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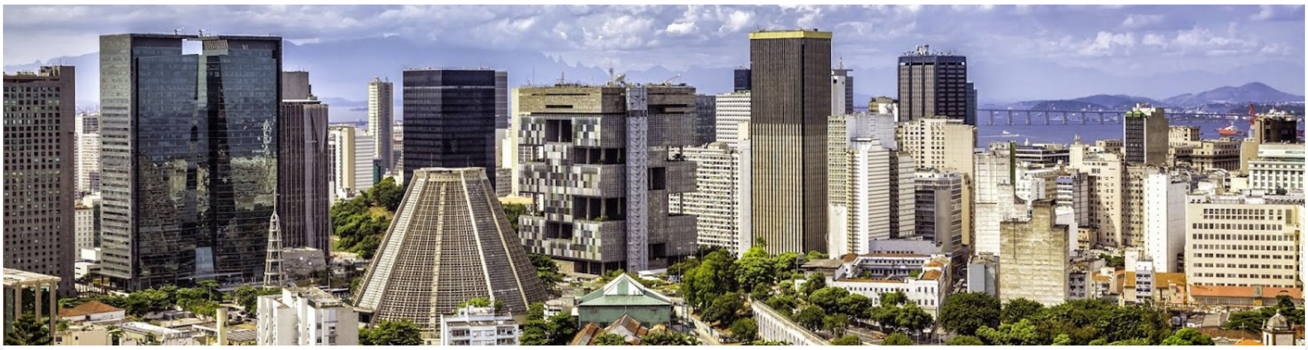

Leveraging Supply Chain Finance for Development

Alexander R. Malaket

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E15 Expert Group on
Trade, Finance, and Development

Think Piece

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For more information on the E15, please visit www.e15initiative.org/

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LIST OF ABBREVIATIONS

ADB	Asian Development Bank
AfDB	African Development Bank
ASEAN	Association of Southeast Asian Nations
BAFT	Bankers Association for Finance and Trade
BDI	Baltic Dry Index
BIS	Bank for International Settlements
BPO	Bank Payment Obligation
CGFS	Committee on the Global Financial System
DFIs	development finance institutions
EBRD	European Bank for Reconstruction and Development
ECAs	Export Credit Agencies
G-20	Group of Twenty
GFTP	Global Trade Finance Program
ICC	International Chamber of Commerce
ICTSD	International Centre for Trade and Sustainable Development
IFC	International Finance Corporation
IFIs	international financial institutions
IMF	International Monetary Fund
L/C	Letter of Credit
LICs	low-income countries
MENA	Middle East and North Africa
MICs	middle-income countries
SCF	supply chain finance
SMEs	mall and medium-sized enterprises
UK	United Kingdom
UN/CEFACT	United Nations Centre for Trade Facilitation and Electronic Business
WTO	World Trade Organization

LIST OF FIGURES

EXECUTIVE SUMMARY

Trade financing, an esoteric and poorly understood branch of finance, is demonstrably critical to the pursuit and conduct of international trade, by companies of all sizes, and by small and medium-sized enterprises (SMEs) in particular. Those based in developing and emerging markets are in even more urgent need of the liquidity and risk mitigation solutions available through trade financing.

The global financial crisis has demonstrated beyond debate that there is an important role for public sector and international institution actors in assuring the availability of adequate levels of affordably priced trade finance, particularly (but not exclusively) in times of crisis.

It is worth noting explicitly that the discussion which follows necessarily refers to various instruments and structures of trade and supply chain finance for the sake of clarity and to provide concrete examples; that said, reference to trade finance and supply chain finance should be understood in the widest possible sense, encompassing any financing and related activity in risk mitigation, that aims to support the conduct of cross-border trade. The focus ought to be on a holistic understanding of this domain, its linkage to the conduct of trade and its clear potential to contribute to international development and poverty reduction.

Interestingly, some of the techniques evolving with the aim of supporting international supply chains can (and do) apply very well in the context of domestic, supply chain-centered activity.

A core question to consider is whether, independently of instruments and transactional technicalities, there is sufficient capacity in the global system to finance trade, and thereby to create economic value, and contribute to development and poverty reduction.

Even as the research, analysis, deliberations and dialogue around trade financing evolve, there is an opportunity for differentiated contribution to these efforts. Illustrative recommendations include:

1. Advocate for and facilitate a global coordination of efforts, knowledge management and policy recommendations around trade and supply chain finance,

2. Engage with the International Chamber of Commerce (ICC), the World Trade Organization (WTO), the multilateral development banks and others, to add further to the deliberations around appropriate but non-stifling regulation of bank intermediated trade financing in particular, including capital adequacy, compliance, due diligence and related areas. Advocate in support of appropriate treatment of on and off-balance trade financing as well as emerging propositions in supply chain finance. Support the adoption of a global solution to due diligence and "Know your Customer" requirements, such as the SWIFT KYC Registry.

3. Undertake specific analysis on the potential for supply chain finance and emerging solutions like the bank payment obligation, to address the needs of SMEs in developing and emerging markets, and to assist those markets in better linking to global supply chains and value chains

4. Conceive, design and engage in an exploratory dialogue with industry experts and policymakers around innovations in trade financing to address specific, strategically important categories of trade activity, such as high-value services sector trade flows, commodity flows and others deemed important to international development

5. Conceive and lead analysis aimed at identifying innovative ways to address the global gap in trade financing, including through a variety of non-traditional sources and providers, and with consideration of developments in mobile finance, microfinance and similar areas relevant to SMEs and developing economies

THE IMPORTANCE OF FINANCING TO INTERNATIONAL TRADE

LINKING TRADE AND TRADE FINANCING

The global financial crisis and the economic crisis which followed, the consequences of which continue to be felt around the world, had one positive, transformational impact on the world of international trade.

The urgent search for corrective measures and policy levers with global reach and impact caused political leaders, heads of international institutions, and other influential parties to hone in on the potential for robust international trade and investment activity to help set the global economic system on a path of recovery and growth.

That laser-like focus on trade led to the realization, previously shared among a few practitioners and specialists, that trade financing (including highly evolved risk mitigation capabilities) is essential to the conduct of international trade, and by some estimates, supports or enables 80–90 percent of global merchandise trade flows, today worth in excess of US$18 trillion annually. Even by conservative definitions and estimates, bank-intermediated, traditional trade finance has been estimated by various sources to support 30-40 percent of global trade flows.

One perspective on linking trade financing, trade activity, and economic value creation holds, "To understand the significance of trade finance, it is important to view it in the context of an overall trade development strategy whose purpose is to develop and expand sustainable trade flows to support the country's economic development."

The practical reality, however, is that trade finance has historically operated in the background, often behind a veil of complexity and mystery, that did not support the communication of these important linkages. The post-crisis environment has brought trade finance (in its traditional form and in evolving propositions under Supply Chain Finance) sharply into focus, both in the commercial environment and in the context of public and international research, analysis, and policy.

It is notable that part of the focus is specifically on the opportunity and the imperative to allow access to sufficient, affordable levels of trade financing to facilitate the engagement of developing economies (and their largely small and medium-sized enterprise- [SME] driven economies) into the international economic system through trade.

TRADITIONAL TRADE FINANCE AND SUPPLY CHAIN FINANCE

Trade financing today comprises a range of programs, products, and solutions aimed at enabling international commerce. While the boundaries are not absolutely clear, it is useful to distinguish between "traditional trade finance" and "supply chain finance" (SCF).

Traditional trade finance encompasses products and instruments such as documentary letters of credit—

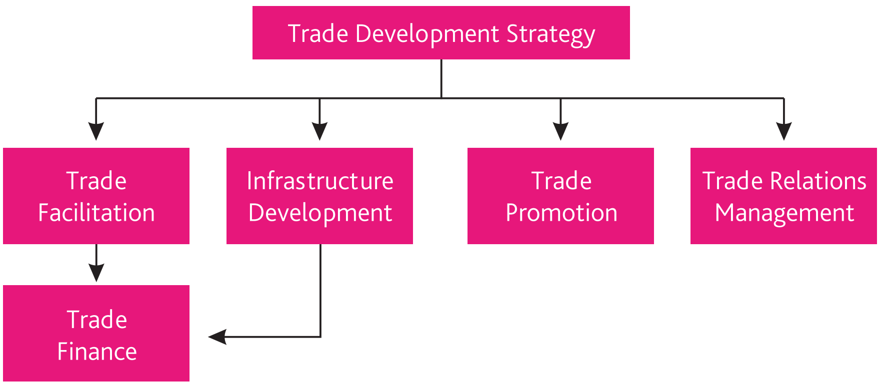


FIGURE 1:

Trade Development Strategy

Source: Trade Finance Infrastructure Development Handbook, 2005, UNESCAP/ ITC.

instruments that have been in use, largely without change, for hundreds of years, with well-established rules, guidelines, and industry practice, and intermediated primarily by banks.

At its most basic, a documentary credit involves a bank providing a legally enforceable payment undertaking on behalf of their importer/buyer client, in favour of an exporter/supplier working with that client. The payment undertaking is contingent upon demonstration by the exporter (through documents produced, collected, and submitted along with a request for payment under the credit) that all agreed terms and conditions have been fully met. Such an instrument allows the exporter to gain the comfort of relying on a payment promise by a bank, and gives the importer assurance that payment will only be made following demonstration of full compliance by the exporter. Numerous features can be included in the terms of a documentary credit that allow importers and exporters to address a range of concerns and requirements.[1]

Figure 2 reflects the trends in global messaging flows through the Belgium-headquartered SWIFT network, which accounts for the vast majority of letter of credit (L/C) flows globally today, as MT 700 category messages. A complementary form of traditional trade finance, the documentary collection, transmitted via MT 400 SWIFT messages, reflects a sharper decline.

Even as the L/C arguably fades in relative importance as an instrument of trade finance, many of the hard-won lessons and effective practices of trade finance embodied in the features, flexibility, and global acceptance of this mature instrument of international finance can and should be leveraged to inform the development of new models, frameworks, and programs for financing international trade.

In sharp contrast, the more recent propositions encapsulated by the term supply chain finance show rapid growth, and target the support of the vast majority of trade activity today, which is conducted on so-called open account terms.

For numerous years, with real momentum in evidence just prior to the global financial and economic crisis, importers and exporters have shown a desire to shift away from traditional, largely bank-intermediated trade financing to less paper-intensive and less-expensive open account terms, where an exporter effects shipment and an importer initiates payment at an agreed point in the transaction lifecycle. These transactions involve little bank engagement (other than the transmission of the payment), and typically little to no focus on risk mitigation.

Banks responded to this near-global shift (the Middle East and North Africa [MENA] region has remained demonstrably more loyal to L/Cs and traditional mechanisms than other parts of the world) by envisioning, developing, and proposing SCF as a solution aimed at supporting open account trade flows.

The propositions here are so new that the term "supply chain finance" itself has numerous meanings, ranging from single products to comprehensive programs aimed at supporting large ecosystems of trading relationships in complex domestic and/or international supply chains. SCF is such a new proposition (though it is enabled through certain instruments that are long-standing in the market) that there is currently a multi-association initiative tasked with devising and then advocating the adoption of a set of consistent definitions for SCF and a subset of financing techniques.

SCF solutions are made available to importers and exporters by a more varied group of providers than is the case with traditional trade finance products. Non-bank specialist finance firms, bank-affiliated entities and technology platform providers, including electronic and mobile payment providers, are challenging banks on market share, growth rates, and market prominence.

1 A non-technical treatment of trade finance, including documentary credit transactions, is provided in Malaket (2014); ITC (2009) is also relevant.

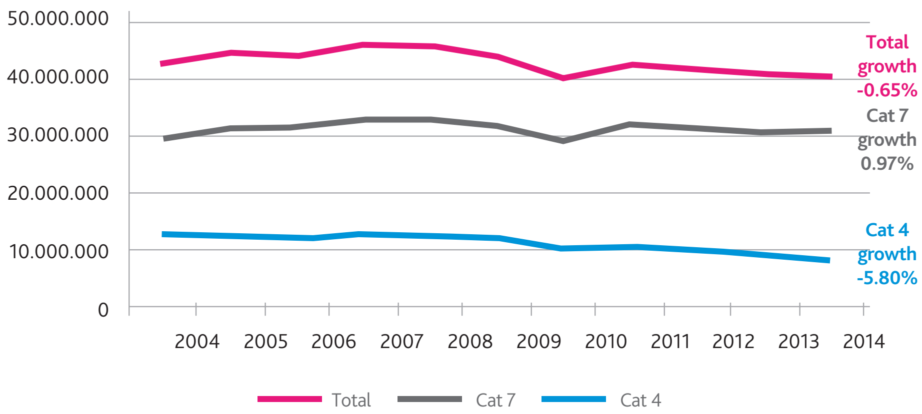


FIGURE 2:

SWIFT Message Traffic: Documentary Credit (Cat 7) and Collections (Cat 4)

Source: Rethinking Trade and Finance, ICC Banking Commission (2014)

SCF motivates an ecosystem view of trade, sometimes involving a major global buyer with a community of thousands or tens of thousands of suppliers, with participation in such supply chains (even indirectly through aggregators and so-called "tier one" suppliers) providing comfort to SME suppliers, and offering a basis for financing propositions. Certain forms of SCF enable small suppliers to access trade financing on the strength of the borrowing capacity of a large buyer, or alternatively, to raise financing locally on the basis of that relationship. This latter variation is not always considered to be trade finance, though it clearly supports trade activity.

Traditional trade finance, by contrast, is generally about one bilateral trading relationship between buyer and supplier, and in textbook terms, key instruments like the documentary letter of credit are used in the context of trade involving higher-risk markets, or immature trading relationships where trust has not yet been established.

Fundamentally however, it remains the case that trade financing—both traditional trade finance and SCF—is critically important to the enablement of international trade. SCF, defined in its widest sense (that is, as a comprehensive program), is particularly interesting for its promise as a solution to SME and developing market access to trade-focused financing. Additionally, recent efforts to leverage SCF techniques to enable a flow of liquidity to SMEs in jurisdictions such as the United Kingdom (UK),[2] where government departments and large corporates are being persuaded to implement SCF programs, reflect the potential for effective public and international policy in this area.

THE FOUR ELEMENTS OF TRADE FINANCING

Despite the increase in focus, analysis, and attention on trade financing, this specialism in finance remains poorly understood by senior bankers, regulatory authorities, and private sector finance and treasury experts.

It can be argued that trade financing, at its core, is about some combination of four elements.

1. The facilitation of secure and timely payment across borders.

2. The provision of financing options and solutions for one or more trading parties.

3. The provision of effective risk mitigation.

4. Information flow related to the physical movement of a shipment and/or the associated financial flows.

The exact combination of these elements and their relative importance in the context of a trade transaction, relationship or supply chain ecosystem will vary. Access to affordable trade financing, including effective and viably-priced risk mitigation

2 See Prime Minister Announces Supply Chain Finance Scheme," 2012, https://www.gov.uk/government/news/prime-minister-announces-supply-chain-finance-scheme.

FIGURE 3:

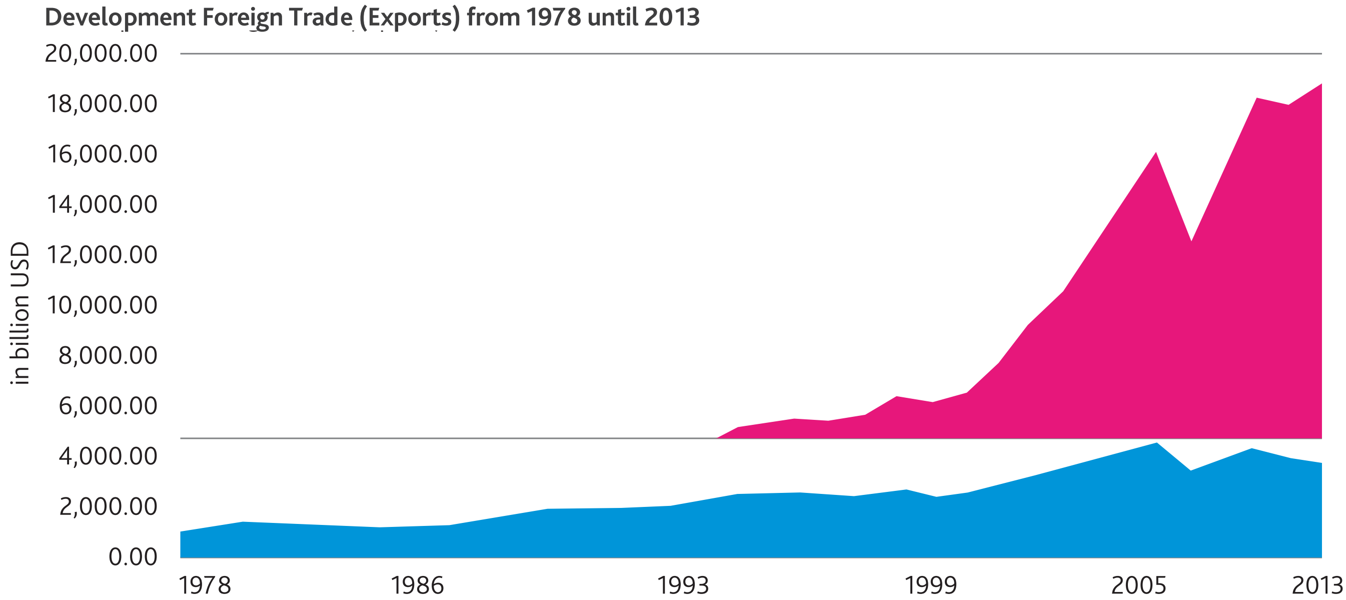
Traditional Trade Finance vs. Open Account (Supply Chain Finance) Volumes

LEGEND:

Open account

LCs

Source: Unicredit Group, compiled through WTO, Berne Union and FCI (2014).



is critical to the ability of SMEs based in developing markets to pursue opportunities in international trade. It is in the issues that enable as well as restrict access to this type of trade financing that policy ideas, priorities, and recommendations ought to be articulated through the E15 Initiative.

It is worth noting that much of the attention to date related to trade finance has focused on so-called traditional trade finance mechanisms, such as Documentary Letters of Credit, which are contingent instruments that lead to a financial obligation only once certain conditions have been met. They are, by nature, off-balance sheet obligations and thus represent only a subset of the trade financing that is provided by banks and others in support of trade activity.

While there has been some attention to data collection around loans for import and export through the International Chamber of Commerce (ICC) Banking Commission, it has been suggested that greater focus is needed this time around on-balance sheet trade financing facilities, particularly their treatment by regulatory authorities, so that this form of trade finance can remain commercially viable.

TRADE, FINANCE, AND DEVELOPMENT

In addition to the increasingly solid linkage between trade activity and the underpinning role of trade financing, a further connection has been the subject of renewed attention in the post-crisis environment—the connection between financing, trade, and international development. Access to Finance, or A2F, with finance defined in the commonly understood, wider sense, has certainly been an area of focus for development specialists. It is the specific connection to trade financing (both traditional and supply chain) that is of note here.

> *The structural difficulties of poor countries in accessing trade finance have not disappeared—and might have been worsened during and after the banking crisis. In fact, there is a consistent flow of information indicating that trade finance markets have remained characterized by a greater selectivity in risk-taking and flight to "quality" customers. In that environment, the lower end of the market has been struggling to obtain affordable finance, with the smaller companies in the smaller, poorer countries most affected.*

– Auboin, Marc. 2015. "Improving the Availability of Trade Finance in Developing Countries." WTO Working Paper ERSD-2015-06.

The Asian Development Bank Trade Finance Program has put some research and analytical focus into various issues around access to trade finance, and sought to link that availability of trade finance to economic value, and concurrently aimed to identify some of the major challenges around access to it.

Figure 5 identifies several major impediments to the accessibility of trade finance, and it is easy to see that many of the factors listed (perhaps all of them) would be particularly acute in the context of developing and emerging markets. Other international organizations, including the Geneva-based International Trade Centre (ITC), have focused on demand-side issues, such as the ability of businesses, particularly SMEs, to better understand the mechanics of banking and finance, and by extension, to be able to prepare "bankable" proposals on financing in general, but including trade financing. The African Development Bank (AfDB) is the latest institution to launch its own trade finance program, and unsurprisingly, there are both significant issues and very compelling opportunities in the provision of trade finance for Africa.

> *There are still significant deficits in meeting the demand for trade finance in Africa. Given the estimated rejection/approval rates reported in the survey, the conservative estimate for the value of unmet demand for bank-intermediated trade finance is US$110 billion to US$120 billion, significantly higher than estimated earlier figures of about US$25 billion. These figures suggest that the market is significantly underserved. Unmet demand is also much higher in fragile and low-income countries (LICs) than in middle-income countries (MICs).*

– Trade Finance in Africa, AfDB, 2014.

FIGURE 4:

The Four Elements of Trade Financing

Source: Malaket (2014), Financing Trade and International Supply Chains.

Payment
- Secure
- Timely & Prompt
- Global
- Low-cost
- All leading currencies

Financing
- Available to importer or exporter
- Several stages in the transaction
- No impact in Operating Line for exporters

Risk Mitigation
- Risk Transfer
- Country, Bank and Commercial Risk
- Transport Insurance
- Export Credit Insurance

Information
- Financial flows
- Shipment Status
- Quality of Shipment
- L/C systems include web & desktop solutions

Analysis by the World Economic Forum (2014), likewise, recognizes that lack of access to trade finance is an impediment to trade activity in the Pacific Alliance, Latin America and the Caribbean, as well as in Africa, as shown in Figure 6.

While the analytics related to the nature, value, and impact of trade financing are nascent relative to other areas that have been studied for decades more, there are, even in these early days, indications of a demonstrable linkage between the availability of trade financing and the creation of economic value. Figure 7 illustrates findings from the latest Asian Development Bank (ADB) Survey.

GLOBAL TRADE FINANCE: STATE OF THE MARKET

MARKET SIZING

A robust sizing of the trade finance market is difficult to achieve today, partly due to limitations around available data, and partly due to definitional issues. The Committee on the Global Financial System (CGFS), a committee of the Basel-based Bank for International Settlements (BIS), has endeavoured to arrive at a graphical representation and some quantitative estimates of bank-intermediated versus inter-firm credit supporting international trade.

The CGFS estimates suggest that up to US$8 trillion of bank-intermediated trade finance was provided in 2011, including about US$2.8 trillion in documentary credit-based trade finance. In certain contexts (including the CGFS Schematic), the notion of bank-intermediated trade finance is limited to include traditional trade finance mechanisms only, though banks engage in open account trade activity through fast-evolving SCF.

THE MARKET GAP

The World Bank's International Finance Corporation (IFC) and the ADB have both sought to determine whether or not there is a "market gap" in trade finance, with particular interest on whether such a gap has any particular relevance to developing and emerging markets, and thus, the mandates of these multilateral institutions.

The ADB's latest survey and related analysis suggests that there is indeed a shortfall of trade finance, estimated at about US$1.9 trillion annually around the world.

> *In 2013, the global trade finance gap was estimated at US$1.9 trillion. Of this gap, US$1.1 trillion is in developing Asia (including India and the PRC). Banks reported a global rejection rate of trade finance applications of 29 percent.*
>
> – Trade Finance Gap, Growth and Jobs Survey, ADB Brief No. 25, 2014

Unmet demand for an additional US$2 trillion or so of trade finance support suggests there is both an opportunity and a need to support and enable significant additional volumes

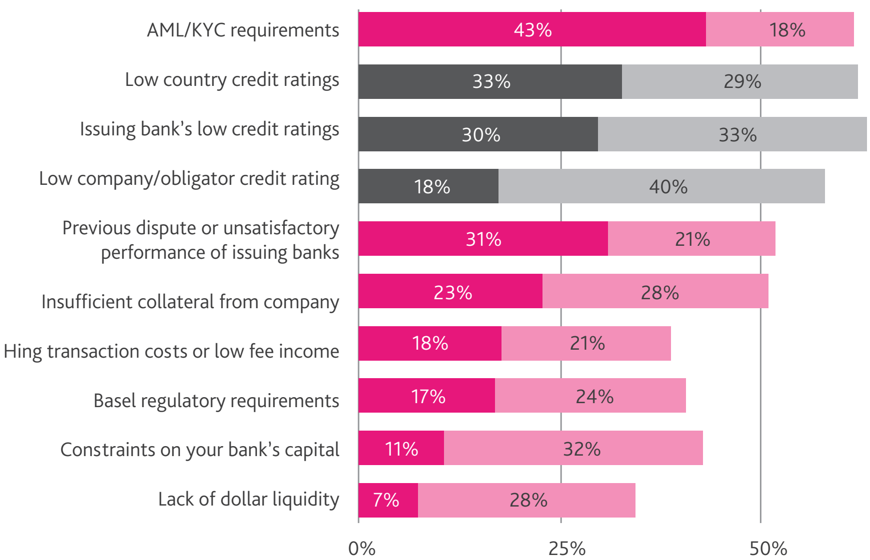


FIGURE 5:

Impediments to the Provision of Trade Finance

Source: Trade Finance Gap, Growth and Jobs Survey, ADB Brief No. 25, 2014.

FIGURE 6:

Most Problematic Factors for Exporting in Africa

Source: Africa Competitiveness Report (2013), WEF.

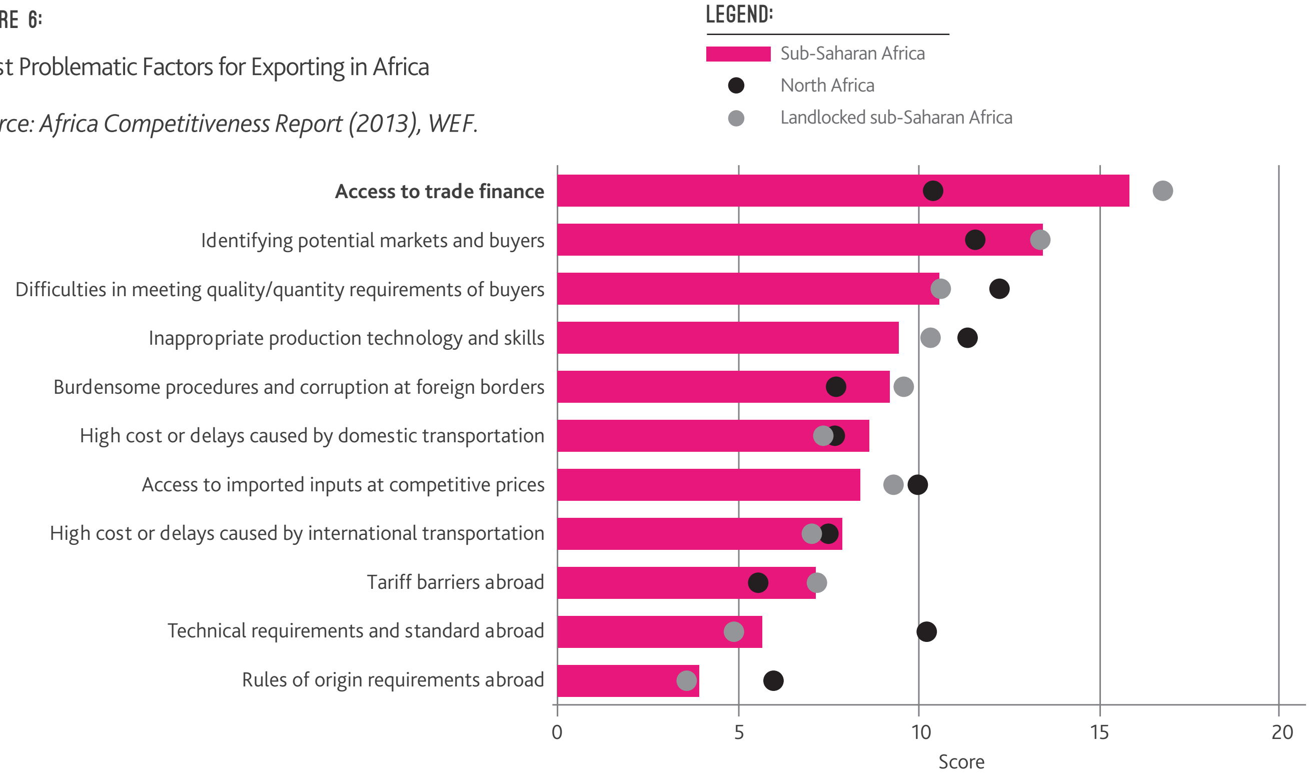
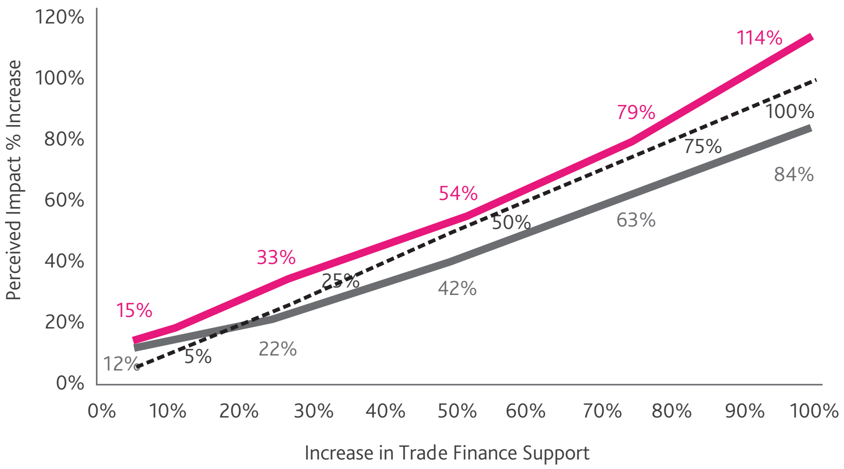


FIGURE 7:

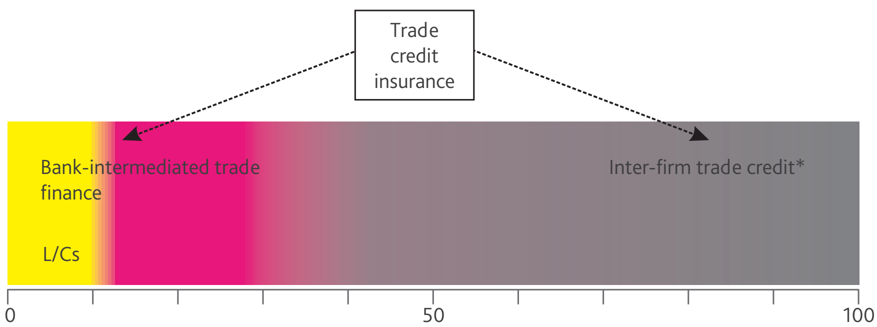
Impediments to the Provision of Trade Finance



Source: Trade Finance Gap, Growth and Jobs Survey, ADB Brief No. 25, 2014.

FIGURE 8:

Schematic View of the Trade Finance Market



* Interfilm trade credit includes open account transactions, where goods are shipped in advance of payment, and cash-in-advance transactions, where payment is made before shipment.

Source: Trade Finance Developments and Issues, CGFS Paper No. 50, 2014.

of international trade—a material portion of it linked to or based in developing and emerging markets. Given the focus of data collection on the banking sector globally, it is clear that the potential economic impact of trade financing on unbanked communities and their businesses is not accounted for at this time.

CORRESPONDENT BANKS: A VITAL GLOBAL NETWORK

A global network of bank-to-bank relationships developed on the basis of appropriate levels of due diligence, credit, and risk analysis is critical to the functioning of the banking sector as an enabler of international business, including cross-border commerce.

Much like relationships developed with corporate, commercial, and SME clients, those developed with/between financial institutions require a commercial rationale, and function on the basis of a certain level of mutual trust relative to ethical conduct, but also competency in the technical aspects of international banking and trade financing. Correspondents maintain accounts with each other in various currencies, and ensure they are able to provide an agreed range of services, from financing to the transmission of funds in support of a cross-border payment, among many other such reciprocal arrangements.

Very few financial institutions truly have "global reach," and a healthy network of trusted, capable correspondents (with an acceptable risk profile) is critical to enabling banks to support their clients in cross-border commercial activity. Such a network can serve as a cost-effective gateway to international markets, bringing with it the all-important advantage of intimate knowledge of local market conditions, including relationships with local businesses.

Historically, it was not uncommon for major institutions to maintain correspondent networks involving thousands of bank relationships around the globe, even in the most obscure or high-risk markets in the world. More recently, the costs and risks associated with maintain such extensive networks, and the regulatory imperative requiring banks to be much more active in due diligence and monitoring relative to those relationships, has led to a global consolidation of correspondent bank relationships and related activities.

The cost of maintaining a single correspondent relationship is estimated to have increased by as much as 300 percent or more in the last five years or so, driven significantly by increasingly demanding standards related to due diligence, regulatory compliance around money laundering, and anti-terrorism finance. The costs, risk of non-compliance, and the financial implications of ever-growing fines, together with reputational risk, are such that banks allege they underpin an increasing tendency among global institutions to "de-risk"—exit correspondent relationships, consolidate the markets in which they operate, and reduce the number of commercial relationships maintained and pursued.

While regulators counter that these trends are primarily driven by commercial decisions justified through compliance pressures, and other banks see the de-risking by global players as an opportunity for local/regional institutions to step in, it is clear that there is a reshaping of the global map of bank activities.

One concern is that an unintended consequence of these dynamics is to reduce the network of banking relationships so critical to ensuring that developing markets can engage in international commerce, and, in particular, ensuring that SMEs in those markets can access commercial opportunities through global supply chains.

The net impact of de-risking is unclear at this time, and it has not yet been demonstrated that there is a causal link between de-risking and regulatory/compliance expectations. Anecdotally, practitioners indicate that there is clearly a matter of concern here, and the rising costs of maintaining correspondent relationships can by proxy, suggest that there is a financial dis-incentive for banks to maintain robust networks of relationships.

The impact of this narrowing of the 'gateway' to international markets is most acute in developing and emerging markets.

The issue of de-risking is addressed again in the context of a brief consideration of regulatory and compliance issues in a subsequent section of this paper.

ECAS AND IFIS AS PROVIDERS OF TRADE FINANCING

The global financial crisis motivated a focus on, and a greater understanding of, the role of trade financing in the facilitation of international trade. Perhaps less known among non-specialists is the reality that the crisis also demonstrated some real risks in relying entirely on banks and private sector providers to assure adequate levels of affordable trade financing in times of crisis.

At the peak of the crisis, the inter-bank lending market was critically impacted by concerns about the nature, scope, and opacity of exposure of individual institutions to toxic mortgage assets. This led directly to the evaporation of certain types of trade financing, particularly pre-export finance.

The urgency of the situation was such that a multi-organization effort driven by public sector and international institutions was needed to inject US$250 billion of liquidity in support of trade financing, without which the already dire situation would have quickly deteriorated further.

While there had been serious discussion before the crisis about the anachronistic nature of war-time, public sector institutions called export credit agencies (ECAs), these deliberations have ceased, as the importance of policy-driven availability of trade finance (both financing and risk mitigation) is an important complement to private sector-based trade financing.

ECAs can be an important source of complementary capacity, including in cases where they are driven by non-commercial, policy, and national interest-related objectives. The development of creative, leading-edge products and solutions can often be traced back to the work of ECAs and international financial institutions, as illustrated, for example, by the development of a service sector export finance proposition by the Export-Import Bank of Malaysia.[3]

In addition to ECAs, the global crisis also highlighted the importance of multilateral development banks (also known as international financial institutions or IFIs) in assuring reliable access to trade financing, either through direct provision of these solutions, or through various guarantee programs aimed at making developing market/bank risk more palatable to international banks. It is notable that since the launch of the first trade finance program by the European Bank for Reconstruction and Development (EBRD) in 1999, the multilaterals have not recorded a single loss attributable to their trade finance programs, as shown in Figure 9.

Multilateral development banks, given their policy-driven, non-commercial mandate, are uniquely positioned to develop (as they have done) financing and risk mitigation options that are particularly suited to the needs of SME suppliers often based in developing and emerging markets. Likewise, they can be particularly effective in supporting specific types of trade flows such as commodities, agri-food, and others of particular relevance to developing economies, and the supply chains to which they can best create commercial linkages. Warehouse and distributor financing, the provision of facilities and risk mitigation to local banks to assist them in engaging with international institutions, and the provision of a range of "technical assistance" programs aimed at raising competency levels to international standards—all are critical contributions to the overall enhanced functioning of the system of international trade and trade financing.

While data on trade financing remains challenging to access, analysis linked to the trade finance programs of the various multilateral institutions—including "independent evaluations" of such programs—can offer a view. The degree of leveraging of trade finance-related support in developing, emerging and low-income countries can be appreciated on the basis of the following summary from the IFC's Global Trade Finance Program (GTFP):

> *GTFP volume in LICs has declined since 2009 because of the movement of several large countries from LIC to MIC status. Although guarantee volume for LICs increased from $200 million in FY06 to more than US$1 billion in FY09, it declined to $500 million in FY12 as large users such as Nigeria, Pakistan, and Vietnam moved from low-income to middle-income status over the period."*

– Evaluation of the IFC's
Global Trade Finance Program, 2006–12, 2013.

3 See Malaysia Exim website, http://www.exim.com.my/islamic-banking/export-services-i.

FIGURE 9:

The Trade Finance Programs of Multilaterals

Source: Rethinking Trade and Finance, ICC, 2014.

	EBRD	IFC	IDB	ADB
Program Title	TFP	GTFP	TFFP	TFP
Number of Countries of Operation	23	96	21	18
Program Commencement	1999	2005	2005	2004
Number of Trade Transactions since Commencement (year end 31 December 2012)	15,508	31,600	4,457	8,338
Value of Transactions since Commencement	EUR9.9 billion	US$28.8 billion	US$4.23 billion	US$16.7 billion
Number of Confirming Banks	800+	1,100	297	124
Claims to Date	2 – no losses	Zero	Zero	Zero
Website	ebrd.com/tfp	www.ifc.org/gtfp	www.iadb.org/tffp	www.adb.org/tfp

MARKET EVOLUTION

The increasing attention and focus on trade financing as an enabler of trade and economic value-creation, and the evolving expectations of importers, exporters and others party to global supply chains combine to create a palpable atmosphere of long overdue innovation and evolution in the business of financing international commerce.

The application of technology to traditional trade finance mechanisms like documentary credits is not new, but its application with the objective of transforming the business model (versus enhancing or sustaining current practices) is new.

Certain non-bank providers, including hedge funds and technology firms with an interest in 'Fintech" or financial services technology, have shown a particular interest in trade finance and SCF, and a few boutique firms have made inroads into what is clearly a bank-dominated line of business. Practitioners will note that non-banks are far too small (and lack the technical competencies around international commerce) to present a viable alternative; others will warn that hedge funds may not be especially well-suited to trade financing activity. Normative observations aside, the global banking system cannot fully meet the needs of importers and exporters for trade financing.

There is, clearly, an opportunity for creative collaboration at minimum, and perhaps the beginnings of a competitive dynamic that could lead to transformational developments in the financing of international commerce, likely to have its greatest effect in emerging markets.

The Bank Payment Obligation (BPO) is a joint initiative of SWIFT and the ICC Banking Commission, and represents one of the major recent innovations in trade financing.[4] (The BPO is a framework that replicates the logic and general flow of the familiar documentary credit, but relies on data-based and automated decisioning as the basis for payment and financing triggers, materially enhancing efficiency, accelerating processing times, removing the subjectivity of human examiners, and enhancing cash flow and working capital positions.

The BPO claims a position squarely between documentary credit and an open account transaction, offering levels of security and protection comparable to the former, and the efficiency and cost-effectiveness of the latter, as shown in Figure 11.

> *Before the BPO, BP could physically move 150,000 cubic meters of LNG (liquefied natural gas) faster than it could process 500 grams of paper [through the banking system]. Things needed to change."*
>
> – Credit Executive, BP Petrochemicals, UK

In addition to the BPO, SCF and its fast-growing role in the financing of international commerce (as well as its direct applicability in supporting domestic supply chain activity) represents another, potentially transformational dynamic in the market. Estimates suggest that perhaps 60–70 percent of trade activity today is conducted on open account terms. This is well suited to support through SCF programs and techniques, yet SCF accounts for only about 20 percent of the portfolio of activity of trade finance banks. Market awareness (and leveraging) of SCF as an option in supporting international trade, likewise, must increase, as illustrated in Figure 12.

Market awareness can be raised significantly through technical assistance programs managed by international institutions, as is being done today for traditional trade finance. In addition, leveraging SCF in the context of public and international policy as a tool for enabling SME access to liquidity, and for directing liquidity to developing and emerging markets is an option. The UK, for example, announced support for SCF as a means of driving the recovery of the economy in 2012, and did so with the personal engagement of the prime minister.[5]

Beyond evolutions like the BPO, which still arguably resemble familiar trade finance models and mechanisms, it is clear that market disruptors perceive an opportunity in addressing the needs of underserved SMEs (and developing economies). Mobile payment solutions, various platform providers, and others are offering what amounts to trade financing, with China-based Alibaba recently announcing the launch of trade financing solutions in support of their SME trader clients, initially in selected markets.

It is perhaps worth noting here that there is some effort under way through a United Nations Centre for Trade Facilitation and Electronic Business (UN/CEFACT) project (co-developed with OPUS Advisory Services) to propose and motivate closer linkage between the techniques and practices of trade financing and the disciplines of trade facilitation.[6] The premise of this initiative is that the role of financing is so critical to the ability of businesses to conduct trade that efforts aimed at the traditional areas of focus of trade facilitation (such as enhanced customs and logistics, improved regulatory context and others) will fail to maximize benefits if the financing element is not more closely and directly integrated into facilitation practices.

4 See the SWIFT Resource Centre for details, case studies and white papers;http://corporates.swift.com/en/resource-category/trade-and-supply-chain

5 See "Prime Minister Announces SCF Scheme," 2012, https://www.gov.uk/government/news/prime-minister-announces-supply-chain-finance-scheme

6 See UN/CEFACT, "Integrating Trade Finance and Supply Chain Finance into Trade Facilitation," http://www1.unece.org/cefact/platform/display/CNP/P1024+-+ODP+1+-+Project+Inception.

The support of the E15 Expert Group in disseminating the premise of the project, assisting in the development of the ultimate UN/CEFACT recommendation, and supporting its adoption globally can be a specific and substantive contribution.

Finally, a less obvious and possibly less visible proposition is notable in terms of the evolution of the market—the blurring of lines between import and export activity based on evolving practices in global sourcing, and the related, increasing

FIGURE 10:

GTFP Reach in Low-Income and IDA Countries

Source: Evaluation of the IFC's Global Trade Finance Program, 2006–12, 2013.

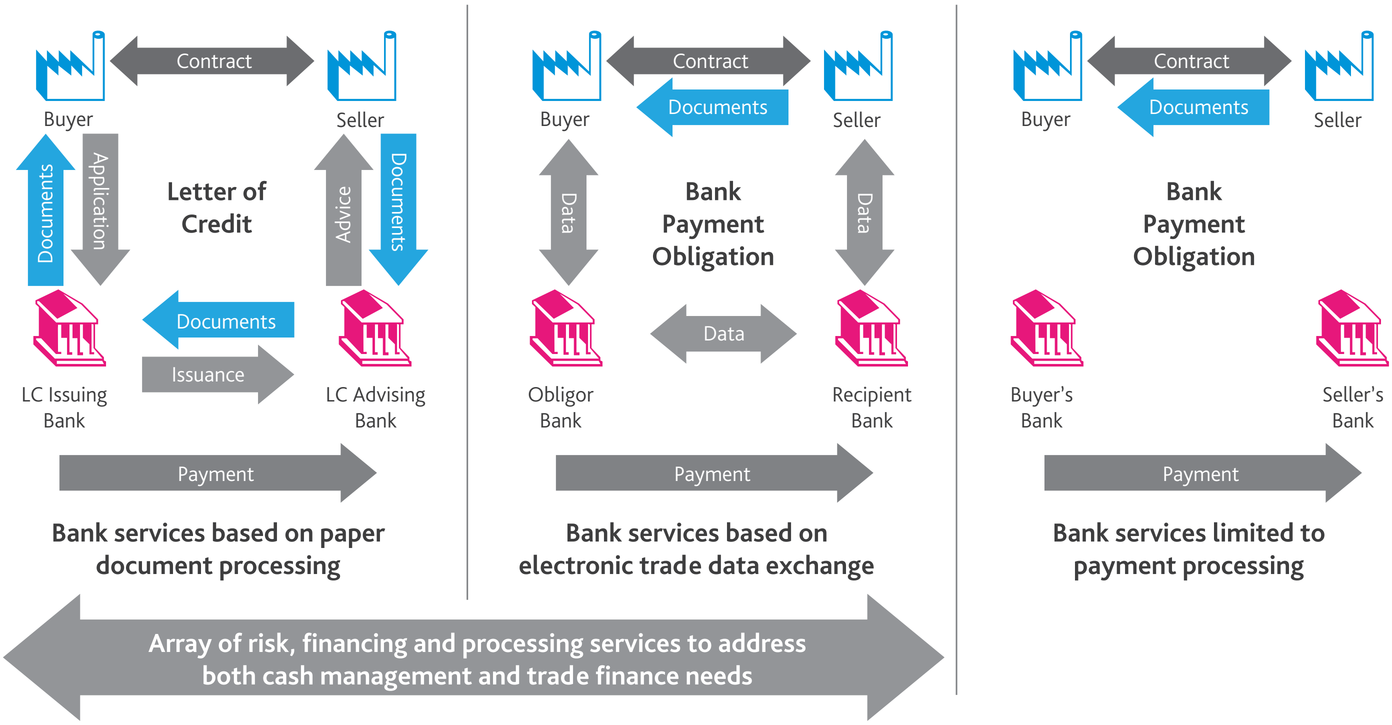
Note:
GDP = gross domestic product
IDA = International Development Association
LIC = low-income country.

	FY06	FY07	FY08	FY09	FY10	FY11	FY12	All years FY-06-12	Share of dev. country GDP	Share of dev. country trade
GTFP volume in LICs ($ millions)	197	406	680	1,022	641	472	505	3,923		
GTFP use by developing country income group (share of total volume)										
High income	0	1	0	1	1	1	1	1	6	7
Upper middle income	8	25	45	42	42	39	44	41	39	35
Lower middle income	17	21	8	14	39	50	46	37	49	50
Low income	74	53	47	43	19	10	8	21	6	7
GTFP use by IDA/Non-IDA status (share of total volume)										
IDA	74	52	46	51	51	53	48	50	4	3
Blend	1	2	5	0	0	0	0	1	12	9
Non-IDA	25	47	49	49	49	47	52	49	84	88

FIGURE 11:

Positioning of the Bank Payment Obligation

Source: Presentation to the WTO Public Forum, 2013, SWIFT (with OPUS Advisory).



connection between international trade and cross-border investment. The familiar, textbook distinctions between import activity and export activity are less relevant today, as is the classical question of whether trade follows investment, or investment follows trade.

A holistic view of the relationship between import, export, supply-chain based sourcing activity, foreign investment and even the dynamics of offshoring (and more recently, reversal of the latter) suggests that the availability of trade finance may have even broader consequences than suggested by a narrower, more traditional view of international commerce.[7] The E15 Experts Group can usefully lead a cross-cutting analysis and assessment of the impact of trade financing on trade flows, investment activity, and on the strategies of businesses in their engagement in international markets under such a holistic framework.

PUBLIC SECTOR, POLICY AND TRADE FINANCE

TRADE, FINANCING AND THE PUBLIC SECTOR

The availability of adequate levels of trade financing globally cannot be left entirely to profit-driven commercial decisions. This is particularly true in relation to meeting the critical need for trade and SCF in developing and emerging markets as one mechanism for enabling the engagement of SMEs in the international economic system.

Given the global scope, implications, and cross-cutting nature of trade financing, there is (as was clearly demonstrated during the global financial crisis) both an opportunity and a need for international institutions and their leaders to become conversant in the issues surrounding trade finance. They have to complement (or even lead) the efforts of national public sectors in assuring the availability of adequate levels of trade finance in the international system.

It is clear to a growing number of practitioners that the role of international institutions in enabling access to trade finance for developing economies as part of a broader development and poverty reduction agenda is of paramount importance. It could be useful for the E15 Initiative to articulate this notion in the form of a white paper, building upon the market sizing and market gap analysis already initiated by the ADB, IFC, AfDB, and others.

There may also be opportunity to engage national export credit agencies or development finance institutions (DFIs) in a dialogue around the importance of trade financing, including as a potential form of development support. In such a case, there is further opportunity for the E15 Initiative to help articulate and shape policy measures aimed at ensuring that ECAs and DFIs are given a mandate—and adequate support—to engage in such activity. This is perhaps especially critical at a time when many ECAs have shifted to commercially oriented activity.

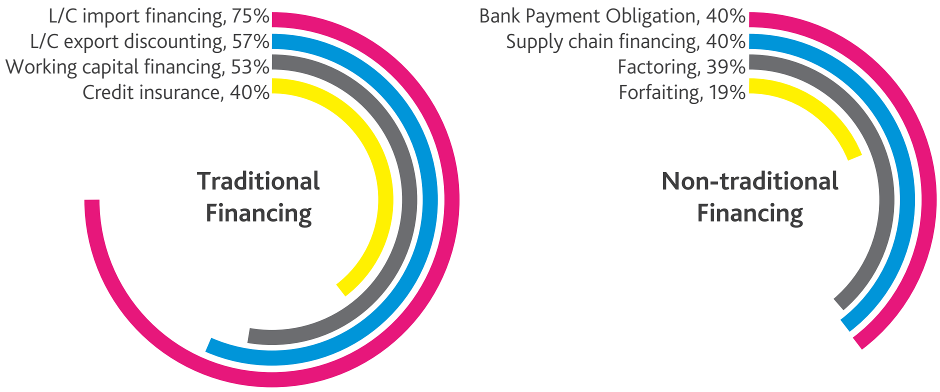
The importance of public sector engagement through appropriate regulation, support of effective export credit programs, and agencies and initiatives aimed at increasing global capacity in trade financing, among others, is perhaps further amplified if we consider the increasing linkages between international trade and cross-border investment

7 See, for example, Poloz (2012).

FIGURE 12:

Awareness/Leverage of SCF versus Traditional Trade Finance

Source: Trade Finance Gap, Growth and Jobs Survey, ADB Brief No. 25, 2014.



flows, as described in models like the integrative trade framework referenced earlier.

Trade finance is heavily impacted, sometimes unintentionally so, by regulatory and compliance requirements that fall in the realm of international and domestic policymaking, and therefore public sector authorities. This is clearly an area where engagement must be substantive, and should be a matter of continuing urgency.

There are numerous positive signs and developments in terms of international and public sector engagement in trade financing, both at the level of increasing awareness, dialogue, and research, and at the level of concrete and substantive action. These include the following.

- Ongoing and growing interest and advocacy on the subject of trade finance by the World Trade Organization (WTO), at the most senior levels.
- Engagement by the World Bank, the International Monetary Fund (IMF), and other international institutions.
- Continuing visibility of trade finance in the deliberations and priorities of the B20 Task Forces, currently presided over by Turkey for 2015, with indications already that the Chinese presidency has been asked to consider keeping trade finance "on the radar" for 2016.
- Indications that the Group of Twenty (G-20) and the Financial Stability Board likewise perceive trade financing to be a matter requiring further analysis and focus.
- Increasing cross-association dialogue, collaboration, and advocacy in support of adequate (and equitably regulated) trade finance and SCF.
- Increasing volume and quality of academically rigorous analysis on various topics linked to trade finance.[8]

That said, there is ample opportunity for further intellectual energy, robust methodology, and advocacy to be applied to various aspects of trade financing, perhaps in particular at the leading edge of industry evolution. The scope of such opportunities ranges from education and awareness-raising through robust research, and analysis to contributing to or leading a global effort around developing and supporting policy measures aimed at assuring adequate levels of affordable trade financing (including through appropriate regulatory treatment), and supporting the development of alternate sources of trade financing aimed at addressing the global shortfall. Collection of objective, trusted industry data and metrics is not a matter of common practice in trade finance, and the intervention of trusted interlocutors like the ICC Banking Commission, and perhaps the E15 Initiative, could prove invaluable in raising overall understanding about the business of trade financing.

It has been suggested that there might be opportunity in looking at trade financing on a more local or regional basis, for example, in the context of the Association of Southeast Asian Nations (ASEAN), and that perhaps the development of supporting infrastructure such as competent rating agencies and/or credit bureaus might contribute usefully to the creation of additional trade financing capacity. Such considerations are currently under review in various contexts, including in deliberations first initiated through the ICC Banking Commission.

CAPITAL, REGULATORY AND COMPLIANCE ISSUES

Although there is a natural perception that cross-border financing activity such as that involved in trade financing ought to be risky by definition, and certainly higher risk than conventional, domestic banking, it was a combination of investment banking and domestic products that triggered the global financial crisis.

The industry has since demonstrated through an initiative of the ADB and the ICC Banking Commission that trade finance is, as was claimed anecdotally, a very low-risk and low-default business when assessed from a credit-risk perspective.

The ICC Trade Register, which receives data on a voluntary basis from 20-plus participating trade banks representing perhaps 60 percent of global volumes of the traditional trade finance products covered, shows the negligible default and loss experience at a global level.

It should be noted that not all "defaulted" transactions ultimately led to a loss for the financier—significant percentages of the defaulted amounts were actually recovered through mitigation measures, collateral, and post-default negotiation. Default and loss rates have been reported to be higher in certain regions, as noted in the AfDB report on trade finance in Africa.

> *Specifically, the average default rate on trade finance operations reported by our responding banks in 2011 and 2012 is 4 percent (Figure 22). This is significantly lower than their average non-performing loan (NPL) ratios, which stood at about 9 percent over the same period. Notably, our findings suggest that default rates on trade finance operations in Africa are much higher than in other regions. So while it may be low*

8 See for example, APEC Secretariat, Policy Support Unit: +ODP+1+-+Project+Inceptiont+inception"eme"? that go into HSBC for , http://publications.apec.org/publication-detail.php?pub_id=1570. See also, "What Drives bank-Intermediated Trade Finance: Evidence from Cross Country Analysis", Bank of Canada, 2015, http://www.bankofcanada.ca/2015/02/working-paper-2015-8/.

risk compared to other African banking activities, trade finance is hardly a "free lunch" for African banks.

– Trade Finance in Africa, AfDB, 2014.

The foregoing analysis and related advocacy efforts enabled trade financiers and industry groups such as the ICC Banking Commission and the Bankers Association for Finance and Trade (BAFT) to successfully engage the BIS and national regulatory authorities in a dialogue around targeting risk-aligned regulatory treatment of trade finance, particularly related to the amount of capital to be held in reserve against trade finance transactions.

There has been important progress in reducing the regulator-defined capital cost of certain types of trade finance, thus increasing trade financing capacity and reducing cost. However, advocacy and dialogue are ongoing, as the industry remains subject to capital adequacy requirements that do not fully align with the favourable risk profile of trade finance.

There is some consensus in the market that similar advocacy efforts must extend to on-balance sheet trade financing activity, and ought to extend to cover SCF and other products or programs. The ICC Banking Commission is actively reviewing the scope of the Trade Register Project, and interventions with political and regulatory authorities reinforcing the value of this (voluntary) exercise would be most welcome and helpful to industry.

Perhaps relatedly, trade finance banks (as opposed to non-bank providers) are also the subject of very stringent compliance requirements related to due diligence and knowledge of clients and trading counterparties ("Know Your Client" and "Know Your Client's Client"), both correspondent banks and commercial/corporate entities. There is, additionally, increasing pressure on banks to become part of the detection and enforcement machinery related to money laundering and terrorism finance, the merits of which are apparent and acknowledged. But the costs (and risks of non-compliance) are increasingly material—to the point that some argue trade finance as a business within many banks has become unviable.

The opposing views shaping regulatory treatment of trade finance can be contrasted simplistically as two ends of a spectrum. At one end is a view that recognizes trade (and by extension, trade-enabling finance) as "good" because of its clear capacity for economic value-creation and poverty reduction. And at the other end is a view that focuses on the reality that trade finance, if poorly monitored, can be a mechanism for money laundering and terrorism finance, and is therefore "bad" and ought to be subject to significantly higher levels of regulatory oversight.

Regulatory and compliance requirements are alleged (subject to objective, data-based demonstration of a causal linkage) to be at the root of a global "de-risking" effort by large international banks, in particular, exiting markets, correspondent relationships, and commercial relationships to avoid non-compliance.[9] Some regional and local banks have claimed, however, that the decisions of global banks have created opportunities for local institutions to step in to a fill the gap left by the larger institutions in full compliance, based on their more intimate knowledge of local markets and relationships.

Some regulators have suggested that the de-risking activities undertaken by global banks are a matter of commercial choice and internal decision-making, and that the linkage to regulatory risk is inaccurate or perhaps disingenuous on the part of the banking industry.

The regulatory and compliance requirements, in short, are sufficiently stringent today that they may unintentionally reduce overall availability of trade financing and/or increase its cost on a global basis, particularly in developing markets and as they relate to the provision of these forms of financing for SMEs.

9 The ADB and the ICC Banking Commission are in the process of initiating a study on this issue with the support of the WTO; additionally, the World Bank has been mandated to assess the issue with a wider view by the G-20 and the Financial Stability Board.

FIGURE 13:

Transaction Volumes and Default Rates, Short Term Trade Finance

Source: Global Risks Trade Finance Report, 2013.

Total 2008-11	#Transactions	#Defaulted	%Defaulted
Import L/Cs	1,492,447	299	0.020%
Export Confirmed L/Cs	293,313	47	0.016%
Loans for Import	1,912,118	299	0.016%
Loans for Export: Bank risk	1,085,758	319	0.029%
Loans for Export: Corporate risk	2,739,475	574	0.021%
Performance Guarantees	609,920	208	0.034%
Total	8,133,031	1,746	0.021%

The nascent status of SCF and the relatively larger role of non-bank providers in this area combine to suggest that regulatory issues and impacts will be felt at least as acutely by financial institutions, if not more, than is already the case in the context of traditional trade finance products.

There is, then, ample opportunity to explore ways in which public sector and international institution engagement can be aimed at achieving the very legitimate and very urgent objectives of regulatory authorities, while allowing for the continued pursuit of value-creating trade through adequate levels of affordable trade financing.

Specific opportunities include lending support to initiatives like the ICC Trade Register, which aims to provide a fact-based foundation for advocacy efforts with regulatory authorities. Similarly, an effort by Belgium-based SWIFT to create a global due diligence registry, the KYC Registry, merits support as one way of reducing duplication of effort by individual banks in due diligence.

At a higher level, it would be helpful for the E15 Initiative to contribute to informed dialogue with B20/G-20 stakeholders, the Financial Stability Board, and other authorities, regulatory and political, to ensure that regulatory and compliance demands are applied in proportion to the risk profile of trade finance.

The WTO has an annual Experts Group meeting hosted by the Director General in Geneva, aimed at facilitating an exchange of ideas and a review of the state of the market by senior industry leaders. Perhaps a similar initiative could be proposed for the annual Davos meeting of the World Economic Forum, and/or various regional events, to ensure that access to trade finance remains visible and a matter of focus for political leaders and regulatory authorities on an ongoing basis. This will also enable access to the top tier of international and political leadership, where trade and its positive economic consequences remain a matter of potential and priority.

Such an approach, complemented by similar development-related focus in the context of the International Centre for Trade and Sustainable Development (ICTSD), will help mitigate the risk of "issue fatigue" and will ensure that trade financing shifts from an esoteric topic addressed in times of crisis to one that is understood to be fundamental to the conduct of international commerce, and thus in need of ongoing attention. Recent initiatives by industry players to consider the role of financing in sustainable trade,[10] including development-critical commodity trade, offers further opportunity for linkage with the mandate of the E15 Initiative.

International banking, including trade finance, unjustifiably suffers the consequences of being perceived as high-risk, perhaps because of the cross-border nature of the business pursued. It is critically important to offset this inaccurate perception on the basis of objective, independent data collection and analysis to ensure that ongoing engagement by banks in these lines of business remains commercially viable, and is effectively, but equitably, regulated. Such a perceptual shift will be critical to ensuring a robust and sustainable trade finance architecture, and will be particularly important to assuring adequate levels of liquidity in support of international development.

TRADE, FACILITATION AND FINANCING

It is only with the active participation and engagement of international institutions and national authorities that important linkages can be drawn and acted on, between trade financing, effective trade facilitation, and the successful pursuit and conduct of commerce across borders, leading to positive and concrete impacts on international development and poverty reduction.

It is imperative for authorities and industry leaders to build a bridge between trade financing and trade facilitation with the express objective of leveraging trade finance to benefit international development through the creation of trade-based economic value.

CONCLUSION AND RECOMMENDATIONS

CONCLUSION

There is ample opportunity in a field as poorly understood (yet as high impact) as trade financing for additional research, analysis, and advocacy, particularly when such efforts are non-partisan and non-political in motivation, and global in scope. The momentum, which began at the peak of the global crisis, continues as various regions continue to wrestle with the consequences and aftermath of the crisis, directly, or even in terms of markets with which they can engage in trade and investment.

The precedent for involvement by international institutions, and for cross-cutting collaboration is well established. At a time when institutions already engaged in these deliberations continue to focus on core aspects of the dialogue, it may be opportune for a credible initiative that begins to take a

10 See Banking Environment Initiative, Sustainable L/C Initiative, http://www.beiforum2014.com/latest-news/the-banking-environment-initiatives-sustainable-shipment-letter-of-credit-a-financing-solution-to-incentivise-sustainable-commodity-trade.

forward view on the evolution of trade finance and SCF, and its potential as a tool to enable international development through trade. The experts of the E15 Initiative, supported by the ICTSD and the World Economic Forum, are perhaps uniquely positioned to shape a unique contribution to the dialogue around trade financing, trade and international development—one that combines rigorous analysis with innovative policy recommendations at the leading edge, including at the intersection between trade financing and trade facilitation.

Specific efforts aimed at enhancing the reach and effectiveness of trade financing—for example, by assuring an equitable and non-obstructive regulatory environment, and by integrating trade finance and SCF into policy efforts aimed at supporting SMEs, as well as those targeting development aid—can benefit from research, advocacy, and leadership through the E15 Initiative.

RECOMMENDATIONS

1. Advocate for and facilitate a global coordination of efforts, knowledge management, and policy recommendations around trade and SCF through sessions at the annual Davos meeting and the ICTSD.

2. Engage with the ICC, the WTO, the multilateral development banks, and others to add further to the deliberations around appropriate but non-stifling regulation of bank intermediated trade financing, including capital adequacy, compliance, due diligence, and related areas. Advocate in support of appropriate treatment of on- and off-balance trade financing as well as emerging propositions in SCF. Support the adoption of a global solution to due diligence and "Know your Customer" requirements, such as the SWIFT KYC Registry.

3. Undertake specific analysis on the potential for SCF and emerging solutions like the BPO to address the needs of SMEs in developing and emerging markets, and to assist those markets in better linking to global supply chains and value chains.

4. Conceive, design, and engage in an exploratory dialogue with industry experts and policymakers around innovations in trade financing to address specific, strategically important categories of trade activity, such as high-value services sector trade flows, commodity flows, and others deemed important to international development.

5. Conceive and lead analysis aimed at identifying innovative ways to address the global gap in trade financing, including through a variety of non-traditional sources and providers, and considering developments in mobile finance, microfinance, and similar areas relevant to SMEs and developing economies.

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Implemented jointly by ICTSD and the World Economic Forum, the E15Initiative convenes world-class experts and institutions to generate strategic analysis and recommendations for government, business, and civil society geared towards strengthening the global trade and investment system for sustainable development.

ICTSD

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