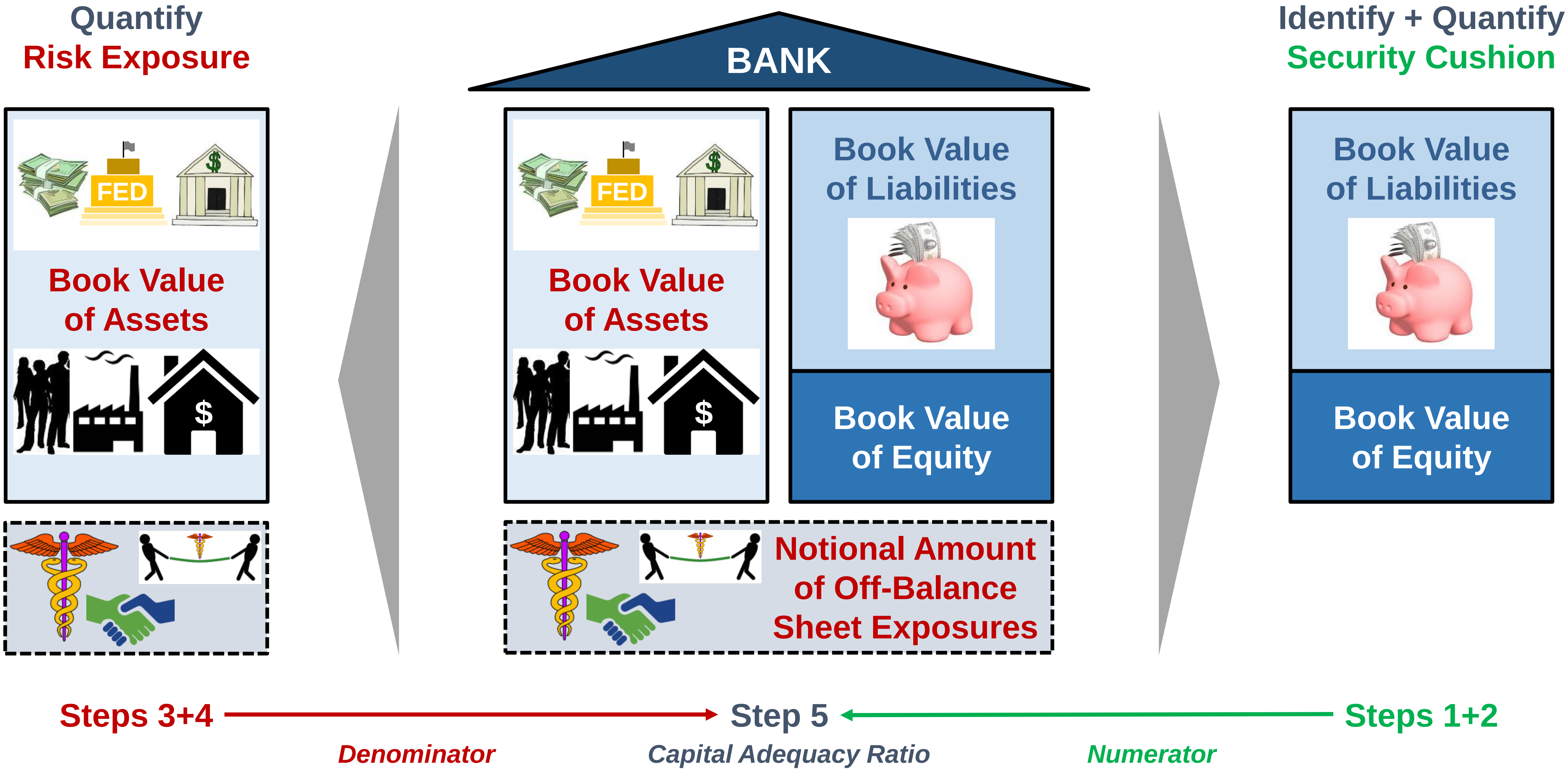


II. Basel Treatment of Funded and Unfunded Exposures

- The process of capital adequacy calculation
- Step 3: Making off-balance sheet items comparable to assets
- Risk profiles and Basel II CCFs of unfunded credit products
- Step 4: Risk-weighting credit risk equivalents and assets

→ Refer to Annexes I and II for more background and details

The Process of Capital Adequacy Calculation



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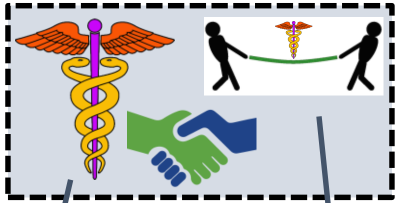
Step 3: Making Unfunded TF Exposures Comparable To Assets

Notional Amount of Off-Balance Sheet Exposures



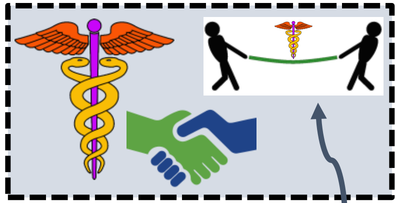
LC issued or confirmed

General guarantee*

Performance guarantee, stand-by LC **

x

Apply Credit Conversion Factors



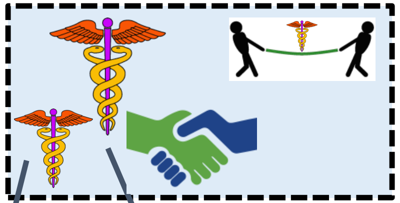
20% or 50%

100%

50%

=

Credit Risk Equivalents



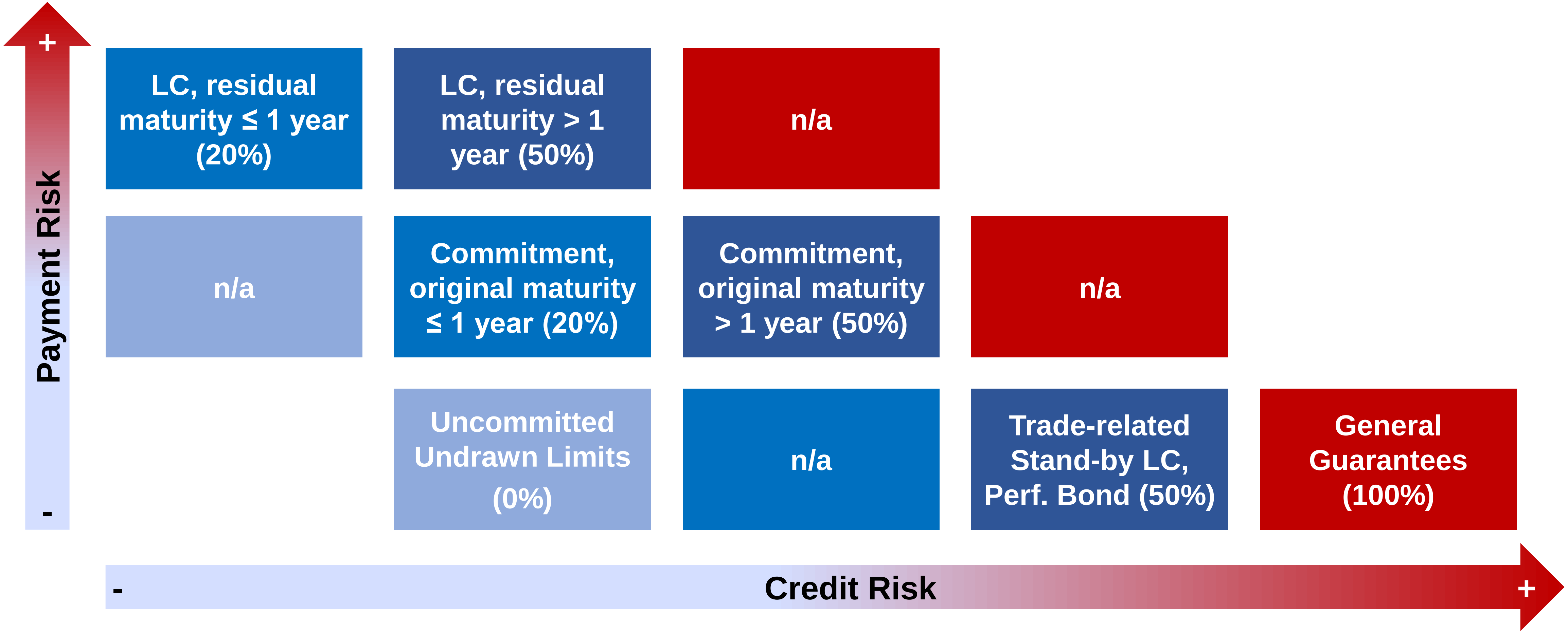
Short-term (≤1 year)

Long-term (>1 year)

* "*Direct credit substitutes*, e.g. *general guarantees* of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including *endorsements with the character of acceptances*)" (Basel I, Annex 3.2.)

** "e.g. *performance bonds*, bid bonds, warranties and *standby letters of credit* related to *particular transactions*" (Basel I, Annex 3.1.)

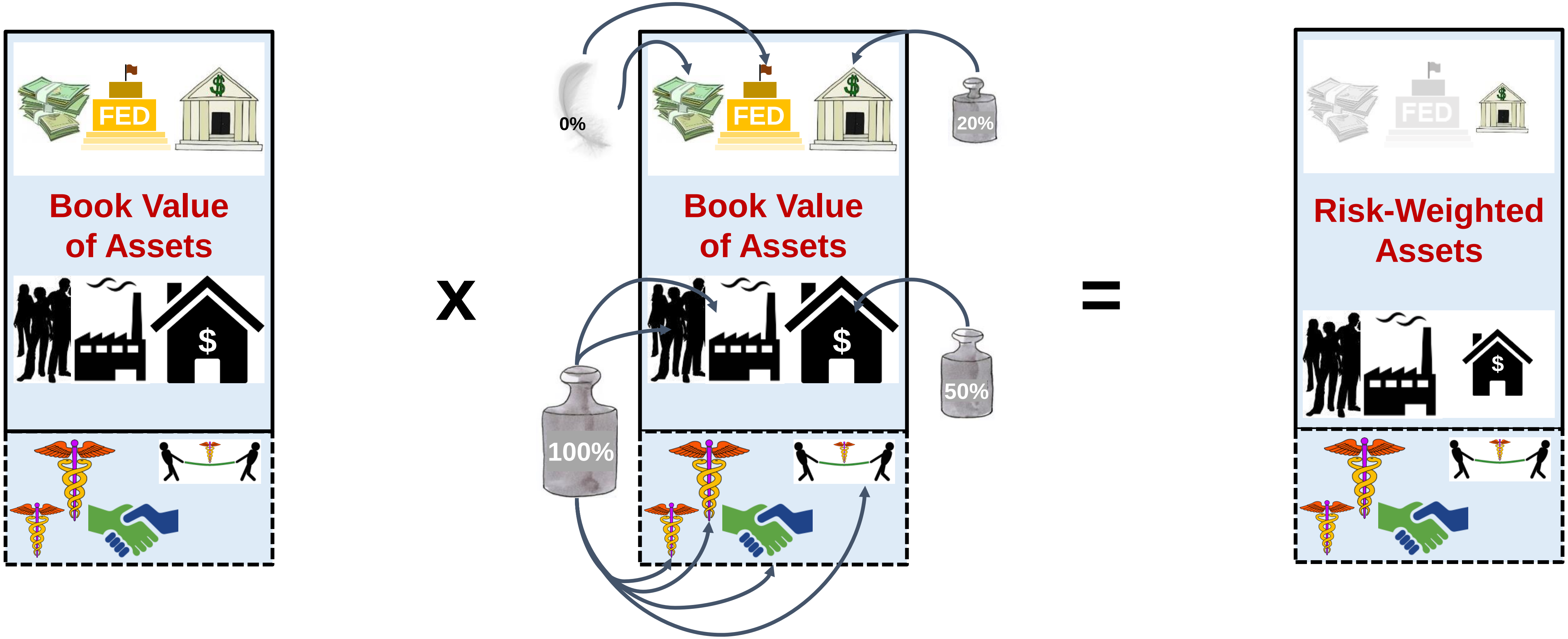
Risk profiles and Basel II CCFs of unfunded credit products



CCFs are determined by Credit Risk (x-Axis) **and Payment Risk** (y-Axis).

They are a gross but necessary simplification of complex products such as (Stand-by) LCs.

Step 4: Risk-Weighting Credit Risk Equivalents and Assets



Assumption: The benefiaries of all off-balance sheet exposures are enterprises, not banks

III. Efficient capital allocation with unfunded trade finance

- Credit conversion factors under Basel I-III and in Uzbekistan
- LCs and stand-by LCs require less capital
- LCs and stand-by LCs can finance larger volumes
- Benefits for capital management

Credit conversion factors under Basel I-III and in Uzbekistan

		Basel I	Basel II	Basel III	Uzbekistan
Uncommitted undrawn limits		**0%**		**10%**	**0%**
Firm lending commitments	short-term*	**0%**	**20%**	**40%**	**20%**
	long-term*	**50%**			**50%**
Letters of Credit (LCs)	short-term	**20%**			
	long-term	**50%**			
Transaction-related contingencies**					
General guarantees		**100%**			

** Treatment of lending commitments depends on the original (rather than residual) maturity*

*** e.g. stand-by LCs, performance bonds/ guarantees*

(Stand-by) LCs Require Less Capital for the Same Volume

<table>
<tr><th>Instrument</th><th>Notional / Book Value</th><th>x</th><th>Credit Conversion Factor</th><th>=</th><th>Credit Risk Equivalent</th><th>→</th><th>Risk-Weighted Assets *</th><th>→</th><th>Capital Required **</th></tr>
<tr><td>LC (short-term)</td><td rowspan="5">$100,000</td><td></td><td>20%</td><td></td><td>$20,000</td><td></td><td>$20,000</td><td></td><td>$2,000</td></tr>
<tr><td>LC (long-term)</td><td></td><td rowspan="2">50%</td><td></td><td rowspan="2">$50,000</td><td></td><td rowspan="2">$50,000</td><td></td><td rowspan="2">$5,000</td></tr>
<tr><td>Stand-by LC</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Gen. Guarantee</td><td></td><td>100%</td><td></td><td>$100,000</td><td></td><td rowspan="2">$100,000</td><td></td><td rowspan="2">$10,000</td></tr>
<tr><td>Loan</td><td></td><td>n/a</td><td></td><td>n/a</td><td></td><td></td></tr>
</table>

x 5

x 2

** 100% risk weight for enterprises per Basel I*

*** Assumption: Minimum Capital Adequacy Ratio is 10%*

LCs Can Finance Larger Volumes with the Same Capital

Instrument	*Available* Capital **	→	Risk-Weighted Assets *	→	Credit Risk Equivalent	÷	Credit Conversion Factor	=	Notional / Book Value
LC (short-term)							20%		$500,000
LC (long-term)					$100,000		50%		$200,000
Stand-by LC	$10,000		$100,000						
Gen. Guarantee							100%		$100,000
Loan					n/a		n/a		

x 5

x 2

* 100% risk weight for enterprises per Basel I

** Assumption: Minimum Capital Adequacy Ratio is 10%

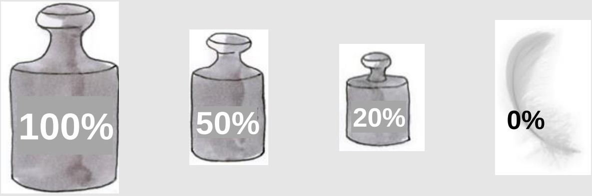
Benefits for Capital Management

- The following CCFs are applied to trade-related unfunded exposures:
  - **20% for short-term LCs**
  - **50% for long-term LCs, stand-by LCs, performance guarantees etc.**

- This reduces the basis for risk weighting, allowing for:
  - **A more efficient use of issuing and confirming bank's regulatory capital**
  - **Higher trade finance volumes with a given risk appetite**
  - **Compared to loans or non-transaction-specific guarantees, the magnitude of this effect is:**
    - ***Five*fold (1 ÷ 20% = *5*) for *short-term LCs***
    - ***Two*fold (1 ÷ 50% = 2) for *long-term LCs* and *all stand-by LCs, performance guarantees etc.***

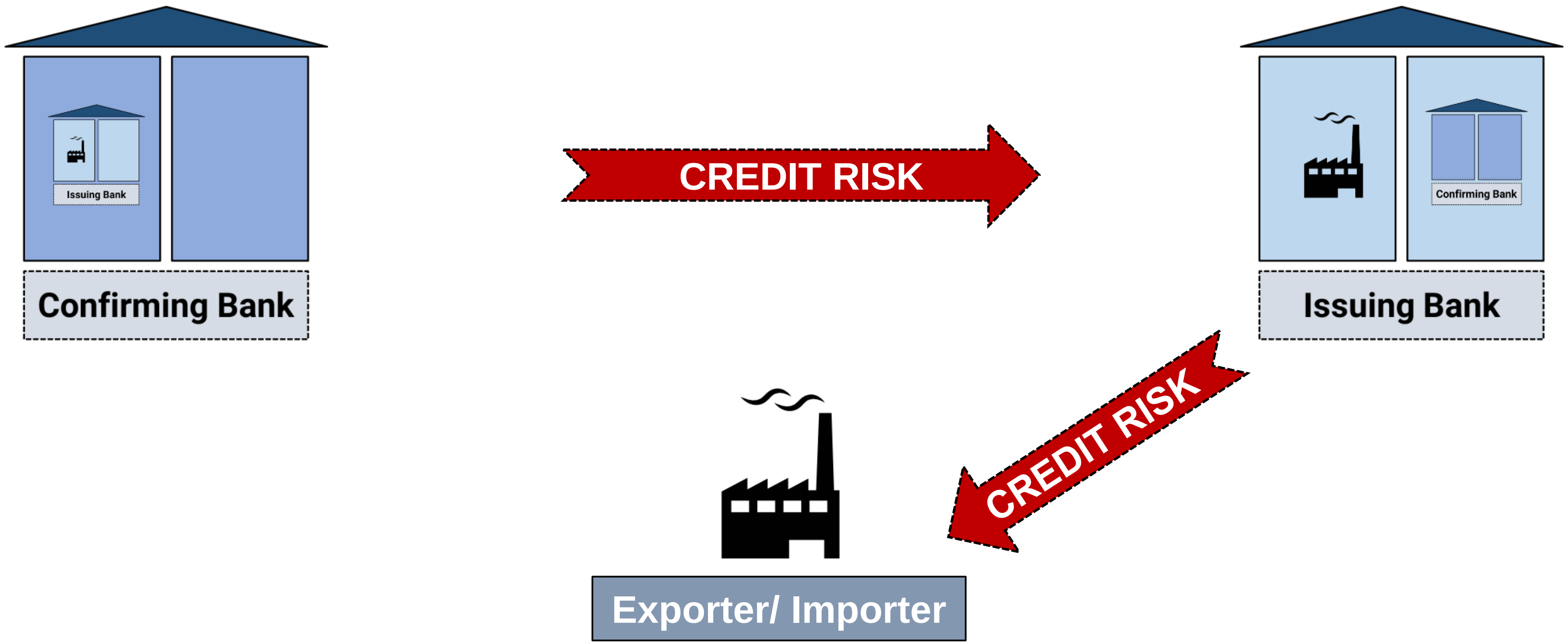
ADB

IV. ADB‘s funded and unfunded trade facilitation



- Credit risk in an international trade finance transaction
- Risk weights and ratings for banks under Basel I and II
- Multilateral development banks as guarantors
- ADB‘s credit guarantee absorbs inter-bank risk
- Partial risk transfer with selected global banks
- Risk relief from the ADB’s 0% risk weight
- Key features of ADB‘s credit guarantees
- ADB‘s revolving credit facility provides liquidity

Credit risk in an international trade finance transaction



Risk Weights and Ratings for Banks under Basel I and II

<table>
<tr><th colspan="2">Basel I</th><th>Risk Weights</th></tr>
<tr><td colspan="2">OECD and domestic banks</td><td rowspan="2">20%</td></tr>
<tr><td rowspan="2">Non-OECD banks</td><td>borrowing in their own currency or for ≤1 year</td></tr>
<tr><td>borrowing in FX or for >1 year</td><td>100%</td></tr>
</table>

<table>
<tr><th colspan="2" rowspan="2">Basel II</th><th colspan="6">Risk Weights for Long-Term Issuer Ratings</th></tr>
<tr><th>Unrated</th><th>AAA to AA-</th><th>A+ to A-</th><th>BBB+ to BBB-</th><th>BB+ to B-</th><th>Less</th></tr>
<tr><td colspan="2">Based on Sovereign Rating</td><td>100%</td><td>20%</td><td>50%</td><td colspan="2">100%</td><td rowspan="3">150%</td></tr>
<tr><td rowspan="2">Based on Corporate Rating and Original Maturity (in Months)</td><td>≤ 3</td><td colspan="4">20%</td><td>50%</td></tr>
<tr><td>> 3</td><td>50%</td><td>20%</td><td colspan="2">50%</td><td>100%</td></tr>
</table>

Risk Weights and Ratings for Banks under Basel II

- Risk weights for banks depend on their corporate rating or the applicable sovereign rating
- Banks need to choose one of these approaches and apply it uniformly to all other banks
- International ratings are not binding for domestic exposures in local currency:
  - ➢ **Sovereign rating approach: 20% risk weight (RW) even if sovereign is rated A+ or worse**
  - ➢ **Corporate rating approach: 20% RW if rating is AA- per national scale but worse internationally**

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<tr><th colspan="2" rowspan="2">Basel II</th><th colspan="6">Risk Weights for Long-Term Issuer Ratings</th></tr>
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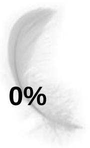
</table>

Multilateral Development Banks as Guarantors

- ADB is a multilateral development bank (MDB)
- **Basel I-III:** Risk weights of obligors can be replaced by those of certain third-party guarantors, including the ADB
  - ➢ **ADB's credit guarantees can lower the risk weight for inter-bank exposures**

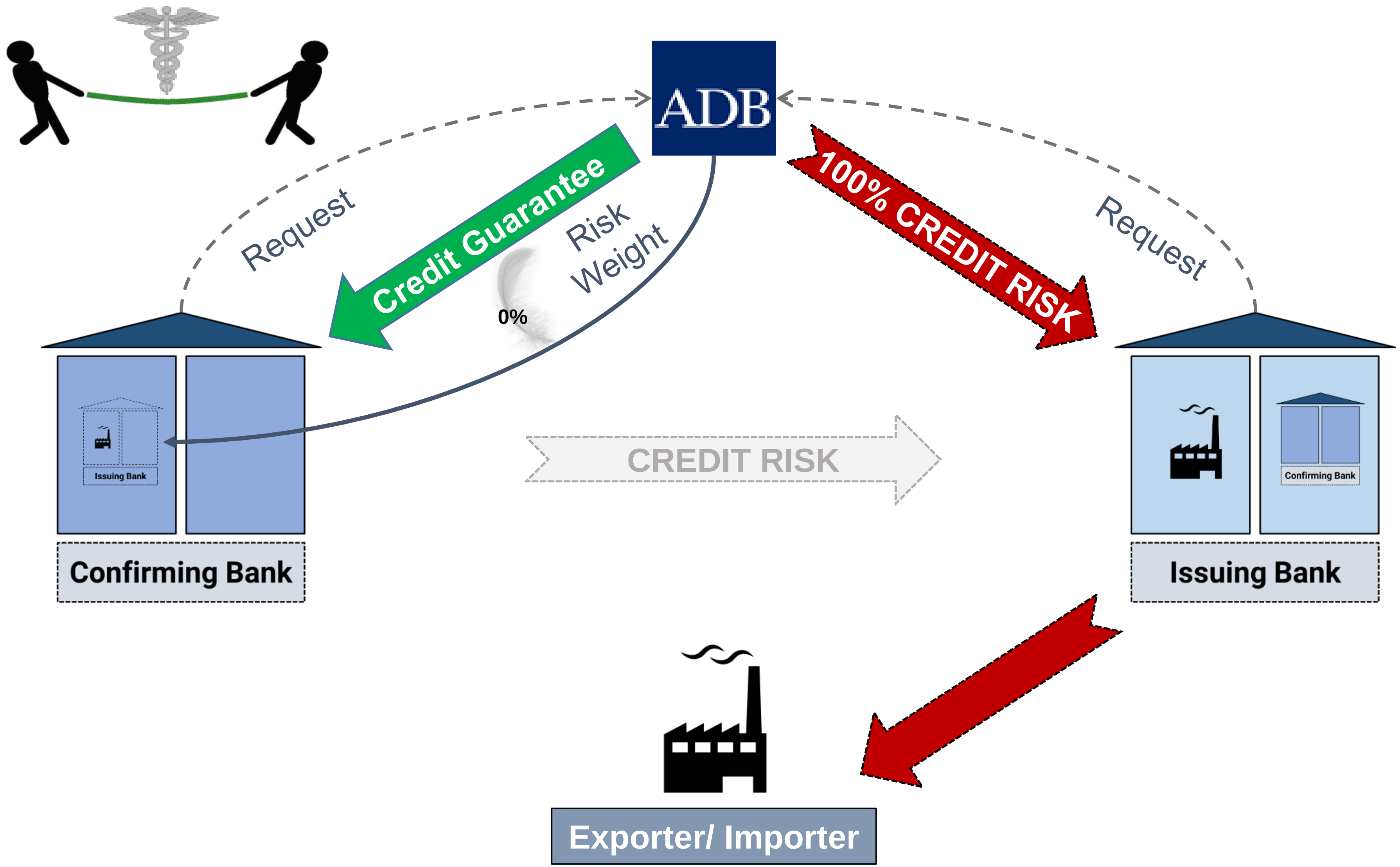
- **Basel I:** 20% Risk weight for credit exposures guaranteed by MDBs
  - ➢ **ADB can support confirming banks where the issuing bank's risk weight is 100%**



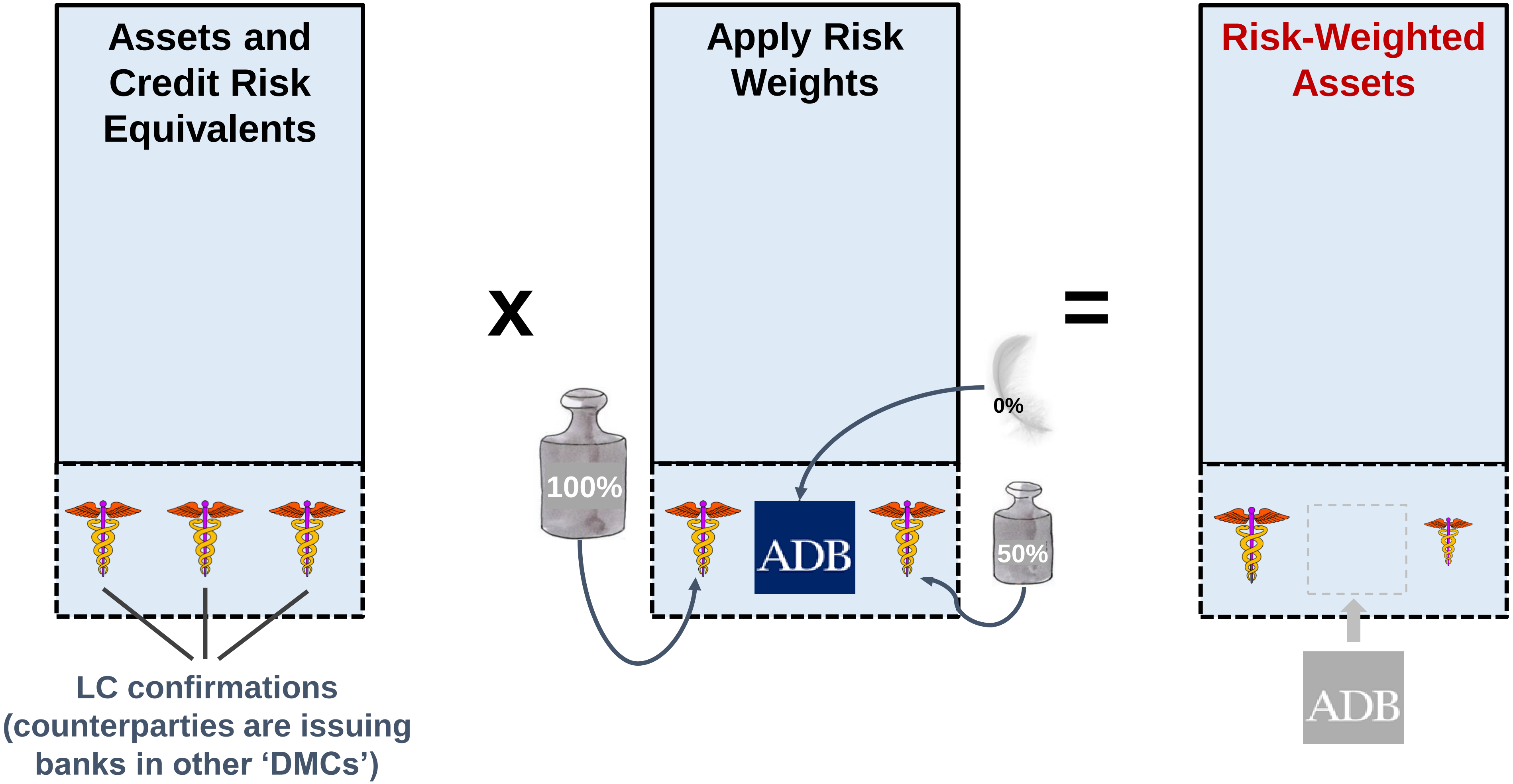
- **Basel II and III:** 0% Risk weight for AAA-rated MDBs
  - ➢ **ADB's credit guarantees are attractive for any inter-bank exposure**
- Even some **Basel I countries** use **Basel II risk weights** for banks and MDBs
  - ➢ **Check national regulations on capital adequacy**

ADB's Credit Guarantee Absorbs Inter-bank Risk

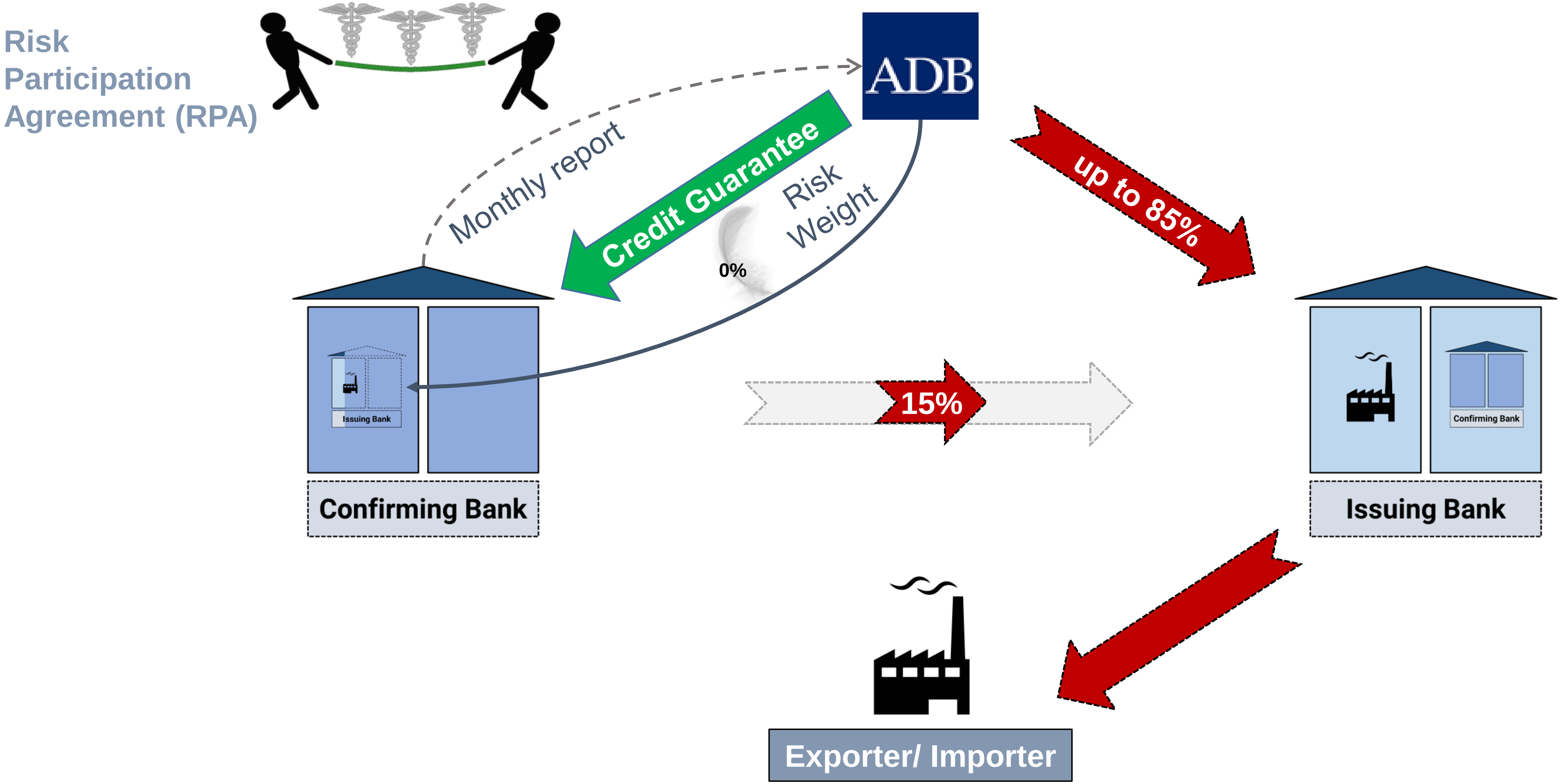
Stand-by LC



Effect of ADB‘s 0%-Risk Weight on Risk-Weighted Assets



Partial Risk Transfer with Selected Global Banks



Risk Relief from the ADB’s 0% Risk Weight

Scenario (Confirming Bank’s Perspective)	RWA Before	–	Risk Transfer	=	RWA After	→	Capital Required *
No Risk Transfer	$100,000		$0		$100,000		$10,000
Credit Guarantee (individual transaction)	$100,000		$100,000		$0		$0
Credit Guarantee (under RPA)	$100,000		$85,000		$15,000		$1,500

** Assumption: Minimum Capital Adequacy Ratio is 10%*

Key Features of ADB's Credit Guarantees

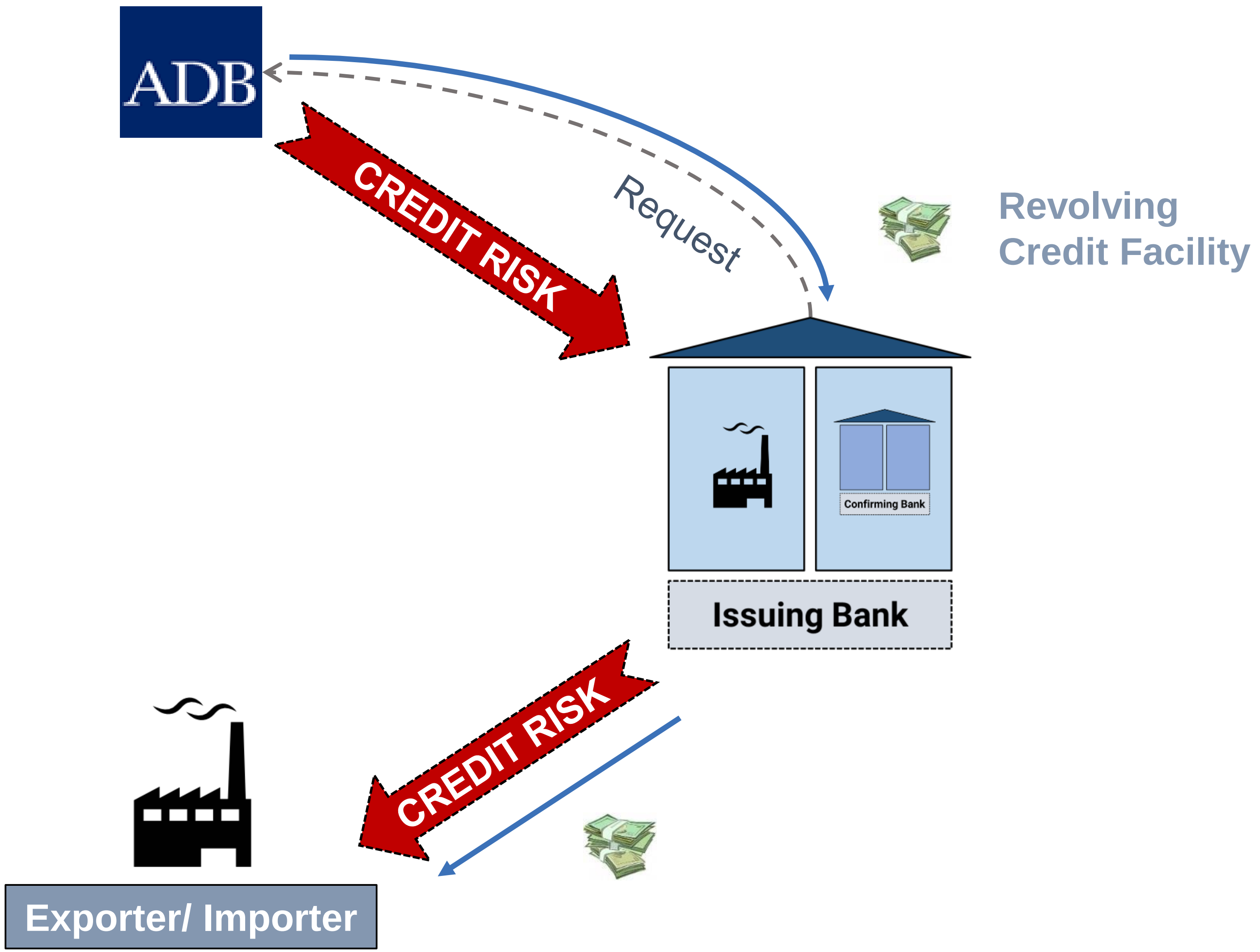
The TFP's credit guarantees mitigate inter-bank risk …

… via the ADB's zero-risk weight under Basel II and III, ...

… allowing for:

- **A more efficient use of confirming bank's regulatory capital**
- **Higher trade finance volumes with issuing banks with a given risk appetite:**
  - **6.7 times as large when bundling transactions under RPAs (100 ÷ [10% × 1.5] = 666.7)**
  - **For individual transactions, constrained only by the ADB's available credit limit**

ADB's Revolving Credit Facility Provides Liquidity

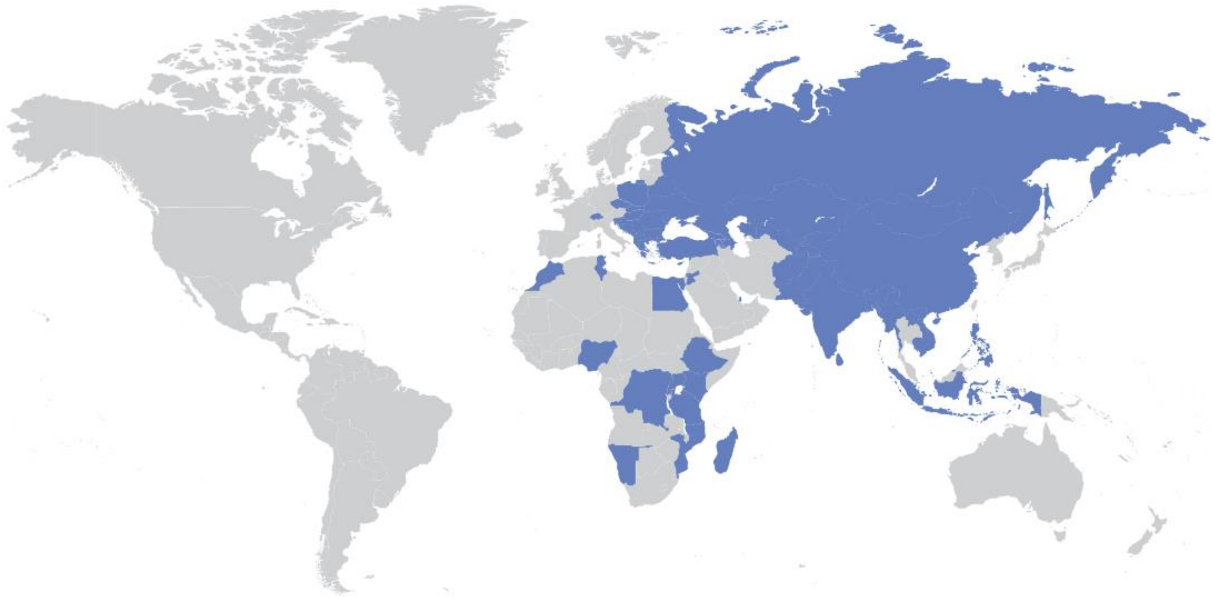


IV. Questions?

Business & Finance Consulting

Andreas Raithelhuber
Senior Bank Advisor

Phone: +41 44 585 39 47
E-mail: raithelhuber@bfconsulting.com



Agrifinance · SME Finance · Microfinance · Green Finance

Max-Högger-Strasse 6
CH-8048 Zurich, Switzerland

Phone: +41 44 784 22 22
Fax: +41 44 784 23 23

info@bfconsulting.com
www.bfconsulting.com

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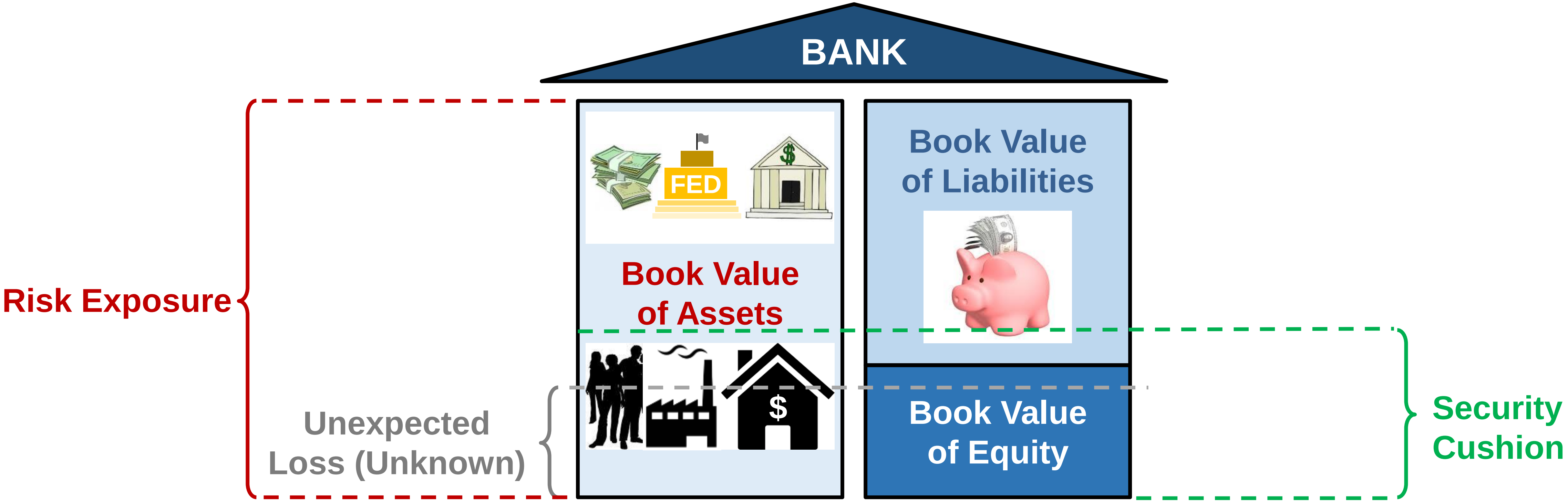
Annex I: Introduction to the Basel capital frameworks

- Capital Adequacy: Security Cushion for Unexpected Loss
- International standard setter for prudential regulation
- Evolution of the Basel Accords
- Elements of Basel I, II and III in Uzbekistan

Capital Adequacy: Security Cushion for Unexpected Loss



$$\text{Regulatory Minimum} = \frac{\text{Unexpected Loss}}{\text{Risk Exposure}} = x\% \leq \frac{\text{Security Cushion}}{\text{Risk Exposure}} = \text{Capital Adequacy Ratio}$$

Capital Adequacy: Security Cushion for Unexpected Loss

- The Unexpected Loss is, by definition, unknown
- All we know is: our Security Cushion must exceed it
- And we are able to assess our Risk Exposure
- Hence, the regulator prescribes how to identify and quantify these variables and obliges banks to maintain the relationship between
  - Security Cushion (Numerator) and
  - Risk Exposure (Denominator), i.e. the
  - Capital Adequacy Ratio, above a certain level – the Regulatory Minimum
- The Regulatory Minimum represents the regulator‘s risk appetite

$$\text{Regulatory Minimum} = \frac{\text{Unexpected Loss}}{\text{Risk Exposure}} = x\% \leq \frac{\text{Security Cushion}}{\text{Risk Exposure}} = \text{Capital Adequacy Ratio}$$

- *x = 8%* *Basel I-II recommendations*
- *x = 10.5%* *Basel III for banks that are not systemically important globally*
- *x = 10-13%* *Most of the ADB's "Developing Member Countries"*

International Standard Setter for Prudential Regulation

BANK FOR INTERNATIONAL SETTLEMENTS

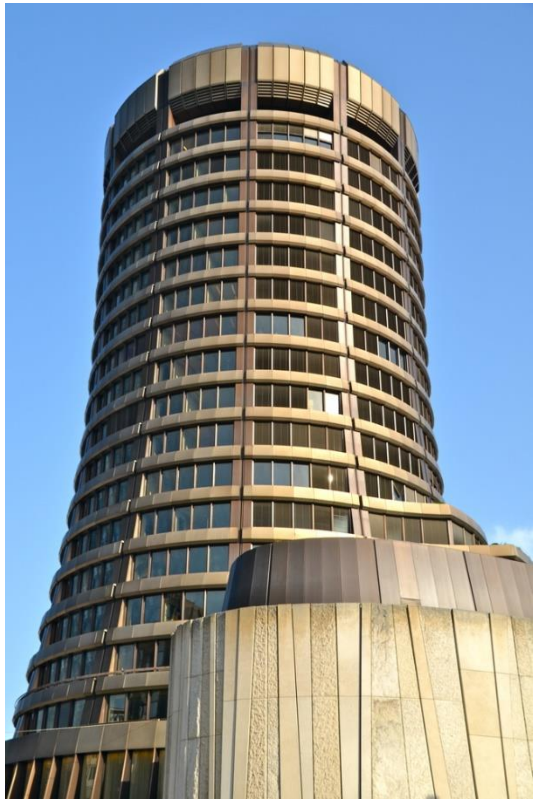
Oldest international financial organization, founded in 1930 in Basel, Switzerland

Fields of activity:

Payments:	Central bank of central banks
Research:	Financial system stability
Regulation:	Policy analysis and dialogue

→ 6 committees issue guidelines, among them the Basel Committee on Banking Supervision (BCBS)

→ Developed the Basel Accords (frameworks)



Evolution of the Basel Accord: Basel I and II

1988: Basel I (1996: Market risk amendment)

- **Soundness of banking systems**
- **Nationally: Maintain capital cushions as risk buffers**
- **Internationally: Converge the national capital definitions**

2004: Basel II

Pillar 1
- **Operational Risk Charge**
- **More risk-sensitive credit risk weights, use of external ratings and internal models**

Pillar 2
- **Improve banks' risk management practices**
- **Converge the risk buffer definitions of regulators and banks**

Pillar 3
- **Promote market discipline by means of enhanced disclosure requirements for banks**

2011-2017: Basel III as reaction of global financial crisis (2007-2009)

Evolution of the Basel Accord: The three pillars of Basel II

FINANCIAL STABILITY

Pillar 1
Minimal Capital Requirements

for:

- Credit Risk
- Market Risk
- Operational Risk

Scope of Basel I

Pillar 2
Supervisory Review Process (SRP)

- Internal Capital Adequacy Assessment Process (ICAAP)
- Supervisory Review Evaluation Process (SREP)

Pillar 3
Market Discipline

- Enhanced Disclosure Requirements for Banks

Capital adequacy is the first of 3 pillars of Basel II

Evolution of the Basel Accord: Stages of Basel III

2011: A global regulatory framework for more resilient banks and banking systems

- **Tier 1 capital: 'common equity' (CET1) vs. 'additional' (AT1), more deductions**
- **Tier 2 capital: stricter eligibility criteria, corresponding deduction of investments**
- **Higher CAR requirements ('buffers') for systemically important banks (SIBs)**
- **Minimum leverage ratio related to banks' size, non-sensitive to risk weights or models**

2013/2014: Net Stable Funding Ratio (NSFR) and Liquidity Coverage Ratio (LCR)

2016: Deduction of G-SIBs' investments in capital instruments (TLAC)

2016/2019: Capital requirements for market risk

2017: Finalizing post-crisis reforms

- **Standardized approaches – more credit risk-sensitive:**
  - Risk weights (e.g. loan-to-value ratio, solvency of bank counterparties)
  - Credit conversion factors (e.g. for lending commitments)
- **Leverage ratio buffers for SIBs Internal models: safeguards against model risk**

Elements of Basel I, II and III in Uzbekistan

I	Few risk weights	✓
	Market risk charge	✓
II	Many risk weights	✗
	External credit ratings	Foreign exposures
	Operational risk charge	✓
III	CET1 and AT1 capital	✓
	More deductions	✓✓
	Stricter T. 2 capital	✗
	Buffers, domestic SIBs	✓
	Leverage ratio	✓
	NSFR, LCR	✓

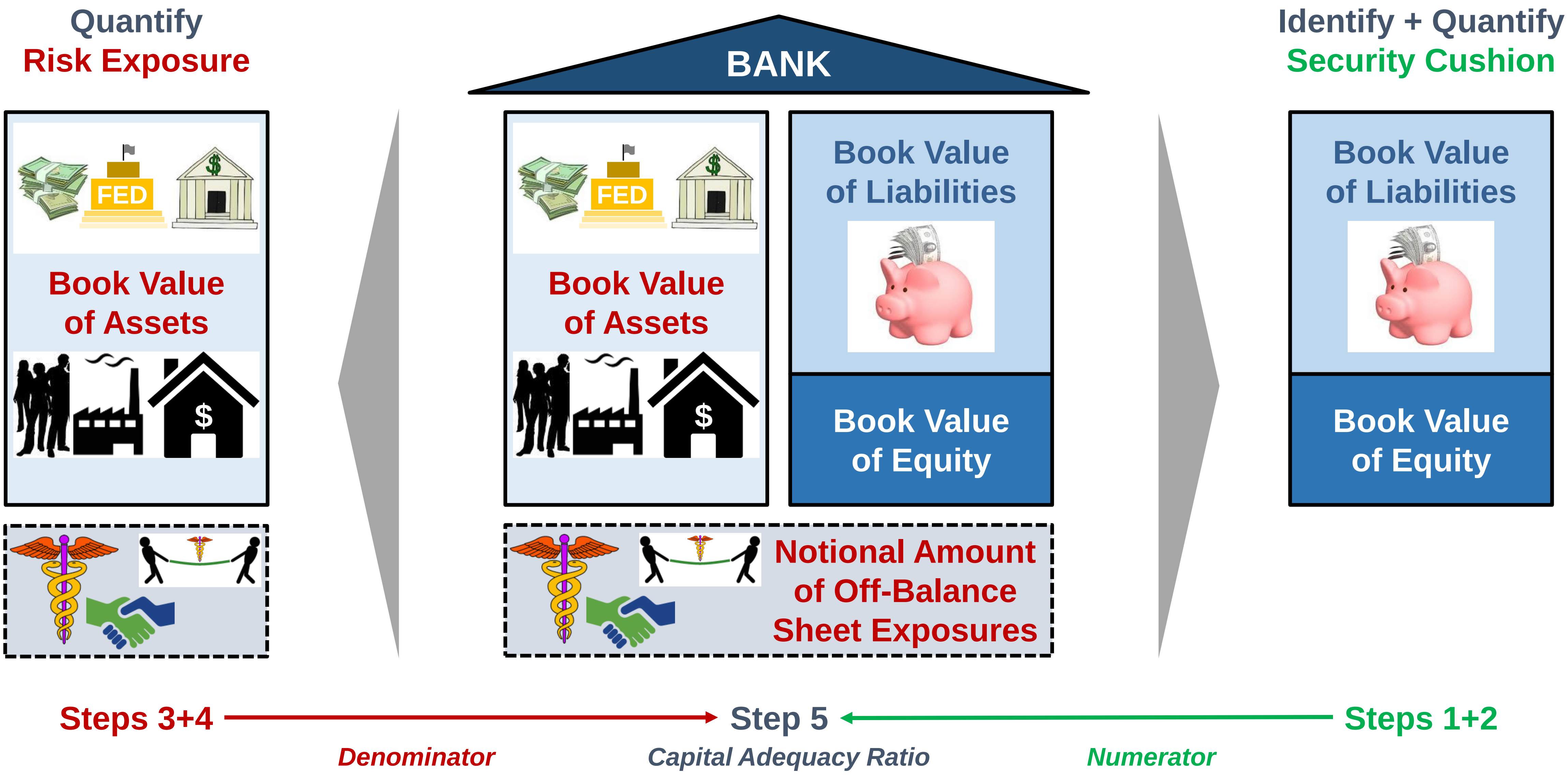
Uzbekistan has adopted most Basel III elements while still applying Basel I risk weights.
It is the country with the strictest rules for capital deductions within the TFP.

Annex II: Capital adequacy calculation in five steps per Basel I

Concept: Adequacy of Security Cushion for Risk Exposure

1. Identify eligible regulatory capital components
2. Prudential adjustments to capital: Limits and deductions
3. Convert off-balance sheet items to credit risk equivalents
4. Risk weights for assets and credit risk equivalents
5. Calculate capital adequacy ratios

Concept: Adequacy of Security Cushion for Risk Exposure



1. Identify Eligible Regulatory Capital Components

Equity and Liabilities

Book Value of Equity

Book Value of Liabilities

Distinguish Items by Quality (Capacity to Absorb Losses)

Paid-up capital, share premium,
Reserves from retained profits

Fair value/ revaluation reserves

Subordinated debt > 5 years
General loss provisions

Customer ,
Senior debt,
Other

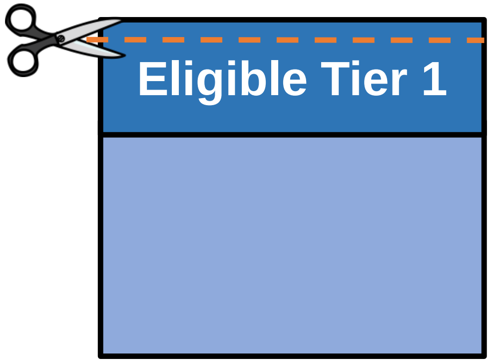
Eligible Capital Components

Eligible Tier 1 Capital

Eligible Tier 2 Capital

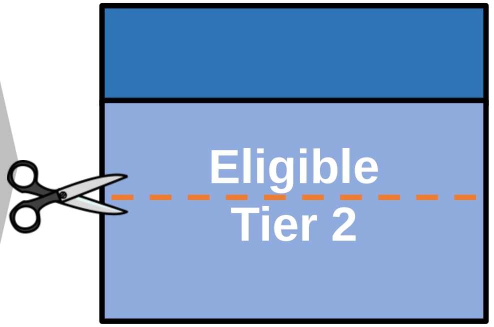
2. Prudential Adjustments to Capital: Limits and deductions

Subtractions from Tier 1 Capital



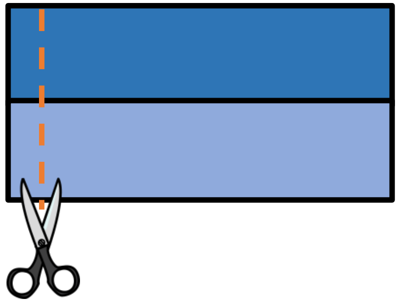
- **Goodwill**

Limitations on Tier 2 Capital



- **Tier 2 ≤ Tier 1**
- **Subordinated Debt ≤ 50% of Tier 1**
- **General Loss Pro-visions ≤ 1.25% of credit RWA**

Subtractions from both Tier 1 + 2 Capital*



- **Investments in deposit-taking subsidiaries**

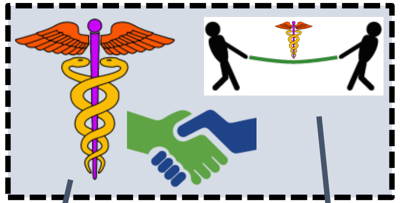
Regulatory Capital

* *Treatment under Basel I differs among countries; 50:50 per Basel II; more sophisticated per Basel III*

bfc

3. Convert Off-balance Sheet Items to Credit Risk Equivalents

Notional Amount of Off-Balance Sheet Exposures



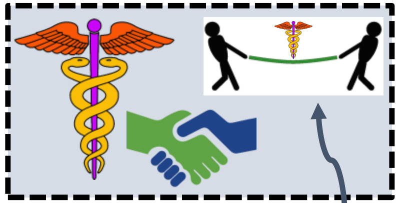
LC issued or confirmed

Credit substitutes *

Transaction-related contingencies **

x

Apply Credit Conversion Factors



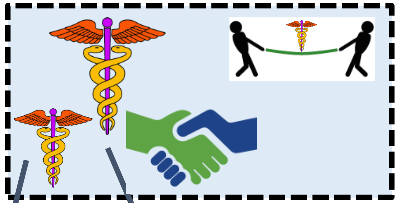
20% or 50%

100%

50%

=

Credit Risk Equivalents



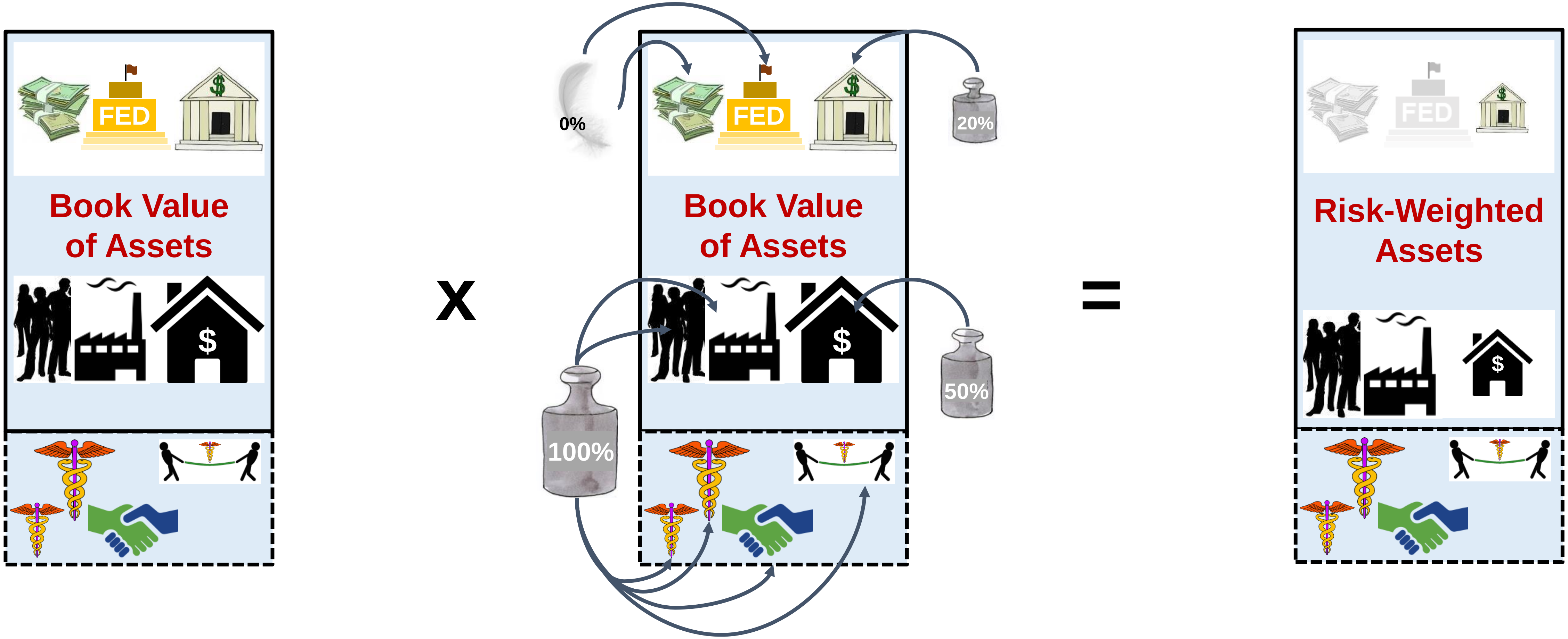
Short-term (≤1 year)

Long-term (>1 year)

* *"**Direct credit substitutes**, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including **endorsements with the character of acceptances**)" (Basel I, Annex 3.2.)*

** *"e.g. **performance bonds**, bid bonds, warranties and **standby letters of credit** related to **particular transactions**" (Basel I, Annex 3.1.)*

4. Risk Weights for Assets and Credit Risk Equivalents

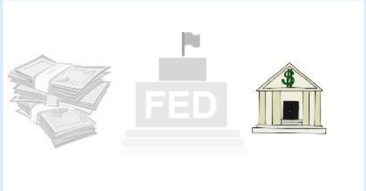


Assumption: The benefiaries of all off-balance sheet exposures are enterprises, not banks

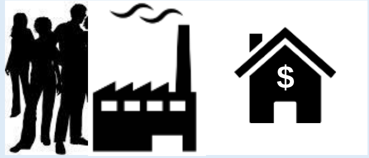
5. Calculate Capital Adequacy Ratios

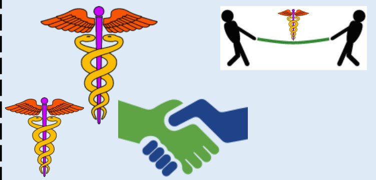
Regulatory Capital

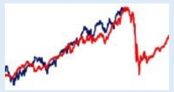
Regulatory Capital		Risk-Weighted Assets		Ratio
Adjusted Tier 1	÷	Risk-Weighted Assets	=	Tier 1 Capital Ratio
Adjusted Tier 1 + Adjusted Tier 2	÷	Risk-Weighted Assets + Market Risk Charge	=	Total Capital Adequacy Ratio



Risk-Weighted Assets







Market Risk Charge

Where to find the Basel Accords

Basel Accord	Title	URL
I	International Convergence of Capital Measurement and Capital Standards	https://www.bis.org/publ/bcbsc111.htm
II	International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version	https://www.bis.org/publ/bcbs128.htm
III	International Regulatory Framework for Banks; Basel III: Finalising post-crisis reforms	https://www.bis.org/bcbs/basel3.htm; https://www.bis.org/bcbs/publ/d424.htm