



# **STRENGTHENING COLLABORATIONS TO BRIDGE THE TRADE FINANCE GAP INSIGHTS FOR G20 COUNTRIES**

Occasional Paper No. 218



# **Export-Import Bank of India**

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### **Strengthening Collaborations to Bridge the Trade Finance Gap: Insights for G20 Countries**

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## EXECUTIVE SUMMARY

Trade finance refers to any type of financing which enables international trade. It encompasses credit, guarantees and insurance needed to facilitate the payment for merchandise or service on terms that satisfy both the exporter and the importer. A well-functioning trade finance market allows the firms with higher risk perceptions to link into global value chains and thereby contributes to employment and productivity growth.

Trade finance products are characterised by short average maturities, combined with low credit risk and default rates. In fact, it is one of the safest forms of financing with less than 1 percent of transactions facing default. The favourable risk profile of trade finance should ideally ensure adequate availability. However, periods of crisis have often witnessed a concomitant contraction in availability of trade finance.

The global trade finance gap was estimated at nearly US\$ 1.7 trillion during 2020, and is forecast to expand to US\$ 2 trillion in 2021/22<sup>1</sup>. It can further exacerbate in the current environment of geopolitical issues, tightening financial conditions, economic sanctions, trade wars, and protectionism, among other. This large and growing global trade finance gap is a major constraint for the overall output growth and employment. There is an urgent need to bridge the unmet demand for trade finance in order to revive the faltering global trade and output growth.

The trade finance architecture currently comprises several conventional and non-conventional sources of financing. This includes commercial banks,

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<sup>1</sup> 2021 ADB Survey on Trade Finance Gaps, Growth and Jobs

development banks, insurance companies, export credit agencies (ECAs), multilateral development banks (MDBs), venture capitalists, business angels, fin-techs, etc. Whilst a concerted action from all these financiers will be required to revive the trade finance flows, the role of MDBs, ECAs and other development finance institutions (DFIs) will be paramount.

Set against this backdrop, the current Study attempts to analyse the recent trends in trade finance, the impact of COVID-19 on trade finance, challenges pertaining to trade finance flows, and strategies which can be adopted to reduce the large deficit in global trade finance. The Study also highlights the various ways in which ECAs, MDBs and DFIs are already contributing towards meeting the trade finance gaps, and explores select options through which these financial institutions can further enhance their role in fulfilling the unmet demand.

## **TRENDS IN TRADE FINANCE**

Most of the trade finance products have witnessed a slowdown in the recent period. During the pandemic, several banks reduced their supply of short-term finance products due to increasing volatility and uncertainty in commodity prices, leading to a flight to quality. Alongside, demand for trade finance also decreased due to a significant reduction in merchandise trade.

The Study analyses the overall trend in various trade finance products over the past several years, as well the impact of COVID-19 on these products. Analysis indicates that during 2019, the SWIFT trade finance traffic, which is a good indicator of overall use of Letter of Credit (L/C), registered a decline of 6.4 percent to reach its lowest levels since 2008. A greater concern is that the year 2019 was not an outlier but followed a trend – that of a secular decline in trade finance traffic ever since 2010. The SWIFT trade related messages which were already relatively low in 2019, witnessed further decline in 2020 with the onset of COVID-19 pandemic, on account of the supply and demand disruptions globally.

On the other hand, international factoring business has witnessed a nearly consistent increase during the period 2015-2021, except a dip in two intervening years—2016 on account of the slowdown in investment and trade from China, and 2020 due to the COVID-19 related disruptions. With the recovery of international trade in 2021, international factoring volumes registered an increase of 14.7 percent in 2021 and were estimated at 597.3 billion Euro (approx. US\$ 706 billion). During the period 2015-2021, international factoring volumes have witnessed a Compound Annual Growth Rate of 2.0 percent.

The global export credit and insurance business has also seen a similar trend with new business volumes increasing from US\$ 2,320 billion in 2017 to US\$ 2,626 billion in 2021. A comparison of new business of Berne Union members with the world exports indicates that credit insurance had shown remarkable resilience and provided much needed support to trade during the COVID-19 crisis as well.

Correspondent banking has played an important role in financing trade. It basically refers to agreements or contractual relationships between banks to enable provision of domestic and cross-border financial services. Since the onset of the global financial crisis, there has been substantial decrease in correspondent banking activities. During the pandemic period in 2020, all regions witnessed a further reduction in the average number of active correspondents across all currencies. The declining correspondent banking relations is exacerbating the already precarious position of trade finance in developing countries.

## **CHALLENGES**

Over the recent years, the global trade finance gap has widened due to various factors, including geopolitical uncertainties, trade wars, economic sanctions, and the COVID-19 pandemic. An attempt has been made to analyse the various challenges to global trade finance. Understanding these challenges would help chart a roadmap to overcome them and better navigate the complex landscape of global trade finance.

**Uncertain Global Dynamics:** The global trade finance industry has faced significant challenges due to the poly-crisis of geopolitical issues, trade wars, protectionism, and the COVID-19 pandemic. According to the 2021 ADB Survey on Trade Finance Gaps, Growth and Jobs, the trade finance gap has widened due to higher risk perception on account of the continued global uncertainties. The survey noted that nearly 50 percent of the respondent banks anticipated higher trade defaults, which resulted in higher rejection rates in trade finance.

The rise in interest rates have further dampened sentiments of trade finance providers. According to a recent survey by Accenture, nearly two-thirds of the borrower firms have been impacted by rising interest rates and noted an increase in the cost of credit from their trade financiers over the past 12 months. The impact has been notably higher in Asian developing economies such as Thailand, India, Malaysia and Singapore.

Besides, trade wars and protectionism also continue to remain a cause of concern for trade financiers. According to a recent survey by the FCI, more than half of the respondents perceived that protectionism could further widen the trade finance gap.

Clearly, the uncertain global dynamics continue to pose headwinds for trade finance. While some banks have managed to support trade despite the higher risks, the impact of these challenges on the industry is significant.

**AML/KYC Requirement:** The increasing focus on Anti-Money-Laundering (AML), Combating-the-Financing-of-Terrorism (CFT), and Know-Your-Client (KYC) requirements is one of the most important and longstanding impediments to trade finance.

According to the 2021 ADB Survey on Trade Finance Gaps, Growth and Jobs, nearly 72.4 percent of the respondent banks considered AML/KYC requirements as the biggest hindrance to trade finance. These requirements increase the cost of providing loans as complying with them is time-consuming, complex, and occasionally difficult to navigate. Additionally, the regulations lead to greater rejection of applications and termination of



correspondent banking relationships, limiting bank lending to smaller firms and developing countries.

The Financial Action Task Force sets global standards for AML and CFT, which follow a risk-based approach that provides banks with flexibility to develop their own processes for identifying and addressing money laundering/ terrorist financing risks. However, these incident-based standards bring in immense subjectivity and ambiguity, and render banks vulnerable to large fines in case of incidents, raising the cost of cross-border exposure for banks and financial institutions. According to a report by Fenargo, regulatory levies to financial institutions on account of noncompliance have surged steadily since 2007, to reach an estimated US\$ 56.1 billion by 2022, on account of failures pertaining to AML, data privacy, and ESG compliance violations, among others. In 2022 alone, fines for non-compliance totalled US\$ 4.17 billion. The enforcement actions for global AML-related compliance breaches recorded a remarkable y-o-y rise of 52 percent in 2022.

Further, the KYC norms and customer due diligence processes have also increased the costs for financial institutions. The projected total cost of compliance to combat financial crimes across financial institutions worldwide stood at nearly US\$ 274.1 billion in 2022, up from US\$ 213.9 billion in 2020. Among the G20 countries, the cost of compliance was the highest in European nations like Germany, and France, with total compliance cost in these two countries alone amounting to nearly US\$ 88.9 billion in 2022, followed by countries like the USA, Canada, Brazil and India, among others.

A survey by Fenargo on KYC in 2022 noted that KYC is a major component of the total compliance related spending for banks, representing nearly 31-40 percent of the total compliance budget for almost one-third of banks participating in the survey. The survey also noted that KYC procedures make it costlier to bring a new client on-board, with nearly 65 percent of the survey respondents noting that a KYC review costed between US\$ 1,501 and US\$ 3,500 per client in 2022. Moreover, KYC reviews are also incredibly time-consuming for firms that serve corporate customers, indicating substantial strain on the banks' operating costs to meet the compliance requirements.

The increasing compliance costs have compelled the banks to withdraw from several geographies and client segments, in a process which is referred as 'de-risking', leading to financial exclusion of businesses and markets. Going forward, compliance costs are expected to further increase, and there is a need to ensure that the rising compliance costs do not lead to financial exclusion.

**Impact of Basel Norms:** The 2021 ADB Survey on Trade Finance Gaps, Growth and Jobs revealed that the Basel norms are one of the key challenges to trade finance, with nearly 62.1 percent of the respondent banks considering it a major issue.

The 2017 revisions in Basel III are expected to result in banks allocating more risk and capital to many of their products, leading to capital shortfall. A recent report by the European Banking Authority, indicates that a full implementation of the Basel III reform could lead to a capital shortfall of nearly EUR 0.8 billion for Tier 1 risk-based capital requirements, for a sample of 160 banks in the region. The implementation of the revised leverage ratios framework would create an additional Tier 1 shortfall of EUR 0.4 billion, on top of the risk-based capital requirements. This shortfall could impact their pricing, resulting in some products, including trade finance products, becoming less commercially available. A structural feature of cross-border banking is its high degree of concentration, with a small number of very large institutions in advanced economies such as those in the EU, accounting for the lion's share of the total global cross-border bank credit. Thus, the impact of capital shortfall in European banks is also likely to have spillover effects on cross-border lending to emerging market economies, thereby widening the trade finance gaps further.

Moreover, the Basel III's treatment of trade L/Cs also remains largely unresolved, with the norms still not reflecting the low riskiness of these trade finance instruments. Under Basel III, leverage ratio was defined as a new component of Pillar 1 capital requirement. The off-balance sheet credit

conversion factors<sup>2</sup> (CCF) for leverage ratio calculation is 20 percent for L/Cs and 50 percent for guarantees. However, this level of CCF under the Basel III does not reflect the low riskiness of these trade finance instruments. According to the ICC Trade Register 2022, the default rates of trade L/Cs are the lowest among similar asset classes. For instance, the exposure-weighted default rates for import L/Cs stood at a mere 0.1 percent in 2021, while on transaction-weighted basis also the default rate on import L/Cs were around 0.11 percent in 2021. Likewise, the default rates on export L/Cs stood even lower at 0.01 percent in 2021, on both transaction-weighted and exposure-weighted basis. The risk weights are not reflective of the low risk attached to L/Cs, and greater capital allocation would disincentivise the relatively lower-margin trade finance relative to other categories of assets.

**MSME's Constrained Access to Trade Finance:** MSMEs face large trade financing gaps due to several reasons including higher risk perception by banks, lack of sufficient collaterals, and lack of formal structures and documentation, among others. MSMEs have also been more severely impacted by the pandemic, worsening their already limited access to trade finance. According to the ADB, the share of SMEs in total trade finance loan proposals has sharply declined in 2020, as compared to 2016, indicative of a relative decline in demand for trade finance as compared to the non-MSME firms. Moreover, supply of trade finance remained a challenge even in 2020, with SMEs continuing to face high rejection rates and accounting for 22 percent of the total trade finance rejections in 2020. Consequently, as per ADB, the global trade finance gap for MSMEs widened to an estimated US\$ 0.8 trillion in 2020, from an estimated US\$ 0.6 trillion in 2018.

Some of the top reasons for higher rejection rate included the loan application being totally unsuitable for support, lack of additional collateral and COVID-19 related concerns, among others. Besides, there is also a lack of awareness among SMEs, and they may not fully appreciate the importance banks place on KYC processes and the time banks need to analyse and evaluate trade

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<sup>2</sup> Under the Basel norms, for off-balance sheet items, credit conversion factors (CCF) are used to get their on-balance sheet equivalents. The CCF ranges from 0-100 percent, depending on the product.

finance applications. As per the ADB Survey, less than 1 percent of respondent firms believed KYC as a potential factor for rejections faced on their trade finance proposals, whereas banks considered KYC concerns as the fifth most important reason for rejecting trade finance proposal.

**Uneven Adoption of Digital Technologies:** The uneven adoption of digital technologies in trade and trade finance is another major challenge. A significant barrier that separates developed economies from developing economies and big corporations from small businesses is the digital gap. While developed countries have far outpaced the global average in terms of implementation of paperless trade, developing nations, particularly in South Asia and Africa recorded a slower progress when compared to the global average in 2021.

One of the reasons for the varied degrees of adoption of digitalisation in trade documentation is the lack of legal framework. Many countries continue to lack legislations for recognising digital documents, including electronic signatures. Moreover, there are significant differences between the laws in different geographies, which may lead to overwhelming complexities, particularly in the cross-border context.

Adopting uniform legal rules for electronic data interchange would be an important factor for digitalisation. In order to promote cross-border trade by establishing legal recognition for electronic transferable records, the United Nations Committee on International Trade Law (UNCITRAL) established the Model Law on Electronic Transferable Records (MLETR) in 2017. However, only seven countries have so far adopted MLETR.

In terms of adoption of digital technologies by banks, a common concern pertains to the high cost of technology. In the ADB Survey, more than half of the respondents cited cost of technology adoption to be the most important concern. Although the pandemic has accelerated digitalisation in the private sector, government push for enhancing adoption of digital technology would be equally critical for integrating domestic and international banks, businesses, and customers, and easing trade finance flows.

## **ROLE OF EXPORT CREDIT AGENCIES AND MULTILATERAL BANKS**

The emergence of poly-crisis and weakening of global demand has reinforced the need for ECAs to address the financial constraints for growth in exports. During crises, as countercyclical support providers, ECAs are tapped by their governments as critical policy instruments to bring normalcy and facilitate recovery. This trend was also seen during the period of pandemic-induced shock to the global economy and trade. During the pandemic, governments increasingly relied on their ECAs to bridge funding shortfalls.

One of the immediate effects of the pandemic on global trade finance was the sudden tightening of credit markets. In response to funding gaps due to COVID-19, countries and their ECAs acted promptly by implementing various measures, including increasing ECA support capacity, broadening working capital programmes, launching new facilities to sustain exports and exporters, and providing more adaptable terms and conditions for the official support. Most ECAs have increased their flexibility and relaxed terms for policyholders, increased the timeliness of approvals and claims processing, expanded their risk appetite, and made concessions through waivers or flexibility on fees and premium payments.

In the face of slowdown in global merchandise exports, ECAs have enhanced their focus on project exports as important conduit for expansion of exports from their country. Several ECAs are also working in partnership with each other for effective project finance. OECD ECAs are also collaborating with non-OECD ECAs to provide 100 percent cover for projects, making the terms more generous for the borrowers than allowed under the OECD Arrangement. Further, as part of the B3W initiative, the EU is also exploring the possibility of a European export credit facility to complement existing export credits of member states. The EU ECA would likely be focused on additional trade-related financing or other financing outside the scope of the OECD Arrangement.

ECAs also continue to maintain high level of engagement in the MSME segment. The amount and method of supporting SMEs is wide and varied. In Europe, ECAs continue to develop substantial short-term exposure

to non-marketable risks around their small business products. Focus of European ECAs on MSMEs further increased during the COVID-19 pandemic. For example, for SMEs and mid-tier companies, Bpifrance increased its cover for credit institutions from 80 percent to 90 percent for the entire duration of the pandemic. During 2020, SACE (Italy) announced an additional US\$ 5 billion in guarantees to contribute to Italy's 'Promotion of Made in Italy' plan, out of which about US\$ 600 million were kept for guaranteeing SME support for new business in emerging markets. Asian ECAs are also providing a wide array of support to SMEs. The Japan Bank for International Cooperation is supporting SMEs through long-term fixed-rate local currency loans. India Exim Bank has also launched the Ubharte Sitaare Programme to identify and nurture future export champions in the MSME sector.

ECAs also provide trade finance products to facilitate domestic companies' exports. Most countries have ECAs that provide loans, loan guarantees and insurance to help eliminate the uncertainty of exporting to other countries. Products such as the letter of credit guarantee scheme also allow ECAs to support short-term trade finance in their respective countries. India Exim Bank has also started a new programme called Trade Assistance Programme to support cross-border trade transactions in untapped markets where the absence of such support could be a deterrent to trade.

Going forward, due to the diminishing risk appetite of commercial lenders, short-term trade finance would continue to be a focus area for ECAs. Alongside, the traditional area of MLT financing would also gain salience, especially with the expected increase in infrastructure investments and associated project financing.

MDBs have also set up several programmes which provide risk mitigation capacity (guarantees) to both issuing and confirming banks and allow for rapid endorsement of letters of credit. The trade finance programmes of MDBs are private sector based, demand-led programmes, with a special focus on clients in developing countries, particularly the poorest and marginalised ones. These programmes are facilitating trade from the remotest regions of the world and meeting the aim of financial and trade inclusion.

The demand for trade finance support from MDBs witnessed an increase in the light of COVID-19, and accordingly the major MDBs enhanced their support towards trade finance. In July 2020, the heads of the World Trade Organization, International Finance Corporation, European Bank for Reconstruction and Development, Asian Development Bank, African Development Bank Group, International Islamic Trade Finance Corporation, and the Inter-American Development Corporation also released a joint statement promising to address shortages in trade finance, given the financial market stresses arising from the COVID-19 crisis.

Many of the trade finance programmes of MDBs had started much before the financial crisis of 2008, but the post-crisis period and the pandemic period more recently, has seen significant increase in the lending limits and resources of several programmes. This has helped trade financing in emerging markets and SMEs, and promoted inclusive financing. Several of the MDBs with regional focus have also imparted a fresh resonance to intra-regional trade through their trade finance programmes.

## WAY AHEAD

**Establishing Harmonized KYC Standards:** Establishing harmonised KYC standards is a crucial step in reducing frictions in cross-border payments and facilitating trade finance. The pandemic has accelerated the adoption of e-KYC globally, but the lack of uniformity in the due diligence process across different jurisdictions remains a challenge. Different countries have adopted different e-KYC models, such as the 'Video-based Customer Identification Process' used by India and Germany, and the 'Identity Authentication and Matching Model' used by Hong Kong, Malaysia and the EU. While each model has its own benefits, inconsistencies in the quality of information obtained from different e-KYC standards can be challenging for trade finance and trade. The G20 countries can collaborate to establish consistent KYC standards, which would help ease the screening and risk assessment requirements, and reduce administrative processes and costs. Doing so would also help to minimise impediments to cross-border payments and facilitate the exchange of financial services globally. In addition to harmonising e-KYC standards, banks and financial institutions should also prioritise upgrading their legacy

technology platforms and invest in advanced data analytics capabilities to improve the processing of compliance checks and reduce the risk of fraudulent transactions.

**Leveraging Digitalisation:** Digitalisation can help with issues like information asymmetry, regulatory compliance, and process inefficiencies in trade and trade finance transactions. The study discusses four potential areas of collaboration that the G20 can explore in order to leverage digitalisation for bridging trade finance gaps viz. i) adoption of the legal entity identifier (LEI); ii) harmonising reporting standards; iii) adoption of the Model Law on Electronic Transferable Records; and iv) bridging the digital divide.

Adoption of the Legal Entity Identifier (LEI): The LEI is a worldwide unique identifier, which helps improve interoperability in digital finance applications and payments by providing legal organisations with a global, digital identity. Currently, the adoption of LEI is uneven around the world and even among G20 countries, with some G20 countries having significantly lower numbers of active LEIs compared to others. Wider adoption of the LEI can greatly improve the efficiency and transparency of cross-border financial transactions. The G20 could work together to further strengthen LEI as a global identification standard for financial transactions. The G20 could also collaborate to help reduce or eliminate the costs associated with obtaining the LEI for businesses. Bolstering the role of the LEI as the global standard for entity identification and verification for cross border transactions can simplify procedures and increase transparency and traceability for trade finance.

Harmonising Reporting Standards: Harmonising reporting standards also remains an unfinished agenda that requires global cooperation. The Financial Stability Board's 'Report on Market Fragmentation' (June 2019) noted that while there has been progress in harmonising standards for data fields by standard-setters e.g. the LEI, more efforts are needed to implement standards to obtain comparability of information to allow data aggregation and to streamline reporting processes. Harmonised reporting standards would be important for the use of artificial intelligence and big data in trade finance transactions.



Adoption of MLETR: Harmonised legislative reforms and common standards, including from invoicing to financing products, from identity to security, are necessary enablers of digitalisation of trade and trade finance. The adoption of the UNCITRAL's MLETR or its equivalent legislation could foster an atmosphere that is smooth for the electronic interchange of documents and tackling documentation-related non-tariff barriers for ease of access to foreign markets. While the UK and the USA have introduced legislations that are MLETR-equivalent, other G20 countries are yet to adopt similar measures to harmonise digital documentation. The G20 could actively promote increased usage and acceptance of digital documentation relevant to cross-border exchanges by encouraging the alignment of national laws and legal frameworks to the MLETR, consistent with other international standards. The alignment should address documents of transport, bills of lading, bills of exchange, promissory notes, and warehouse receipts, among others.

Bridging the Digital Divide: Bridging the digital divide is crucial for enabling businesses and financiers to make use of the digital economy, boosting productivity and making growth more inclusive. In this regard, collaborative efforts among developed and developing countries for enhancing investments for augmenting digital infrastructure, and technological and organisational know-how would be critical. Policies that lower barriers to broadband deployment, simplify the rights of way application procedure, and help communication operators make investments more easily and affordably are important drivers of upgrading and expanding communication networks and closing connectivity gaps. Additionally, it would also be important for developing country DFIs, commercial banks and other financial institutions to collaborate with their counterparts in the developed countries for financing projects related to enhancing digital connectivity as also for leveraging technology solutions for digitalising trade and trade finance. The G20 as well as multilateral institutions should become a driving force for enhancing global investment to build quality and affordable digital infrastructure, and promoting platforms to stimulate network-development and connectivity. The G20 countries would need to also significantly scale up and enhance coordination of existing trade-related capacity-building programmes to bridge digital skill gaps including in the financial services sector.

**Collaboration among Development Finance Institutions:** Collaboration among MDBs, ECAs and national DFIs can help meet the growing infrastructure requirements, while concomitantly sustaining trade flows in a period of declining merchandise trade. There has been a substantial increase in such transactions by MDBs, ECAs, and national DFIs. More collaborations for co-financing / parallel financing could be envisaged by MDBs, ECAs and DFIs, to meet the financing needs for development projects in partner countries, and in turn create project export opportunities for companies. Such collaborations would also help these institutions manage their country-specific exposure limits.

The G20 ECAs could enter into co-financing arrangement among themselves. Support may be required from the G20 governments to make the co-financing approach effective, by aligning the differences in funding structures and cost of fund among their DFIs.

Another way in which ECAs, MDBs and national DFIs can collaborate is through information sharing. All institutions face challenges in terms of financing projects which may originate on account of regulatory issues, structural challenges, public sector inefficiencies, etc. Structural exchange of information can reap substantial benefits for the institutions.

These institutions can also collaborate in the sphere of creation of bankable projects through initiatives such as project preparation facilities.

Further, MDBs, ECAs and DFIs can also collaborate through creation of liquidity pools. Establishment of targeted liquidity pool can help ensure that adequate funds are available to SMEs, new exporters and firms in smaller geographies during times of contraction in liquidity and credit.

The G20 can also consider the creation of a new global liquidity insurance mechanism as proposed by Brahim Sangafowa Coulibaly and Eswar Prasad (2021) and discussed in the Study, to fill the gap in systematic provision of foreign exchange liquidity among a broader set of countries. This would help create a more robust and resilient global financial system.

**Alternative Trade Financing:** Going forward, the role of fin-techs and alternative finance providers will be crucial in bridging the trade finance gaps. One area where such collaboration can be fostered is supply chain financing (SCF). Fintechs can supplement conventional sources of trade financing, mostly banks, by using digital interfaces and electronic invoice systems. SCF solutions provided by fintechs can be an alternative to bank-intermediated financing. They are built on inter-firm open account trading and allow suppliers to raise money based on the creditworthiness of the business at the top of the supply chain while a third party bridges the gap for early payment. Fintechs can also be beneficial for bridging the financing gap for SMEs, as they can utilise the technology platforms of fintechs to sell their trade receivables.

Despite the substantial advantages of SCF, financial institutions in many emerging economies find it difficult to offer the SCF products because of lack of financial infrastructure, technological capability, resources, and awareness. To that end, MDBs and DFIs can be instrumental in alleviating the challenges to SCF. MDBs and DFIs could develop and operate multi-funder, blended finance platforms to incentivise the participation in SCF of lenders who may otherwise be unable or unwilling to develop their own SCF program. Besides, these institutions could also initiate dialogue with regulators and policy makers to develop an enabling framework for SCF, and advise and support commercial banks in developing new products. DFIs of several G20 countries like Mexico and Argentina, are already undertaking SCF-related interventions in collaboration with the private sector.

**Trade Finance Facility:** National DFIs and ECAs from developing countries, with support from MDBs can explore the prospects for a trade finance facility to enhance the access to trade finance by companies and banks from participating countries. While many MDBs already have risk mitigation instruments, the scope and reach of such instruments can be significantly enhanced with the involvement of national developmental agencies.

These facilities can be established at the regional level, and can provide non-funded guarantee to enhance the international confirming banks' appetite for dealing with local issuing banks by substitution of risk

from the local bank to the facility. The facility can also extend trade finance loans, structured around a company's trade cycle period. The facility can also provide training and capacity building support to local banks. Further, a subsidy can be provided by the respective Governments to cover the cost of compliances which may be associated with on-boarding of banks.

Such dedicated trade finance facilities can be formed through cooperation amongst the G20 countries. The facility will be especially beneficial in case of countries that have seen a precipitous decline in correspondent banking relationships.

**Mitigating Data Gap in Trade Finance:** Currently, there is not yet a single, comprehensive source for data on international trade financing, though information on the amount and composition of trade finance transaction by type, as well as other trade finance information at an aggregated level are periodically published by major market participants. There remains considerable scope for improvement in availability of consistent and uniform trade finance data. Such data would be crucial for policymaking, and can also offer essential insights to support and facilitate early warning analysis of potential liquidity crises. Collaborative efforts at the national and international levels are needed to create timely, official trade finance statistics. The G20 countries could collaborate for promoting compilation and research on trade finance data, in order to monitor the actual level of trade finance, as also improve trade finance policy design and operation for more inclusiveness.

## CONCLUSION

Global trade finance gaps have been exacerbated due to the heightened global uncertainties in the recent years. The gaps have emerged not just from the dearth of liquidity in the system, but also from the stringent regulations and compliances over the years. The financial sector has responded to this by reducing exposure to firms and geographies which are small and have higher risk perception. The response of MDBs and ECAs, as highlighted in the Study, has been pivotal in restoring balance, and financing transactions which

would otherwise not have been financed. Going forward, inter-governmental collaboration among countries, including the G20 countries, as well as the interventions by the MDBs, ECAs and national DFIs will be crucial in bridging the trade finance gap, as also in catalysing private finance. Alongside, leveraging emerging technology will also be crucial to augment the availability and reduce the cost of trade finance.

# 1. Introduction

## TRADE FINANCE: A PRIMER

Trade finance refers to any type of financing which enables international trade. It encompasses credit, guarantees and insurance needed to facilitate the payment for merchandise or service on terms that satisfy both the exporter and the importer. According to the International Trade Centre (2009), trade finance mechanism provides support primarily in the following four areas:

- Payment facilitation, enabling secure and timely payment across borders, for example through proven communication methods such as SWIFT;
- Financing to one or more parties in a trade transaction, whether it is the importer, exporter, or one of the banks;
- Risk mitigation, either directly through the features available in a trade financing mechanism, or indirectly through insurance or guarantee products designed to meet the needs of importers and exporters;
- Providing information on the movement of goods and/or the status of the related financial flow<sup>3</sup>.

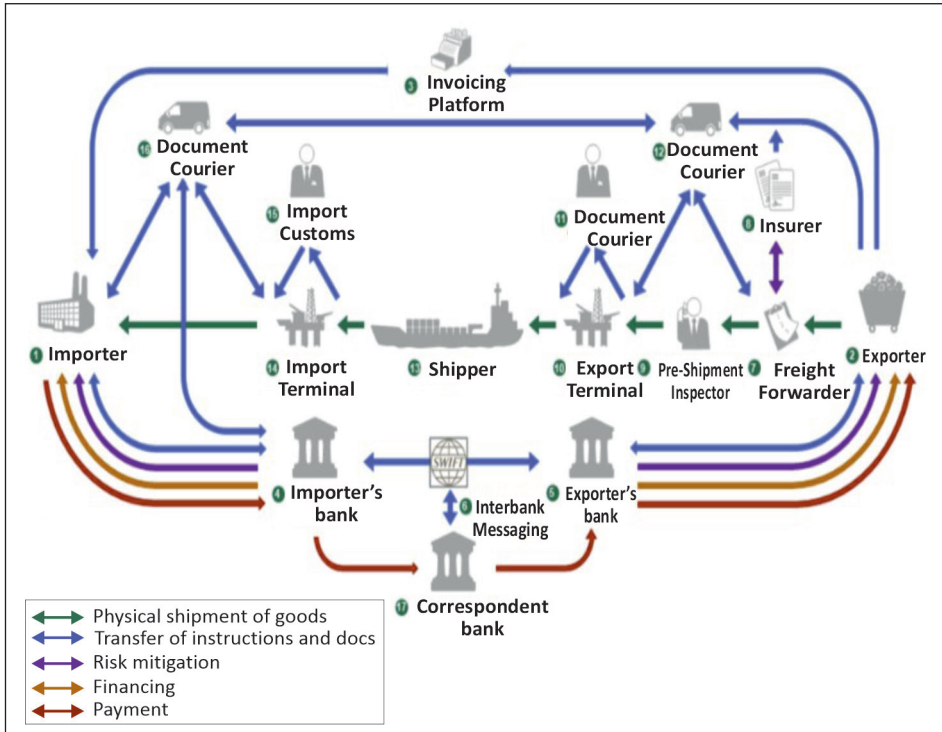
The trade finance ecosystem is spread across several players and processes. The corporates which include importers and exporters avail of the services of banks and facilitators. Banks provide financing and risk mitigation services to corporates. Facilitators such as SWIFT provide services to support the

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<sup>3</sup> ITC (2009), How to Access Trade Finance: A Guide For Exporting SMEs, International Trade Centre

trade finance ecosystem. Apart from these, there are also governing bodies such as customs which set the rules and standards. Finally, there has also been emergence of disruptors such as financial-technology firms (fin-techs) which introduce technology enabled solutions and bring about change in the traditional trade finance ecosystem (Exhibit 1).

**Exhibit 1: Trade Finance Ecosystem**



Source: Boston Consultancy Group Analysis

Banks are one of the principal agents in the trade finance ecosystem. Bank-intermediated trade finance may be provided “off-balance sheet” in the form of documentary, commercial or standby letters of credit, promissory notes, bills of exchange, and guarantees. It may also be extended through “on-balance sheet” transactions in the form of short-term trade finance loans. The financing needs of companies involved in international trade transactions are usually characterised as follows-

- **Pre-shipment financing:** This financing is needed to support pre-export activities prior to the shipment of goods and is used for meeting wages and other overhead costs during this period. Companies can seek pre-shipment lines of credit from banks by providing necessary documentation and meeting their pre-defined criteria.
- **Post-shipment financing:** Better terms of payment can improve the competitiveness of exports. In an attempt to achieve this, post shipment financing provides adequate liquidity to the exporter till the time purchaser receives the product and initiates payment.

Some of the common methods used to receive pre-shipment and post-shipment financing are:

- **Export receivables-backed financing:** Banks/ financial institutions provide loans to the exporter with repayment scheduled from the sale of exported goods. The physical goods and an assignment of the receivables serve as the collateral under the export contract.
- **Warehouse receipt financing:** Under this model, exporter stores the goods in warehouse under the control of an independent third party in exchange for a warehouse receipt. The receipt issued by the warehouse, certifying the storage of goods of certain quality and quantity, is then used as collateral.
- **Pre-payment financing:** Buyer purchases goods by paying the exporter in advance through a loan extended by a bank/financial institution for that specific order. Normally, under this model, the goods are either already in a warehouse or about to be assembled. The buyer obtains the title to the goods and then transfers its rights under the pre-payment contract to the bank that provided the loan. The bank gets paid once the supplier fulfils its export contract. Through this method, the bank shares key financing risks with buyer, while simultaneously reducing the risk of non-payment.
- **Factoring:** The Factor discounts the export bill and pays the exporter upon completion and shipment of the order. This is a non-



recourse mode of financing where risk of non-repayment by the overseas buyer is borne by the Factor. The exporter is free of all his liabilities once the bill has been factored by the institution.

- **Leasing:** Some financial institutions provide leasing as a medium to long term (MLT) financing option. It can be used by companies that need to import equipment or machinery to manufacture goods for export. The company acquires the equipment and pays a monthly rental fee to a leasing company (or financial institution), which owns the equipment. This allows exporter to acquire capital goods without making large onetime cash outlay.
- **Supply Chain Finance:** This is a technology-based financing process that links various parties in a transaction to lower financing costs and improve business efficiency. It usually leverages on the high rating of buyer. The suppliers to a large, creditworthy buyer can opt to get their invoices paid earlier at a cost payable to the bank.

Trade credit insurance is another important intermediation in trade finance. The purpose of export credit insurance is to offer protection to exporters of goods or services who sell their products on credit terms. The exporter is insured against losses arising from a wide range of risks, which can be broadly classified into either commercial risks or political risks.

## SCOPE OF THE STUDY

With the unprecedented challenges caused by the COVID-19 pandemic and the subsequent supply chain disruptions, the global volume of merchandise trade witnessed a decline of (-) 5.2 percent during 2020. Alongside, trade finance volumes also declined, with constraints on both demand and supply side. Not only has the demand for trade finance products been affected on account of reduction in global trade, but it has also become more expensive and less available, thereby exacerbating the already large trade finance gap. The global trade finance gap was estimated at nearly US\$ 1.7 trillion during 2020. While trade has recovered in 2021 and 2022, the challenges to trade finance remain in an era of heightened uncertainties, and the trade finance

gap is forecast at US\$ 2 trillion in 2021/22<sup>4</sup>. The trade finance gap particularly affects the small and medium-sized enterprises, which are the top drivers of growth and jobs, especially in developing countries.

Given that trade accounts for more than half of the world's output, the trade finance gap is a major constraint for the overall output growth. A well-functioning trade finance market allows the firms with higher risk perceptions to link into global value chains and thereby contributes to employment and productivity growth. Trade finance helps ensure that buyers get what they paid for, and sellers get paid for the goods they produce. Without sufficient levels of trade finance, the world will not be able to realise many Sustainable Development Goals.

There is a need to bridge the unmet demand for trade finance in order to revive the faltering global trade and output growth amid the rising uncertainties. The need is more pronounced in case of countries and businesses which are small, remote and less developed. High risk perception of developing countries and weak credit worthiness of SMEs affect their ability to access trade finance. Moreover, the growing regulatory challenges and declining correspondent banking relations is also affecting access to trade finance in developing countries.

The trade finance architecture currently comprises several conventional and non-conventional sources of financing. This includes commercial banks, development banks, insurance companies, export credit agencies (ECAs), multilateral development banks (MDBs), venture capitalists, business angels, fin-techs, etc. Concerted action from all these financiers will be required to revive the trade finance flows.

Set against this backdrop, the current Study attempts to analyse the recent trends in trade finance, the impact of COVID-19 on trade finance, challenges pertaining to trade finance flows, and strategies which can be adopted to reduce the large deficit in global trade finance, estimated at 10% of the

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<sup>4</sup> ADB

global merchandise exports. MDBs, ECAs and other development finance institutions (DFIs) shall form the cornerstone of strategies for augmenting the local capacities and enhancing access to trade finance. The Study highlights the various ways in which MDBs, ECAs and DFIs are already contributing towards meeting the trade finance gaps, and explores select options through which these financial institutions can further enhance their role in fulfilling the unmet demand.

## 2. Review of Trade Finance Market

Finance has a significant bearing on the export performance of a country. The extent of finance-trade relationship can be adjudged from the fact that nearly 80-90 percent of world trade today relies on some form of trade finance, mostly of a short-term nature<sup>5</sup>. Research also indicates that countries with higher level of financial development have higher shares of manufactured exports in GDP<sup>6</sup>. Export-led economic growth in developing countries therefore critically hinges on the development of a robust trade finance architecture.

Trade finance products are characterised by short average maturities, combined with low credit risk and default rates. In fact, it is one of the safest forms of financing with less than 1 percent of transactions facing default. During 2008–2021, default rates were 0.10 percent and 0.02 percent, respectively, for import and export letters of credit, while those for export/import loans were 0.18 percent over the same period (Table 1). Even when defaults happen, recovery rates are quick and high at 62.7 percent and 63.7 percent for import and export letters of credit, and 62.3 percent for export/import loans during the same period. In fact, default rate for export L/Cs declined in 2021 as compared to 2020 on an exposure<sup>7</sup> (0.01 percent in 2021 versus 0.07 percent in 2020), obligor<sup>8</sup> (0.05 percent versus 0.06 percent) and transaction weighted basis<sup>9</sup> (0.01 percent versus 0.02 percent)<sup>10</sup>. The favourable risk profile of trade finance should ideally ensure adequate

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<sup>5</sup> WTO

<sup>6</sup> Beck, T. (2002), “Financial development and international trade: is there a link?”, *Journal of International Economics* 57(1): 107-131

<sup>7</sup> total amount of money owed by importers or buyers in all outstanding L/Cs.

<sup>8</sup> number of importers or buyers who have defaulted on their L/C payments.

<sup>9</sup> takes into account the size of individual L/C transactions.

<sup>10</sup> ICC Trade Register Report 2022

availability. However, periods of crisis have often witnessed a concomitant contraction in availability of trade finance.

**Table 1: Default Rates in Trade Finance Instruments, 2008-2021 (%)**

Trade Finance Product	Exposure Weighted Default Rate	Recovery Rate	Expected Loss
Import letters of credit	0.10	62.7	0.04
Export letters of credit	0.02	63.7	0.01
Loans for import/export	0.18	62.3	0.07
Performance guarantee	0.24	42.0	0.00
Supply chain finance	0.24	-	-
Export finance	0.62	95.2	0.03

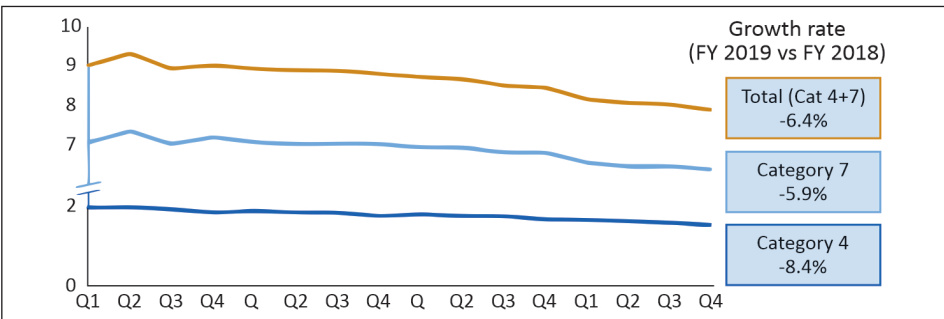
*Note: Exposure weighted default rate refers to bank-declared default weighted by the volumes of exposure in line with Basel methodology. Recovery rate is the extent to which principal and accrued interest on defaulted debt can be recovered. Expected losses refer to banks' expected losses resulting from lending to borrowers that may default.*

*Source: ICC Trade Register Dashboard, ADB*

## VOLUMES OF TRADE FINANCE

Most of the trade finance products have witnessed a slowdown in the recent period. Letters of Credit (L/C) is a commonly used instrument in trade finance. SWIFT trade finance volumes are a good indicator of the overall use of L/Cs, as nearly 90 percent of these transactions are routed through SWIFT. During FY2016 to FY2019, SWIFT trade finance traffic witnessed a decline (Exhibit 2).

**Exhibit 2: Global SWIFT Trade Traffic: Recent Trends (FY2016-FY2019)**



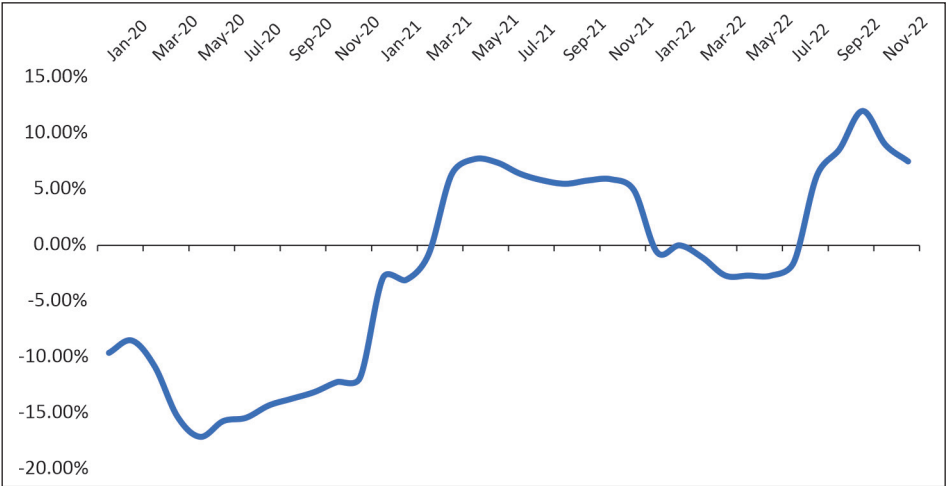
*Note: Category 7 messages: Flows for commercial and standby letters of credit and guarantees  
Category 4 messages: Flows for documentary collections, excluding the three least commonly used "cash letter" messages*

*Source: ICC Global Survey on Trade Finance, 2020*

SWIFT trade finance volume fell 6.4 percent in 2019 from the year before, in large part due to a 5.9 percent drop in category 7 and 8.4 percent drop in category 4 traffic.

The SWIFT trade related messages which were already relatively low in 2019, witnessed further decline in 2020 with the onset of COVID-19 pandemic, on account of the supply and demand disruptions globally. However, the trade related messages gradually increased with recovery in trading activities. Thereafter, another major shock to trade related messages was witnessed during the start of 2022, as the global uncertainties grew due the Russia-Ukraine conflict. As per the latest data available, the y-o-y growth in trade related messages in SWIFT is once again slowing down, which could be attributed to the global slowdown in demand (Exhibit 3).

**Exhibit 3: SWIFT Trade Related Messages (Y-o-Y Change)**



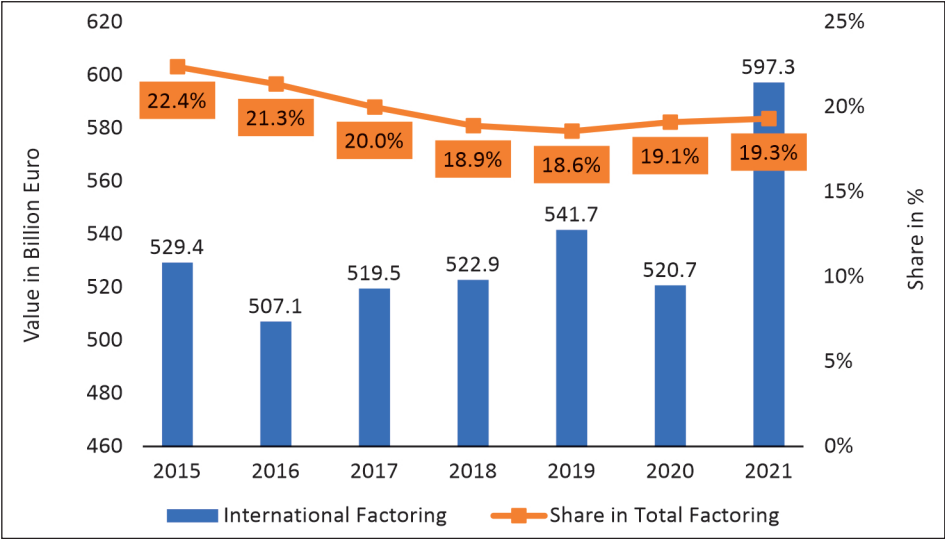
*Note: Monthly values correspond to the growth in YTD value for the month.*

*Source: SWIFT FIN Traffic Document Centre, Exim Bank Research*

International factoring business has witnessed a nearly consistent increase during the period 2015-2021, except a dip in two intervening years—2016 on account of the slowdown in investment and trade from China, and 2020 due to the COVID-19 related disruptions. With the recovery of international trade in 2021, international factoring volumes registered an increase of 14.7 percent in 2021 and were estimated at 597.3 billion Euro (approx. US\$ 706 billion).

During the period 2015-2021, international factoring volumes have witnessed a Compound Annual Growth Rate (CAGR) of 2.0 percent; however, its share in total factoring volumes (i.e. including domestic factoring) decreased from 22.4 percent in 2015 to 19.3 percent in 2021 (Exhibit 4).

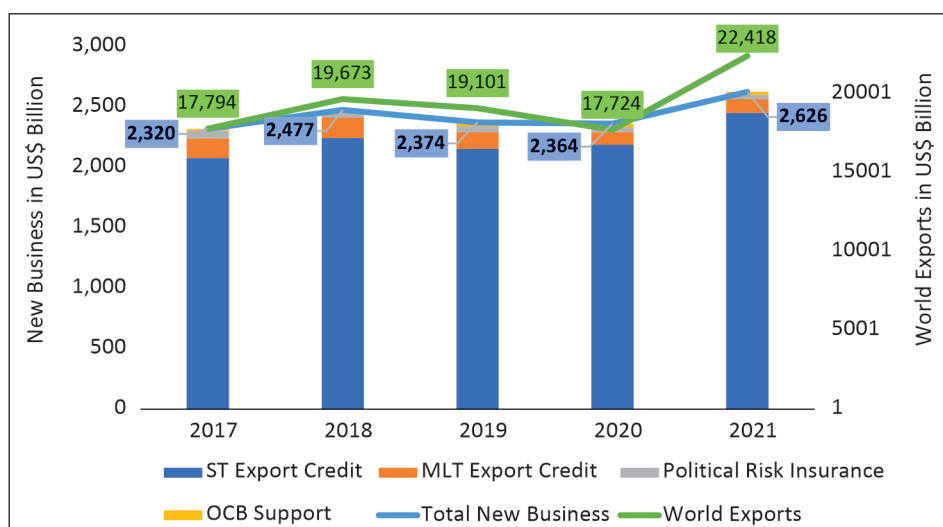
**Exhibit 4: International Factoring Volumes**



Source: Factoring Chain International, Exim Bank Research

The global export credit and insurance business has also seen a similar trend as international factoring, with a dip in 2020 due to the contraction in global trade during the year. New business volumes of Berne Union members increased from US\$ 2,320 billion in 2017 to US\$ 2,626 billion in 2021. A comparison of new business of Berne Union members with the world exports indicates that credit insurance had shown remarkable resilience and provided much needed support to trade during the COVID-19 crisis (Exhibit 5), as new business of Berne Union members declined by a mere (-) 0.4 percent during 2020, as compared to a (-) 7.2 percent decline in global exports during the year.

**Exhibit 5: New Business of Berne Union Members and Global Exports**



*Note: OCB Support is Other Cross-border Support*

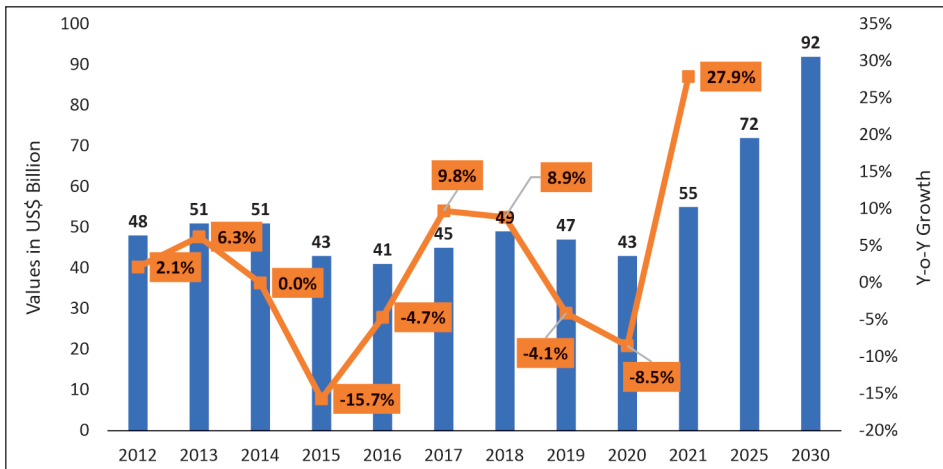
*Source: Berne Union, Exim Bank Research*

Despite some narrowing of margins, trade and supply chain finance revenues recorded a y-o-y growth of 28 percent during 2021 on a nominal basis, reaching US\$ 55 billion during the year, and even exceeding the 2019 revenues by 15 percent. This was due to the post-COVID-19 recovery in trade volumes. Going forward, revenues from trade finance products are expected to witness moderate growth and are expected to increase from the level of US\$ 55 billion in 2021 to US\$ 92 billion in 2030 (Exhibit 6). Trade finance revenues are expected to increase slightly faster than the volume of the underlying trade, a consequence not only of strong margins but of greater penetration of SME trade with digitised products and platforms. These expected gains would be even higher if not for likely price pressure due to increased competition from fintechs and non-banks<sup>11</sup>.

<sup>11</sup> ICC Trade Register 2022



**Exhibit 6: Global Trade Finance Market Revenue**



*Note: Data for 2025 and 2030 is forecast.*

*Source: ICC Trade Register Report 2022, Exim Bank Research*

## TRADE FINANCE IN ASIA-PACIFIC

Asia is the single largest contributor to global output, estimated at nearly 40 percent during 2021. It also accounted for more than 41 percent of the global trade in 2021. This makes the region most in need of increased liquidity. It is unsurprising therefore that the region relies heavily on trade finance products. Asia-Pacific had the largest volume for import L/Cs sent using MT 700s, making up 76.0 percent of world traffic in 2019, while for export L/Cs, Asia-Pacific region accounted for 78.1 percent of the world traffic. Asia-Pacific also had the second highest share of nearly 16.0 percent in the new business reported by the Berne Union members in 2021. The region also accounted for 24.3 percent of global factoring business in 2021.

## TRADE FINANCE GAP

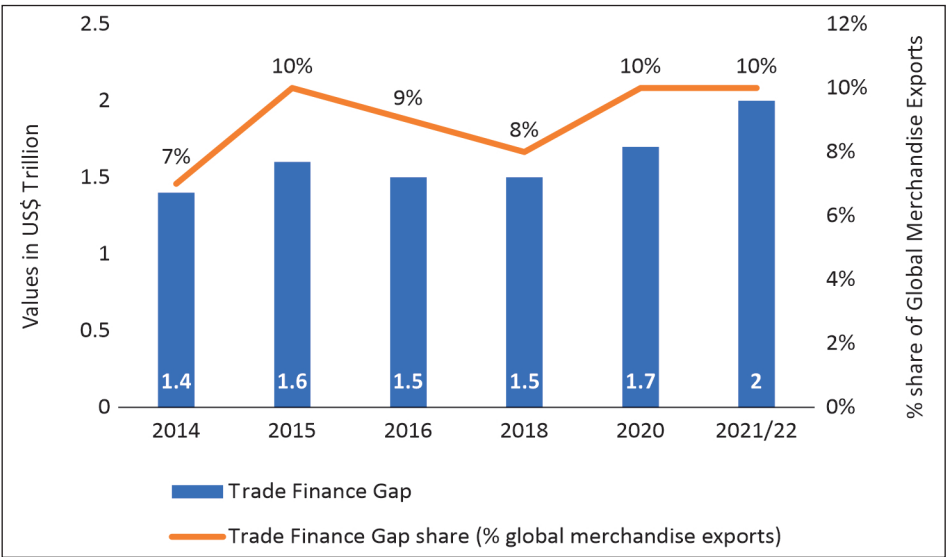
The COVID-19 pandemic has led to a record high trade finance gap, that is, unmet demand for trade finance. The trade finance gap widened to an estimated US\$ 1.7 trillion in 2020, accounting for 10 percent of global goods trade<sup>12</sup>. The pandemic reduced merchandise trade in nominal dollar terms

<sup>12</sup> Toward Inclusive Access to Trade Finance, ADB, August 2022

by 8 percent during 2020 (over 2019) and commercial services exports by 20 percent during the same period, pushed up the cost of trade, and reduced trade finance availability and revenues<sup>13</sup>. Macroeconomic uncertainty also intensified banks’ perceptions of default risks of borrowers and overshadowed banks’ efforts to maintain capital availability and credit lines for its clients, thereby leading to higher rejection rates.

The trade finance gap has historically hovered around 7 percent–10 percent of global merchandise export values, hitting its highest level during the pandemic in 2020. According to the ADB, if merchandise trade value is assumed to grow about 15 percent in 2022, maintaining a trade finance gap of 10 percent would result in a trade finance gap of around US\$ 2 trillion (Exhibit 7). If constraints on trade finance push banks to reject more trade finance proposals, the trade finance gap could be even larger<sup>14</sup>.

**Exhibit 7: Trade Finance Gap**



*Note: Data for 2021/22 is a forecast*

Source: ADB

<sup>13</sup> WTO

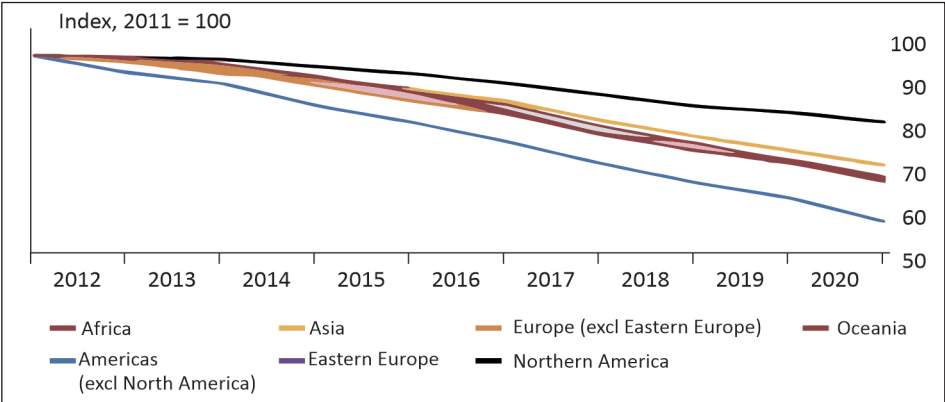
<sup>14</sup> ADB

# DECLINE IN CORRESPONDENT BANKING RELATIONSHIP

Correspondent banking has played an important role in financing trade. It basically refers to agreements or contractual relationships between banks to enable provision of domestic and cross-border financial services. These relationships serve as an essential mode for cross-border payments, trade finance, foreign currency settlements, securities transactions, and access to foreign financial systems. However, since the onset of the global financial crisis, there has been substantial decrease in correspondent banking activities.

According to Correspondent Banking Data report of the Financial Stability Board (FSB), there has been a consistent decline in correspondent banking relations over the past few years up until 2020, the latest year for which data is available. During the period 2011-2020, the number of active correspondents declined in most regions (Exhibit 8). The maximum decline in number of active correspondents during 2011-2020, was witnessed in Americas (excluding North America) (-39.8 percent), followed by Oceania (-30.2 percent), Europe (excluding eastern Europe) (-29.3 percent), and Eastern Europe (-29.3 percent). While Europe experienced a high rate of decline, it still has the highest number of correspondent banking relations (Exhibit 9).

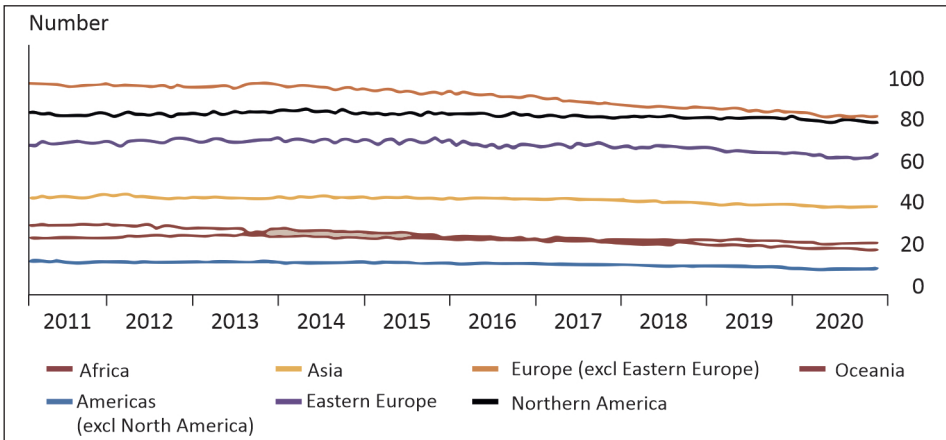
**Exhibit 8: Number of Active Correspondents by Region**



*Note: Correspondents are counted multiple times across corridors, but not across message types and months.*

*Source: SWIFT Watch, National Bank of Belgium, Bank of Mexico, FSB Correspondent Banking Data Report*

**Exhibit 9: Average Number of Counterparties by Region**



Source: SWIFT Watch, National Bank of Belgium, Bank of Mexico, FSB Correspondent Banking Data Report

During 2020, all regions witnessed a reduction in the average number of active correspondents across all currencies. The Pacific regions are already the ones with the least number of active correspondents and the decline in the number of relationships would therefore have a greater impact on the region.

## IMPACT OF COVID-19 ON TRADE FINANCE

The trade finance industry is highly influenced by factors affecting international trade and money supply. All things being equal, less trade means less potential business to finance, while at the same time an increase in the perceived risk of trade can foment an increase in demand for risk mitigation instruments, such as credit insurance or guarantees. Similarly, changes in monetary and fiscal policies can affect the aggregate demand and the financing conditions for firms.

During the COVID-19 pandemic, central banks and governments around the world acted with speed and force using an array of policy tools to combat the negative impact of the pandemic. These facilities targeted different level of governments (from central to local), various size of businesses (SMEs to large corporations), households and non-profit organisations. They included

interest rate cuts (or maintenance at historical low levels), forward guidance on the likely future path of interest rates to stabilise expectations, fiscal stimulus packages, and financial assistance to small businesses in the form of grants and loans, among others. In sum, accommodative fiscal and monetary policies in most countries helped to keep the business sector afloat.

Despite these measures, there was a marked reduction in economic activities during 2020. In 2020, the COVID-19 crisis caused a decrease in demand for short-term trade finance as it impacted both the supply and demand of merchandise trade. The exposure of short-term trade finance dropped by 21 percent in 2020, equivalent to US\$ 2,043 billion, due to a significant reduction in merchandise imports and exports. The primary contributors to this reduction were trade loans and import letters of credit, which decreased by 23 percent and 29 percent, respectively<sup>15</sup>. This reflects the global demand contraction during the first half of 2020, which was linked to a decrease in imports. Consequently, the share of these two products decreased, although they still made up for over half of the total short-term trade finance.

The decrease in short-term trade finance in 2020 could also be attributed to a lower liquidity in the banking sector. Several banks reduced their supply of short-term finance products due to increasing volatility and uncertainty in commodity prices, leading to a flight to quality. While the number of transactions remained relatively stable in 2020, there was a decline in the number of borrowers for trade loans (-8 percent) and letters of credit (-18 percent for exports, -9 percent for imports), which together made up 75 percent of total exposure. Additionally, the median amount for trade loans, decreased by 30 percent from US\$ 169 million to US\$ 129 million, resulting in an overall reduction in exposure<sup>16</sup>.

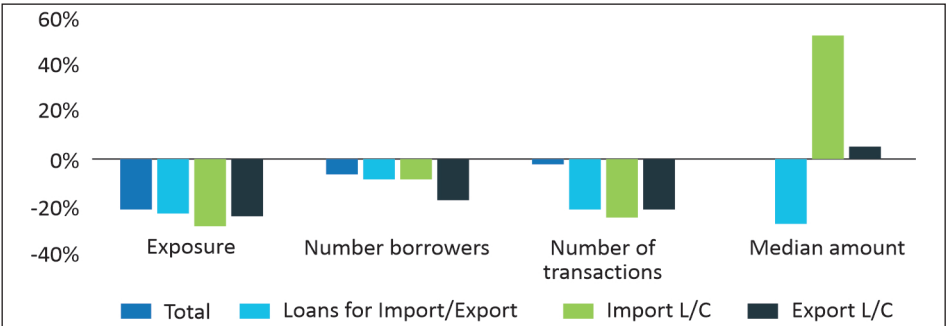
Medium-term trade finance has been relatively more resilient due to government's additional support with credit insurance or guarantees. Medium-term trade finance increased by 26 percent between 2019 and 2020 to reach US\$ 65 billion.

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<sup>15</sup> Impact of the Covid-19 Crisis and Challenges Ahead, ICC

<sup>16</sup> Ibid

**Exhibit 10: Overall Exposure, Number of Transactions, Borrowers, and Median Transaction Amount, % Change between 2019-2020**

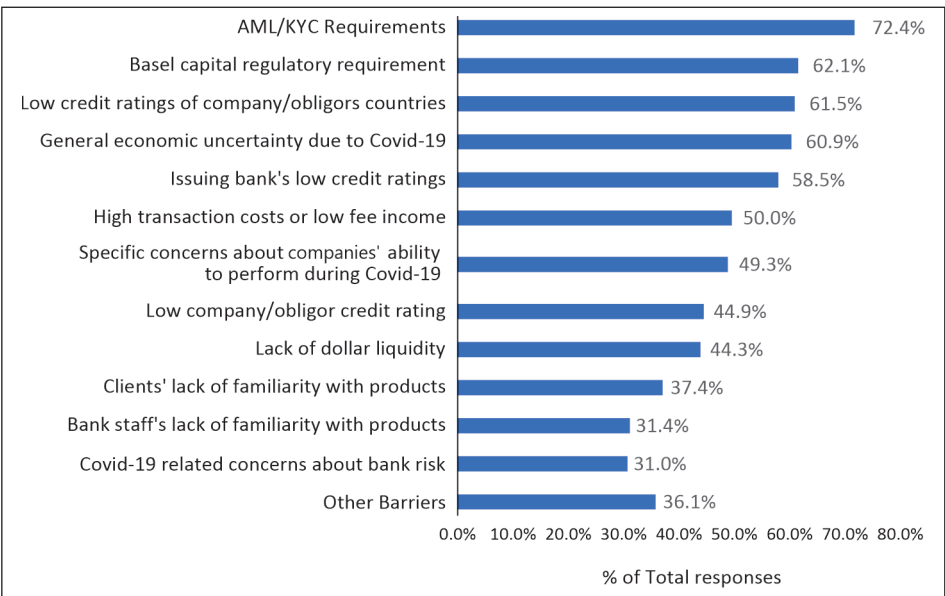


Source: *Impact of the Covid-19 Crisis and Challenges Ahead, ICC*

### 3. Challenges to Trade Finance

As noted in the earlier chapters, trade finance is vital for facilitating and catalysing international trade, but there are several challenges which are leading to a large and growing trade finance gap. Over the recent years, the global trade finance gap has further widened due to various factors, including geopolitical uncertainties, trade wars and economic sanctions, and the COVID-19 pandemic. According to the ADB Trade Finance Gaps, Growth, and Jobs Survey 2021, nearly three-fourth of the total respondents reported AML/KYC requirement as the topmost barrier for servicing the trade finance needs, while more than 60 percent of the respondents also noted Basel norms and general economic uncertainties related to COVID-19 as some of the other key impediments to cater to the global trade finance needs (Exhibit 11).

**Exhibit 11: Barriers to Servicing Global Trade Finance Needs**



Source: ADB Trade Finance Gaps, Growth, and Jobs Survey 2021

Besides these, the lack of firms' familiarity with trade finance products as well as low credit ratings of companies are also reported to be key challenges, which hamper firms' access to trade finance, particularly for MSMEs. Moreover, the rapid pace of technological innovations has further added to the complexity of global trade finance landscape. Against this background, this chapter analyses the challenges to global trade finance and their implications for businesses and the global economy. Understanding these challenges would help chart a roadmap to overcome them and better navigate the complex landscape of global trade finance.

## **UNCERTAIN GLOBAL DYNAMICS**

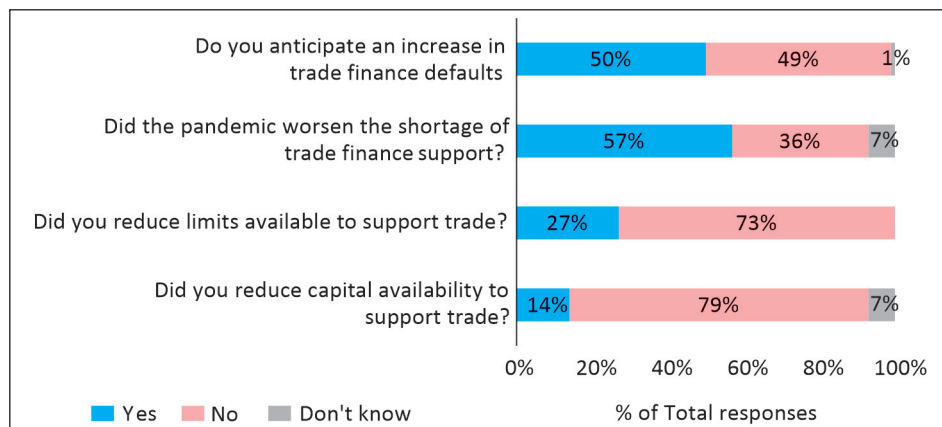
The global trade finance industry has been significantly impacted by the poly-crisis of geopolitical issues, trade wars, protectionism, and the COVID-19 pandemic. The poly-crisis has led to increased uncertainty, volatility, and risk in global trade, making it more challenging for trade finance providers to support cross-border transactions.

As noted in Chapter 2, according to the ADB, the COVID-19 pandemic has led to record high trade finance gap of an estimated US\$ 1.7 trillion in 2020, which is nearly 10 percent of global goods trade during the year. The gap widened during the following year due to higher risk perception on account of the continued global uncertainties. In the 2021 ADB Trade Finance Survey, while nearly three-fourth of the respondent banks noted that they neither reduced capital availability nor reduced limits to support trade, nearly 50 percent of the respondent banks anticipated higher trade defaults, which resulted in higher rejection rates (Exhibit 12). Clearly, higher risk perceptions have led to higher rejection rates for trade finance.

In 2022, global geopolitical issues have further led to increased economic and financial uncertainty and greater risks in global trade. The ongoing conflict between Russia and Ukraine and the subsequent economic sanctions being imposed by the international community have affected trade sentiments. The uncertainty surrounding the conflict have made it more challenging for businesses to engage in cross-border trade and have also increased risk aversion among trade finance providers.



## Exhibit 12: Banks' Approach and Perception towards Trade Finance during COVID-19 Pandemic



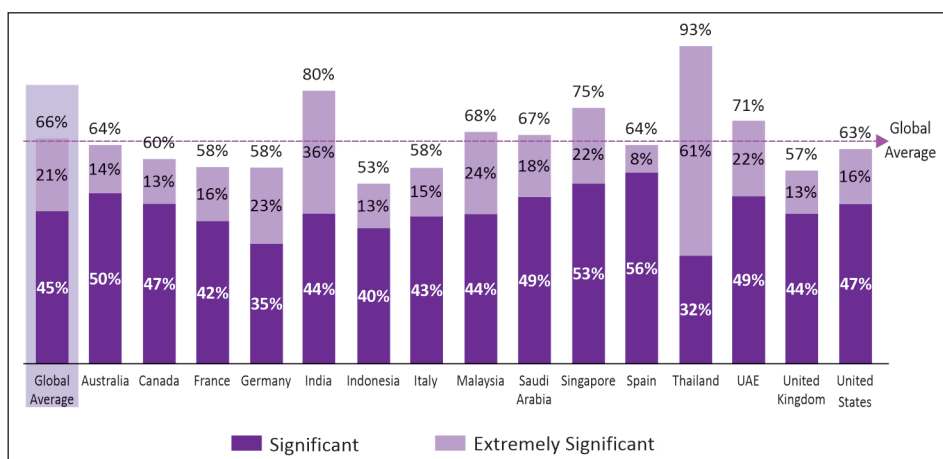
Source: ADB Trade Finance Gaps, Growth, and Jobs Survey 2021

Meanwhile, the rise in central bank rates to fight inflation have further dampened sentiments of trade finance providers. Global inflation peaked at an estimated 8.8 percent in 2022 and is expected to reach 6.6 percent in 2023, which is still significantly above pre-pandemic (2017–19) levels of about 3.5 percent<sup>17</sup>. According to a recent survey by Accenture, many respondent firms felt that their banks are struggling to meet their changing financing requirements in the wake of higher inflation and rising interest rates. As per the Survey, nearly two-third of the borrower firms have been impacted by rising interest rates. Nearly two-third of the respondents also noted that the cost of credit from their trade financiers have increased over the past 12 months<sup>18</sup>. The impact has been notably higher in Asian developing economies such as Thailand, India, Malaysia and Singapore (Exhibit 13).

<sup>17</sup> IMF (2022), World Economic Outlook: January 2023

<sup>18</sup> Accenture (2022), Find Your Competitive Advantage In Trade Finance

### Exhibit 13: The Impact of Increasing Interest Rates on Businesses in 2022



Source: Accenture Research

Trade wars and protectionism have also adversely affected the trade finance industry. The increased concerns regarding the rise in protectionism, the US-China trade war, and the impact of Brexit continue to remain a cause of concern for trade financiers. According to a recent Survey by the FCI, more than half of the respondents perceived that protectionism could further widen the trade finance gap, while nearly one-third of the respondents were unsure of how protectionism would impact the trade finance industry<sup>19</sup>.

Clearly, the global trade finance industry has faced significant challenges due to the poly-crisis. The increased uncertainty, volatility, and risk in global trade is resulting in a record high trade finance gap and higher rejection rates for trade finance. While some banks have managed to support trade despite the higher risks, the impact of these challenges on the industry is evident. As the world moves towards economic recovery, it is important for trade finance providers to adapt to the changing requirements of their clients and find ways to mitigate the risks associated with global uncertainties, protectionism, and trade wars.

<sup>19</sup> FCI (2022), Annual Review Report

## AML/KYC REQUIREMENT

One of the most important and longstanding impediments to trade finance has been the increasing focus on Anti-Money-Laundering (AML), Combating-the-Financing-of-Terrorism (CFT), and Know-Your-Client (KYC) requirements. Nearly 72.4 percent of the banks responding to the 2021 ADB Survey on Trade Finance Gaps, Growth and Jobs, considered AML/KYC requirements as the biggest hindrance to trade finance<sup>20</sup>. The KYC, CFT and AML requirements raise the cost to banks for providing loans. Complying with the requirements is time-consuming, complex, and occasionally difficult to navigate, which increases the cost of processing loans, and makes trade finance providers very selective in approval of applications, often limiting bank lending to smaller firms and leading to termination of correspondent banking relationships.

The Financial Action Task Force (FATF) is an inter-governmental body established in 1989 by the Ministers of its Member jurisdictions. The mandate of the FATF is to set standards and promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and the financing of proliferation, and other related threats to the integrity of the international financial system. In 1990, the FATF first issued its 40 Recommendations, which set out a basic framework for fighting money laundering. In 2012, the most fundamental revisions to the global standards for AML and CFT were undertaken by the FATF. The standards have undergone several more updates since then, with the latest update being in March 2022.

The FATF global standards follow a risk-based approach, which provides banks with flexibility to develop their own processes for identifying and addressing money laundering/ terrorist financing risks. However, these incident-based standard bring in immense subjectivity and ambiguity, and renders, banks vulnerable to large fines in case of incidents. While the risk of penalties is low, the potential of large amount of penalties raises the cost of cross-border exposure for banks and financial institutions. According to a

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<sup>20</sup> ADB (2022), Toward Inclusive Access to Trade Finance: Lessons from the Trade Finance Gaps, Growth, and Jobs Survey

report by Fenargo, regulatory levies to financial institutions on account of non-compliance have surged steadily since 2007, to reach an estimated US\$ 56.1 billion by 2022, on account of failures pertaining to AML, data privacy, and ESG compliance violations, among others<sup>21</sup>. In 2022 alone, fines for non-compliance with financial services regulations totalled US\$ 4.17 billion. In particular, the enforcement actions for global AML-related compliance breaches recorded a remarkable y-o-y rise of 52 percent<sup>22</sup> in 2022.

Further, KYC norms and customer due diligence (CDD) processes have also increased the costs for financial institutions. According to a recent study by LexisNexis Risk Solutions in 2022, the projected total cost of compliance to combat financial crimes across financial institutions worldwide<sup>23</sup> stood at nearly US\$ 274.1 billion<sup>24</sup> in 2022, up from US\$ 213.9 billion in 2020.

Evolving criminal threats including those involving digital payments, cryptocurrency, third parties and trafficking of proceeds; increased geopolitical risks; and the rise in AML regulations, driven by the increasing incidences of trade-based money laundering schemes and money mules laundering crimes<sup>25</sup>, among others, are some of the key factors driving the AML compliance cost<sup>26</sup> in 2022 (Exhibit 14). Among the G20 countries, the cost of compliance was the highest in European nations like Germany, and France, with total compliance cost in these two countries alone amounting to nearly US\$ 88.9 billion in 2022, followed by countries like the USA, Canada, Brazil and India <sup>27</sup>, among others (Exhibit 15).

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<sup>21</sup> Fenargo (2022), Global Crypto and AML Fines Surge in 2022

<sup>22</sup> Ibid.

<sup>23</sup> Covering 27 major economies across North America, Europe, Middle East, Africa, Latin America and Asia-Pacific

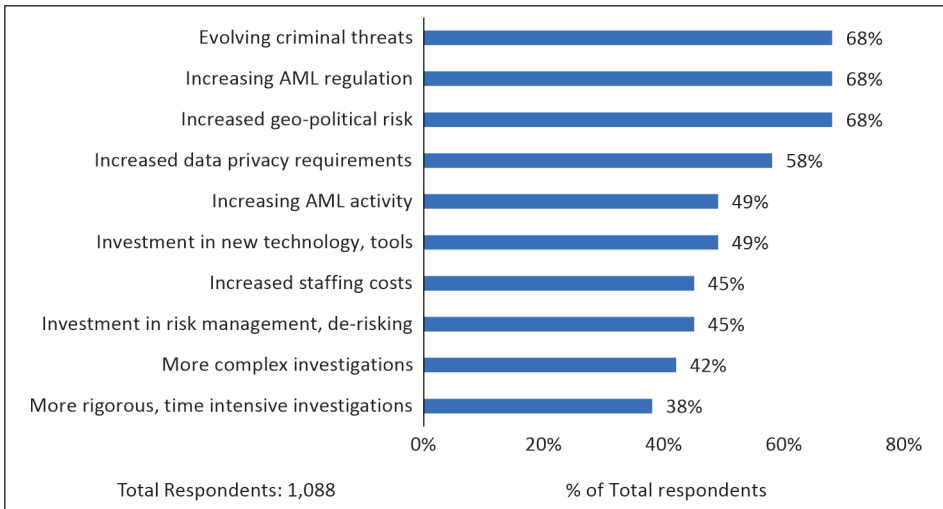
<sup>24</sup> True Cost of Financial Crime Compliance Study 2022: Global Summary, LexisNexis Risk Solutions

<sup>25</sup> Money muling is a type of money laundering. A money mule is a person who receives money from a third party in their bank account and transfers it to another one or takes it out in cash and gives it to someone else, obtaining a commission for it.

<sup>26</sup> True Cost of Financial Crime Compliance Study 2022: Global Summary, LexisNexis Risk Solutions

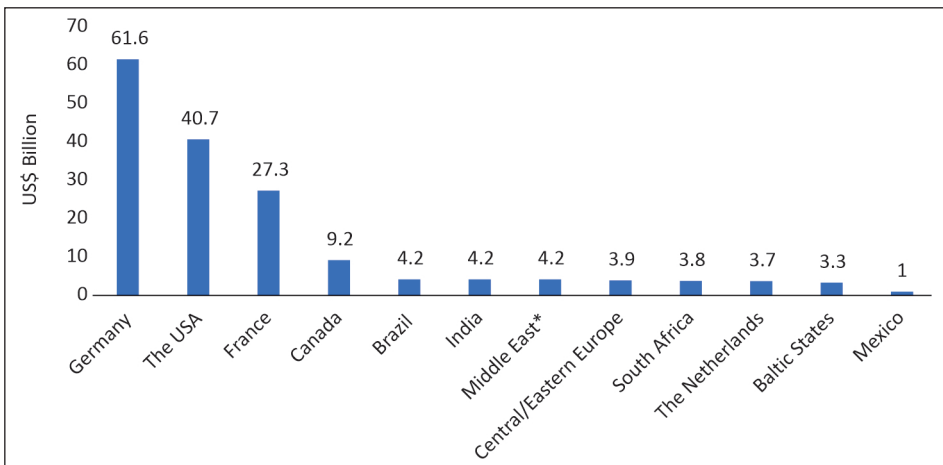
<sup>27</sup> Ibid.

**Exhibit 14: Factors Driving AML Compliance Costs in 2022**



Source: LexisNexis Risk Solutions

**Exhibit 15: Total Cost of Financial Crime Compliance in 2022 in Select G20 Countries**



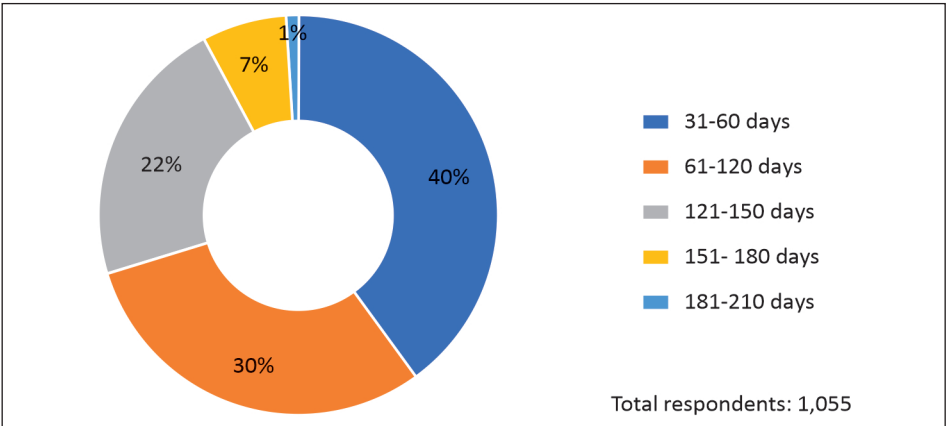
Note: \*Data for Middle East includes Saudi Arabia, UAE, Bahrain and Qatar. Saudi Arabia is a G20 country.

Source: LexisNexis Risk Solutions

Another survey by Fenengo on KYC in 2022 noted that KYC is a major component of the total compliance related spending for banks, representing nearly 31-40 percent of the total compliance budget for almost one-third

of the banks participating in the survey. The survey also noted that KYC procedures make it costlier to bring a new client on-board, with nearly 65 percent of the survey respondents noting that a KYC review costed between US\$ 1,501 and US\$ 3,500 per client in 2022. Hence, for a bank that may onboard nearly 10,000 new clients, the cost of KYC review may go up to US\$ 35 million. Moreover, KYC reviews are also incredibly time-consuming for firms that serve corporate customers. The survey noted that for nearly 40 percent of the participating banks, the KYC review for a single corporate client may take 31 to 60 days to complete, while another 30 percent of the participating banks took about 61 to 120 days for the same (Exhibit 16), indicating substantial strain on the banks' operating costs to meet the compliance requirements.

**Exhibit 16: Time Spent by Banks on KYC Reviews**



Source: Fenergo KYC in 2022 Report

Increasing compliance cost, coupled with diminishing profitability and higher capital requirement under Basel III (discussed later), have compelled banks to withdraw from several geographies and client segments, in a process which is referred as 'de-risking'. De-risking refers to the phenomenon where banks and financial institutions terminate or restrict business relationships with clients or categories of clients to avoid, rather than manage risk. This has contributed towards retrenchment of financial institutions from the correspondent banking system, as was highlighted in the previous chapter. These correspondent banking systems are integral for ensuring availability of trade finance in developing countries.

Going forward, compliance costs are expected to further increase. According to the Compliance Risk Study 2022 by Accenture, nearly 90 percent of the respondents expect an increase in compliance cost by nearly 30 percent<sup>28</sup> in the near future, owing to the evolving business, regulatory, and customer demands. While the necessity of these requirements is undeniable, there is a need to ensure that the rising compliance costs do not lead to financial exclusion of businesses and markets.

## IMPACT OF BASEL NORMS

Another important issue for trade finance has been the Basel capital requirements. According to the 2021 ADB Survey on Trade Finance Gaps, Growth and Jobs, the Basel requirements are the second biggest hindrance to trade finance, with nearly 62.1 percent of the respondent banks considering it a major issue.

Basel Accords have been integral to the financial regulatory reform agenda since 1988, when the Basel Committee on Banking and Supervision (BCBS) first published the Basel I norms with an aim to strengthen the stability of the banking system. This was followed by the Basel II framework in 2004, which corrected the deficiencies in Basel I and significantly widened the scope and focus of these regulations by putting in place the ‘three pillars’ viz. minimum capital requirements, supervisory review, and information transparency. In the aftermath of the financial crisis, the BCBS, moved to overhaul the regulatory framework for banks related to capital adequacy, leverage and liquidity, with the Basel III accord. The Basel III accord was directed at addressing the shortcomings in the pre-crisis regulatory framework and providing a foundation for a resilient banking system that would help avoid the build-up of systemic vulnerabilities.

Under the Basel III framework, banks’ capital requirements are calculated by dividing regulatory capital<sup>29</sup> by the amount of risk-weighted assets. Credit risk, market risk, and operational risk are the three main risk factors used in

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<sup>28</sup> Accenture (2022), Compliance Risk Study 2022 Report

<sup>29</sup> Regulatory capital consists of common equity tier 1, additional tier 1, and tier 2 capital; Regulatory capital absorbs losses in a way that reduces the likelihood of a bank failure.

the computation of risk-weighted assets (RWA). The RWA is made up of the assets of banks when they are all combined and weighted by the risk factors. A separate risk weight is given to each type of asset since they each have unique risk characteristics. Banks can calculate credit risk and, by extension, RWA in two different ways. The first is the standardised approach (SA), in which country-level regulators predetermine the risk weights that individual banks need to apply to their exposures. The second is the internal ratings-based (IRB) approach, in which banks may employ their own internal models to calculate credit risk under specific circumstances. Globally, most banks use the latter approach, however, there were several shortcomings with this approach including the excessive complexity of the IRB approaches of different banks, the consequent lack of comparability in banks' internally modelled IRB capital requirements and the lack of robustness in modelling certain asset classes, among others<sup>30</sup>.

Consequently, the 2017 revisions in Basel III introduced several constraints in the use of the IRB approaches and promoted integration towards the standardised approach. For instance, under Basel III reforms, the capital requirements calculated under the IRB model must be at least 72.5 percent of that of the standardised approach, which is known as the 'output floor'. In addition, banks using IRB models must also top-up any shortfall in risk weightings and capital allocation, as compared to the standardised approach. These revisions, however, are expected to result in banks allocating more risk and capital to many of their products, leading to capital shortfall. A recent report by the European Banking Authority (EBA), indicates that the weighted average increase in total Tier 1 Minimum Required Capital after a full implementation of the BASEL III reform would be nearly 15 percent, across a sample of 160 banks in the region<sup>31</sup>. The capital shortfall owing to the full implementation is estimated to be nearly EUR 0.8 billion for Tier 1 risk-based capital requirements. The implementation of the revised leverage ratios framework would create an additional Tier 1 shortfall of EUR 0.4 billion, on top of the risk-based capital requirements noted earlier<sup>32</sup>. This shortfall in

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<sup>30</sup> BIS (2017), High-level summary of Basel III reforms

<sup>31</sup> EBA (2022), Basel III Monitoring Exercise – Results Based on Data As Of 31 December 2021

<sup>32</sup> Ibid.



capital could in turn impact their pricing, resulting in some products, including trade finance products, becoming less commercially viable<sup>33</sup>.

Lending between financial institutions, particularly cross-border lending, is an essential element of trade finance, with banks often representing their clients through instruments like letters of credit. A structural feature of cross-border banking, however, is its high degree of concentration, with a small number of very large institutions in advanced economies such as those in the EU, accounting for the lion's share of total global cross-border bank credit<sup>34</sup>. Thus, a deterioration in the capital availability, especially in the Euro area, could significantly affect cross-border bank lending. The impact of capital shortfall in European banks is likely to have spillover effects on cross-border lending to emerging market economies, thereby widening the trade finance gaps further.

Moreover, another important issue viz. the Basel III's treatment of trade L/Cs—one of the most typical instrument used in trade finance—also remains largely unresolved. Trade letters of credit are off-balance sheet items, which are extensively used by both advanced economies as well as emerging economies<sup>35</sup>. Under Basel III, leverage ratio was defined as a new component of Pillar 1 capital requirement. The initial off-balance sheet credit conversion factors<sup>36</sup> (CCF) for leverage ratio calculation was 100 percent, which was extremely high for trade finance products given their low default rates. In 2014, conditions for trade finance products were relaxed with the CCF for L/Cs and guarantees being reduced to 20 percent and 50 percent, respectively. However, even with CCF of 20 percent for L/Cs, the Basel III norms still do not reflect the low riskiness of these trade finance instruments. According to the ICC Trade Register 2022, the default rates of trade L/Cs are the lowest among similar asset classes. For instance, the exposure-weighted default rates for import L/Cs stood at a mere 0.1 percent in 2021, while on

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<sup>33</sup> Standard Chartered (2021), Basel IV: Standardising Risk and Capital Calculations

<sup>34</sup> BIS (2019), Concentration in cross-border banking

<sup>35</sup> Standard Chartered (2021), Basel IV: Standardising Risk and Capital Calculations

<sup>36</sup> Under the Basel norms, for off-balance sheet items, credit conversion factors (CCF) are used to get their on-balance sheet equivalents. The CCF ranges from 0-100 percent, depending on the product.

transaction-weighted basis also the default rate on import L/Cs were around 0.11 percent in 2021. Likewise, the default rates on export L/Cs stood even lower at 0.01 percent in 2021, on both transaction-weighted and exposure-weighted basis. Thus, although the leverage ratio was introduced to curb the build-up of excessive on- and off-balance sheet leverage in the banking system<sup>37</sup>, the risk weights are not reflective of the low risk attached to L/Cs. Greater capital allocation would disincentivise the relatively lower-margin trade finance relative to other categories of assets.

## **MSME'S CONSTRAINED ACCESS TO TRADE FINANCE**

Micro, small, and medium-sized enterprises (MSMEs) are the growth engines of the world, accounting for 90 percent of businesses, 60-70 percent of employment and 50 percent of GDP worldwide<sup>38</sup>. In emerging economies, formal SMEs accounted for nearly 40 percent of their GDP<sup>39</sup>.

Trade can be a vital conduit for MSMEs to improve productivity, move to a higher growth trajectory, and increase their contribution to the national output. Increasing MSMEs' participation in global value chains and international commerce has time and again been highlighted as essential to unlocking higher productivity and inclusive growth.

MSMEs now have greater options to participate in global trade and boost economic growth, owing to the rise in global value chains and e-commerce. However, MSMEs continue to face higher trade costs and are less equipped than large firms for managing risks. They also face large financing gaps due to several reasons including higher risk perception by banks, lack of sufficient collaterals, and lack of formal structures and documentation, among others. Globally, the total unmet financing needs for MSMEs was estimated to be nearly US\$ 4.8 trillion<sup>40</sup> in 2018.

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<sup>37</sup> BIS (2022), Evaluation of the Impact and Efficacy of the Basel III Reforms

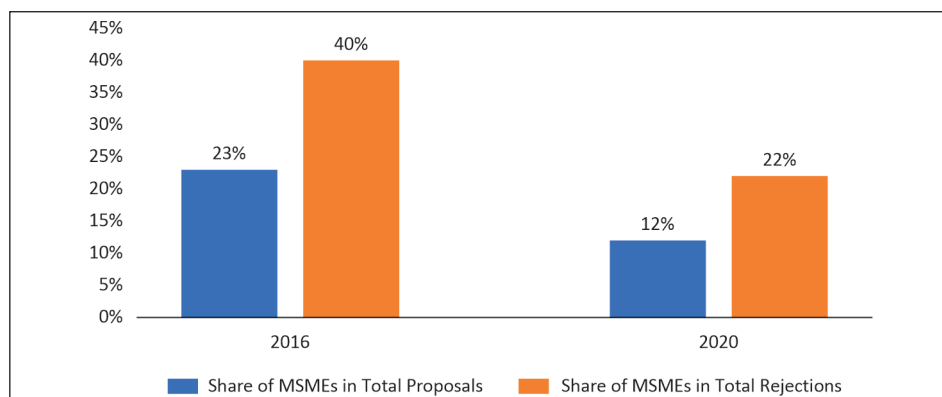
<sup>38</sup> UN (2022), Resilience and Rebuilding: MSMEs for sustainable development at the forefront of building back better and stronger from the impacts of the COVID-19 pandemic, climate crisis and conflicts

<sup>39</sup> World Bank (2022), Small and Medium Enterprises (SMEs) Finance

<sup>40</sup> IFC (2017), MSME Finance Gap: Assessment of the Shortfalls and Opportunities in Financing Micro, Small, and Medium Enterprises in Emerging Market

MSMEs have also been more severely impacted by the pandemic, worsening their already limited access to finance, including their access to trade finance. According to the ADB, the share of SMEs in total trade finance loan proposals has sharply declined in 2020, as compared to 2016, indicative of a relative decline in demand for trade finance as compared to the non-MSME firms. Moreover, supply of trade finance remained a challenge even in 2020, with SMEs continuing to face high rejection rates and accounting for 22 percent of the total trade finance rejections in 2020<sup>41</sup> (Exhibit 17). Consequently, as per the ADB, the global trade finance gap for MSMEs widened to an estimated US\$ 0.8 trillion in 2020, from an estimated US\$ 0.6 trillion in 2018.

**Exhibit 17: Share of MSMEs in Total Trade Finance Proposals and Rejections (2016 vs 2020)**

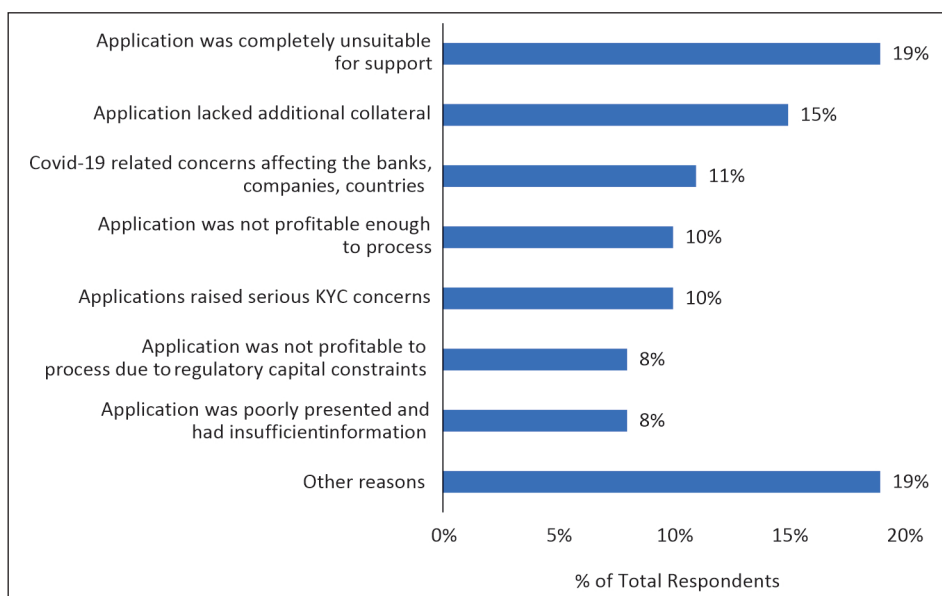


Source: ADB Trade Finance Gaps, Growth, and Jobs Survey 2021

Analysis of the reasons for rejection of trade finance proposals indicates that the topmost reason for rejection by banks was the application being totally unsuitable for support. Moreover, lack of additional collateral and COVID-19 related concerns were also key reasons for loan rejections by banks (Exhibit 18).

<sup>41</sup> ADB (2022), Toward Inclusive Access to Trade Finance: Lessons from the Trade Finance Gaps, Growth, and Jobs Survey

### Exhibit 18: Reasons for Banks' Rejection of Trade Finance Proposals



Source: ADB Trade Finance Gaps, Growth, and Jobs Survey 2021

Smaller firms face greater rejections in their trade finance applications because they have limited collateral, which makes banks wary to lend to them, especially in developing economies where legal systems backing property registry and enforcement of property rights tend to be weak. Besides, many SMEs are unaware of the standard requirement for information disclosure, which has an effect on their interactions with lending institutions. In fact, as per the ADB Survey, less than 1 percent of respondent firms believed KYC as a potential factor for rejections faced on their trade finance proposals, whereas banks considered KYC concerns as the fifth most important reason for rejecting trade finance proposal. This indicates that there is also a lack of awareness among SMEs, and they may not fully appreciate the importance banks place on KYC processes and the time banks need to analyse and evaluate trade finance applications.

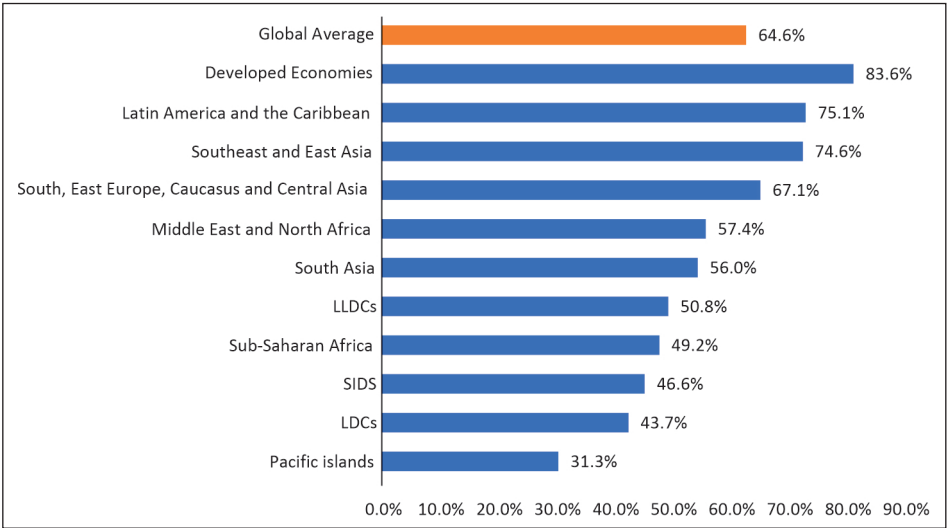
## UNEVEN ADOPTION OF DIGITAL TECHNOLOGIES

Trade finance digitalisation has the potential to transform the industry by streamlining processes, increasing transparency, and reducing costs. While

the pandemic has hastened the move toward digitalisation of trade and trade finance, there remain several challenges that need to be addressed.

Firstly, there is an uneven implementation of paperless trade across different regions. While developed countries have far outpaced the global average in terms of implementation of paperless trade, developing nations, particularly in South Asia and Africa recorded a slower progress when compared to the global average in 2021 (Exhibit 19). Even from an overall perspective, according to the UN Global Survey on Digital and Sustainable Trade Facilitation, the implementation of cross-border paperless trade recorded one of the lowest implementation rates when compared to other trade facilitation parameters in 2021<sup>42</sup>.

**Exhibit 19: Region-wise Implementation of Paperless Trade (2021)**



Source: UN Global Survey on Digital and Sustainable Trade Facilitation 2021

A significant barrier that separates developed economies from developing economies and big corporations from small businesses is the wider digital gap<sup>43</sup>. Owing to the relatively lower technical know-how among businesses

<sup>42</sup> UN (2021), Global Survey on Digital and Sustainable Trade Facilitation

<sup>43</sup> ADB (2022), Driving Inclusive Digitalization in Trade and Trade Finance

in developing countries, particularly SMEs, as well as a general lack of capital, and lower rate of adoption of digital finance, developing economies and SMEs tend to have low rate of digitisation in trade and trade finance.

Besides, another reason for the varied degrees of adoption of digitalisation in trade documentation is the lack of legal framework. Many countries continue to lack legislations for recognising digital documents, including electronic signatures and there is large reliance on physical documentation. According to a recent report, majority of the countries that have already put in place laws for recognising electronic signatures and papers are developed countries such as the USA, Canada, Australia, Japan, and the EU<sup>44</sup>.

Moreover, there are significant differences between these laws, which may lead to overwhelming complexities, particularly in the cross-border context. As a result of these complexities, many countries may continue using traditional means of doing business, including paper-based trade, despite the many advantages of digital documents and signatures.

Adopting uniform legal rules for electronic data interchange would be an important factor for digitalisation. In order to promote cross-border trade by establishing legal recognition for electronic transferable records, the United Nations Committee on International Trade Law (UNCITRAL) established the Model Law on Electronic Transferable Records (MLETR) in 2017. The MLETR builds on the principles of functional equivalence, technology neutrality, and non-discrimination against the use of electronic means. According to the UNCITRAL Secretariat, only seven countries have so far adopted MLETR viz. Bahrain (2018), Belize (2021), Paraguay (2021), Abu Dhabi Global Market (2021), Kiribati (2021), Singapore (2021), and Papua New Guinea (2022)<sup>45</sup>.

In terms of adoption of digital technologies by banks, a common concern pertains to the high cost of technology. In the ADB Survey, more than half of the respondents cited cost of technology adoption to be the most

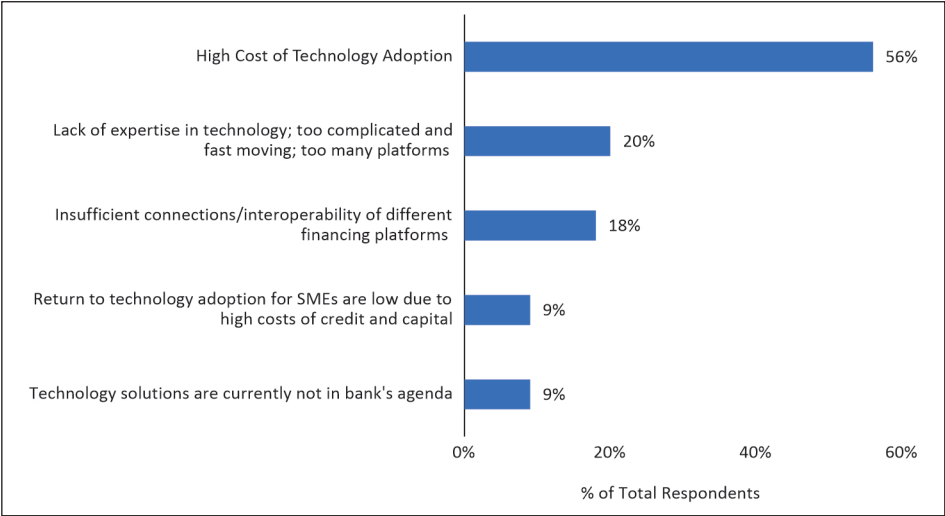
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<sup>44</sup> Determann, L (2021), Electronic Form Over Substance: eSignature Laws Need Upgrade.

<sup>45</sup> Status: UNCITRAL Model Law on Electronic Transferable Records, Accessed on March 03, 2023

important concern<sup>46</sup> (Exhibit 20). Some of the other major areas of concern for banks include the lack of expertise in technology, insufficient connections/ interoperability of different financing platforms; lower perceived returns to technology adoption, particularly for SMEs, among others. These concerns demonstrate banks’ cautious approach to investing in technology.

**Exhibit 20: Banks’ Major Areas of Concerns Regarding Digital Technology Adoption**



Source: ADB Trade Finance Gaps, Growth, and Jobs Survey 2021

Although the pandemic has accelerated digitalisation in the private sector, government push for enhancing adoption of digital technology would be equally critical for integrating domestic and international banks, businesses, and customers, and easing trade finance flows.

## CONCLUSION

Globally, trade finance continues to face diverse and complex challenges, including uncertain global dynamics, regulatory changes, rising compliance requirements, uneven adoption of digitalisation in the wake of rapidly

<sup>46</sup> ADB (2022), Driving Inclusive Digitalization in Trade and Trade Finance

advancing technologies, and uneven access to finance. As the industry continues to evolve, it will be important for trade finance providers as well as the businesses to adapt to and address these challenges, in order to successfully tap new opportunities for growth. The G20 countries could also cooperate and collaborate to improve the availability of trade finance and bridge the existing gaps, for bolstering global trade.



## 4. Role of Multilateral Banks and Export Credit Agencies in Trade Finance

### EXPORT CREDIT AGENCIES

An ECA can be defined as an agency in a creditor country that provides insurance, guarantees, or loans for the export of goods and services. These can be wholly owned by the Government or private companies which operate on behalf of the Government. Over the past several decades, the number of ECAs has grown manifold, and the products offered by them have increased alongside. However, the three main trade-related financing instruments which form the cornerstone of ECA financing are:

- Credits for cross-border trade transactions which either may not be available or may be more costly through purely commercial lending,
- Guarantees for repayment of credits which help exporters obtain more favourable lending terms from banks,
- Insurance for exporters against commercial and political risks.

ECAs differ in their ownership structure, role, function, resources, but most of them focus typically on supporting exports on medium and long term credit basis. The Government backing available in majority of ECAs allows them to take on higher risks and on longer terms than commercial banks. Involvement of ECAs ensures the viability of large projects which may require huge amount of credit and bear substantial investment risk.

Official support for short-term transactions, on the other hand, is legally prohibited in some countries where private sector is capable of meeting such requirements. For example, ECAs in the EU cannot provide short-term public

export guarantees of less than two-year maturity for covering export risks to OECD core members. The European Commission defines these short-term risks as 'marketable' risk, where the private sector has sufficient capacity to serve the market. On the other hand, there are markets such as those in Asia, where lacuna in private short-term credit providers makes a case for ECAs to fill the void. Asian ECAs therefore have significantly large short-term official export credit.

## **IMPACT OF COVID-19 ON TRADE FINANCE AND RESPONSE OF ECA**

The COVID-19 pandemic had a significant impact on global trade finance, disrupting the supply chains and causing trade finance to become increasingly difficult to access. One of the immediate effects of the pandemic on global trade finance was the sudden tightening of credit markets. Banks and other financial institutions became increasingly reluctant to lend, particularly to high-risk borrowers, including those in emerging markets. This led to a reduction in trade credit, making it more difficult for businesses to finance their operations and trade activities. Moreover, the pandemic has also led to a significant increase in payment defaults, further reducing the availability of trade finance. This is particularly true for smaller businesses and those in emerging markets, where access to credit has his affecting the creditworthiness and torically been limited. The pandemic has exacerbated this issue, making it increasingly challenging for these businesses to secure trade finance, thus hindering their ability to participate in global trade.

The COVID-19 pandemic had a severe impact on the demand for trade finance by MSMEs, as also its availability. With many countries implementing lockdowns and putting restrictions on businesses, there was a cut back on consumer spending, which led to a decrease in demand for goods and services. This decrease in demand made it difficult for MSMEs to sell their products, leading to a decrease in their revenue and cash flow. This decrease in revenue made it challenging for MSMEs to continue their operations, let alone undertake investments for growth. Alongside, availability of finance for sustaining trade was also further constrained.

Amidst a restrictive lending climate, private entities turn towards governments to uphold accessible financing channels and safeguard the continuity of supply chains. Participants in the trade sector seek non-private funding sources for short-term trade financing and official export credits for long-term projects. This trend was also seen during the period of pandemic-induced shock to the global economy and trade. During the pandemic, governments increasingly relied on their ECAs to bridge funding shortfalls, a strategy employed during the 2008-2009 financial crisis as well.

As policy based financial institutions, the role of ECAs has evolved in tandem with countries' economic priorities and is acknowledged strongly during the times of crisis. This has been evident from the substantive upgrade in the role of ECAs during the pandemic. ECAs played an important stabilising role by easing the financing terms and increasing the supply of trade finance. Their involvement in trade transactions ensured that exporters were able to offer their goods and services on open account terms in an environment characterised by heightened risk.

In response to funding gaps due to COVID-19, countries and their ECAs acted promptly by implementing various measures, including increasing ECA support capacity, broadening working capital programmes, launching new facilities to sustain exports and exporters, and providing more adaptable terms and conditions for the official support (Table 2).

Most ECAs have increased their flexibility and relaxed terms for policyholders, increased the timeliness of approvals and claims processing, expanded their risk appetite, and made concessions through waivers or flexibility on fees and premium payments. To avoid a liquidity crisis becoming a solvency crisis, many ECAs also focused on support for finance indirectly related to exports, including providing cover for working capital, pre-shipment finance, import guarantees, and bonds. By maintaining and expanding the availability of ECAs' products and tools, many governments were able to provide some support for mitigating the economic effects on ECAs' exporter clients and collectively on the global economy.

**Table 2: Measures taken by OECD Countries and their ECAs in Response to the COVID-19**

Broad category	Sub-category	Detailed measure
Modification of the terms and conditions of official support	Repayment flexibilities	<ul style="list-style-type: none"> <li>– Deferring loan repayments / Moratorium of loan payments</li> <li>– Extending loan terms</li> <li>– Extending restructurings</li> </ul>
	Interest rate and fee flexibilities	<ul style="list-style-type: none"> <li>– Waiving all fees associated with extensions, including legal and documentation fees</li> <li>– Waiving late interest and late fees</li> <li>– Reduction of fees for exporters in case of new demand for insurance cover</li> </ul>
	Changes in premium	– Discounts on premiums (SMEs)
	Cover changes	<ul style="list-style-type: none"> <li>– Expansion of the ST facilities to marketable risks (EU)</li> <li>– Willingness to take on greater risk than in the past when assessing new buyer coverage requests</li> <li>– Increase of the maximum percentage of cover</li> </ul>
	Claim flexibilities	<ul style="list-style-type: none"> <li>– Shortening of claims waiting period</li> <li>– Speeding-up of claims payment (SMEs)</li> </ul>
	Deferment of deadlines	– Extension of the term of export pre-financing guarantee agreements
	National content changes	– Flexibilities to national content rules
	Flexibilities for cancellations	
Working capital	Increasing facilities	
	Cover changes	– Increased maximum cover
	Repayment flexibilities	– Extension of the repayment period of loans, extension of duration to fulfil export commitments for loans
Increased capacity		– Increasing ECAs' statutory limits, Special government-back programmes, etc.
New facilities	Insurance/ Guarantee facilities	
	Direct lending programs	

Broad category	Sub-category	Detailed measure
Other	Application flexibilities	<ul style="list-style-type: none"> <li>– Faster processing of applications</li> <li>– Discounted services (credit research service)</li> </ul>
	Documentation flexibilities	<ul style="list-style-type: none"> <li>– Moratorium on deadlines for submitting documentation and financial reports</li> </ul>
	Reinsurance schemes with private insurers	

*Source: Trade Finance in Times of Crisis - Responses from Export Credit Agencies, OECD*

Additionally, the pandemic has accelerated the adoption of digital technologies in global trade finance. Many businesses have shifted to digital platforms to facilitate trade finance, with the use of blockchain, artificial intelligence (AI), and other digital technologies. This has increased the efficiency of trade finance processes, reduced costs and improved access to finance. Moreover, digital platforms have facilitated the provision of trade finance to smaller businesses, who may have struggled to access traditional forms of finance.

## CURRENT ROLE OF ECA

The emergence of poly-crisis and weakening of global demand has reinforced the need for ECAs to address the financial constraints for growth in exports. During crises, as countercyclical support providers, ECAs are tapped by their governments as critical policy instruments to bring normalcy and facilitate recovery.

While disruptions caused during the COVID-19 period have now dissipated, the ability of banks and financial institutions to support trade finance remains restricted on account of the tightening financial environment, heightened global uncertainties, and escalating debt distress, among other reasons. Due to the diminishing risk appetite of commercial lenders, short-term trade finance would continue to be a focus area for ECAs. Alongside, the traditional area of MLT financing would also gain salience, especially with the expected increase in infrastructure investments and associated project financing.

## Focus on Project Finance

In the face of likely slowdown in global merchandise exports, ECAs would enhance their focus on project exports as an important conduit for expansion of exports from their country. As per Global Investment Hub data, the current global<sup>47</sup> infrastructure investment is estimated at US\$ 79 trillion by 2040<sup>48</sup>, with an investment gap of US\$ 18 trillion. Efforts to bridge the infrastructure gap would provide opportunities for project exports globally.

There is already a renewed focus on infrastructure investments, which is expected to boost demand for project exports. For example, in June 2021, the G7 announced the “Build Back Better” World (B3W) initiative, which is focused on meeting the infrastructure needs of low and middle-income countries. This global infrastructure initiative is characterised as a value-driven, high-standard, and transparent infrastructure partnership led by the G7 to help narrow the US\$ 40 trillion infrastructure need in the developing world. The G7 and other like-minded partners will coordinate in mobilizing private sector capital in four key areas – climate, health and health security, digital technology, and gender equity and equality, creating substantial opportunities for project exports.

The OECD Arrangement places limitations on the financing terms and conditions of officially supported export credits. These include restrictions on the applicable maximum repayment term, the minimum interest rates and the minimum premium rates to be charged for officially supported export credits. ECAs are now increasingly providing products outside of the Arrangement to finance projects abroad. These includes tools such as market windows, untied financing, and investment support, which are outside the purview of the OECD Arrangement. Many ECAs in Asian region, such as China, Japan, South Korea, provide substantial trade-related support through these programmes.

- **Market Window:** Under this financing, an ECA takes a market-based approach and provides finance on terms which are comparable to

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<sup>47</sup>The data forecast is for 56 countries

<sup>48</sup>Includes the investment need inclusive of SDGs

those that the recipient may receive in the market. ECAs adopt a market-based pricing under these programmes. The terms offered under these programmes are not subject to the disciplines of the OECD Arrangement which, inter alia, includes limitations on tenor, no cash payment requirement, and sculpted repayment structures.

- **Untied Support:** In untied programmes, projects are offered loans or guarantees to support national interest or promote business interests. Financing under this is not directly linked to procurement from the country providing the support, but may be linked to nationality of equity ownership and/ or the nationality of significant contract counterparties. Through untied support, ECAs can provide more flexible terms than those offered under the OECD Arrangement.
- **Investment Support:** An ECA may also provide support to projects where domestic companies have equity participation or for the purpose of promotion of national interests. Support in such cases is primarily in the form of loans, but can also be in the form of guarantees or insurance. This is not directly linked to exports from the country.

Several ECAs are also working in partnership with each other for effective project finance. For example, in 2021, EKN (The Swedish Export Credit Agency) provided official MLT financing to several deals in Sub-Saharan Africa where it partnered with the Development Bank of Southern Africa (DBSA) and the Export Credit Insurance Corporation of South Africa (ECIC), which provided financing for the required 15 percent down payment. This structure was used in Angola for solar installations and in Ghana for hospitals and a railway project<sup>49</sup>. Through this structure, EKN found a way to work with non-OECD ECAs to provide 100 percent cover for projects.

Further, as part of the B3W initiative, the EU is also exploring the possibility of a European export credit facility to complement existing export credits of member states. The EU ECA would likely be focused on additional

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<sup>49</sup> Global Export Credit Competition Report 2021, US Exim

trade-related financing or other financing outside the scope of the OECD Arrangement.

### **Focus on Trade Finance**

ECAs also provide trade finance products to facilitate domestic companies' exports. Most countries have ECAs that provide loans, loan guarantees and insurance to help eliminate the uncertainty of exporting to other countries (Table 3). Products such as the letter of credit guarantee scheme also allow ECAs to support short-term trade finance in their respective countries, as these products protect banks from commercial and/or political and/or sovereign risks related to a confirmed Letter of Credit.

During the pandemic, the governments also made efforts to make short-term trade finance more widely available through their ECAs. The European Commission, for example, decided to make short-term export credit insurance more widely available by temporarily removing all countries from the list of "marketable risk", which are normally ineligible for public support. The Export-Import Bank of India (India Exim Bank) has also started a new programme called Trade Assistance Programme (TAP) to support cross-border trade transactions in untapped markets where the absence of such support could be a deterrent to trade (Box 1). The programme is expected to create an enabling environment for counterparties in settlement of trade transactions, support incremental exports, enhance geographical coverage of exports including for MSMEs, provide risk coverage for challenging international trade transactions, and enable local banks in target countries to establish working partnerships with commercial banks in India.



Table 3: Product Range of ECAs

Countries	ECAs/Other govt. agencies	Short- term insurance	MLT export credit schemes	Fixed rate financing (CIRR)	Forex fluctuation cover	Direct lending	Investment insurance	Bond support scheme/ issuance	Unfair calling insurance*	Letter of credit guarantee scheme	Working capital facility
Australia	EFIC	✗	✓	✓	✗	✓	✓	✓	✓	✓	✓
Austria	OeKB/OeEB/ Exportfonds	✓	✓	✓	✗	✓	✓	✓	✓	✓	✗
Belgium	Credendo	✓	✓	✓	✗	✓	✓	✓	✓	✗	✓
Brazil	ABGF /BNDES	✓	✓	✓	?	✓	?	✗	?	?	✓
Bulgaria	BAEZ	✓	✓	?	?	✗	✓	?	✓	✓	✓
Canada	EDC	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
China	Sinosure/China Eximbank	✓	✓	✗	✗	✓	✓	✓	✗	✓	✓
Croatia	HBOR	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
Czech Republic	EGAP/CEB	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
Denmark	EKF	✓	✓	✗	✗	✓	✓	✗	✓	✓	✓
Finland	Finnvera	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
France	Coface	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Germany	Euler Hermes/ KfW	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
Greece	ECIO	✓	✓	✗	✓	✗	✓	✗	✗	✗	✗

Countries	ECAs/Other govt. agencies	Short- term insurance	MLT export credit schemes	Fixed rate financing (CIRR)	Forex fluctuation cover	Direct lending	Investment insurance	Bond support scheme/ issuance	Unfair calling insurance*	Letter of credit guarantee scheme	Working capital facility
Hungary	MEHIB/ Eximbank	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
India	ECGC/Exim Bank	✓	✓	✓	?	✓	✓	✓	✓	✓	✓
Italy	SACE/SIMEST/ CDP	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
Japan	NEXI/JBIC	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
Luxembourg	ODL/SNCI	✓	✓	✓	✗	✓	✓	✗	✓	✗	✓
Malaysia	Exim Bank	✓	✓	✗	✓	✓	✓	✓	✓	✓	✓
Mexico	Bancomext	✓	✓	✗	✓	✓	✗	✓	?	✓	✓
Netherlands	Atradius	✓	✓	✗	✓	✗	✓	✓	✓	✓	✓
New Zealand	NZECO	✓	✓	✗	✗	✗	✗	✓	✓	✓	✓
Norway	GIEK/ECN	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
Poland	KUKE/BGK	✓	✓	✓	✗	✓	✓	✓	?	✓	✗
Portugal	COSEC	✓	✓	✗	✗	✗	✓	✓	✗	✗	✓
Romania	EximBank	✓	✓	✓	✗	✓	✓	✓	✗	✓	✓
Russia	EXIAR	✓	✓	✗	✗	✓	✓	✓	?	✓	✓
Slovakia	Eximbanka SR	✓	✓	✗	✗	✓	✓	✓	✓	✓	✓
Slovenia	SID Bank	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓

Countries	ECAs/Other govt. agencies	Short- term insurance	MLT export credit schemes	Fixed rate financing (CIRR)	Forex fluctuation cover	Direct lending	Investment insurance	Bond support scheme/ issuance	Unfair calling insurance*	Letter of credit guarantee scheme	Working capital facility
South Africa	ECIC SA	✓	✓	✓	✓	✗	✓	✓	✓	✗	✓
South Korea	K-sure/KEXIM	✓	✓	✓	✓	✓	✓	✓	✓	✗	✓
Spain	CESCE/ICO	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
Sweden	EKN/SEK/ALMI	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
Switzerland	SERV	✓	✓	✗	✗	✓	✗	✓	✓	✓	✓
Taiwan	Eximbank	✓	✓	✗	✗	✓	✓	✓	?	✓	✓
Thailand	Eximbank	✓	✓	✗	✓	✓	✓	✓	?	✓	✓
Turkey	Eximbank	✓	✓	✗	✗	✓	✗	✓	✓	✗	✓
The UK	UKEF	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓
The USA	US Exim Bank	✓	✓	✓	✗	✓	✓	✓	✓	✓	✓

*Note: \* Unfair calling insurance refers to the insurance coverage to protect principals who have issued demand guarantees or bonds against an unfair or abusive call of the bond/guarantee i.e., one which is not truly based on non-performance by the principal.*

*Source: British Exporter's Association and UK Export Finance Annual Benchmarking 2021; India Exim Bank Research*

### **Box 1: TAP Programme of India Exim Bank**

India Exim Bank has launched a new trade facilitation initiative— Trade Assistance Programme. Under TAP, India Exim Bank provides support through credit enhancement to trade instrument(s), thereby enhancing the capacity of commercial banks/ financial institutions to support cross-border trade transactions involving markets where trade lines are constrained or where the potential has not been harnessed, and transactions may not materialise in the absence of such support.

The key objectives of this programme include:

- i) Create an enabling environment for counterparties in settlement of trade transactions;
- ii) Support incremental exports by facilitating access to identified untapped markets;
- iii) Provide market entry mechanism, while enhancing the geographical coverage for exporters, including MSMEs;
- iv) Provide risk coverage for challenging international trade transactions; and
- v) Enable local banks in target countries to establish working partnerships with commercial banks in India.

Under the programme, India Exim Bank, by leveraging its experience and network of alliances, is building a network of partnerships among commercial banks in India and identified overseas banks that can seek risk mitigation support from India Exim Bank.

TAP offers participating commercial banks in India partial or full guarantees to cover payment risk on banks from the emerging markets, and at the same time also facilitates Indian banks in meeting their commitment by fronting their guarantees, to encourage participation of Indian contractors to win/execute project in the overseas market. These credit mechanisms are transaction-specific covering:

- **Standby Letter of Credit:** India Exim Bank issues Stand by Letter of Credit (SBLC) in favour of a bank in India (Confirming Bank), which adds confirmation / negotiates Letter of Credit issued by overseas banks (Issuing Bank), for export of goods/ services from India. Under the SBLC, India Exim Bank undertakes to make payment to the Confirming Bank of the due amount, if the overseas Issuing Bank fails to make payment to the Confirming Bank.
- **Irrevocable Reimbursement Undertaking (IRU):** At the request of overseas Issuing Bank, India Exim Bank issues IRU in favour of commercial bank in India, under LC issued by the Issuing Bank. Under the comfort of IRU issued by India Exim Bank, Indian commercial banks may negotiate the export bills and can submit reimbursement claim with India Exim Bank for settlement.
- **Fronting of Guarantees:** This product is catering to the requirements of Indian companies to cover their performance obligations abroad. Under this product, India Exim Bank issues counter guarantees in favour of overseas banks, to enable them to issue guarantee favouring local bodies, covering project exports of goods/services from India. India Exim Bank issues such counter guarantees against the guarantee issued by Indian commercial banks, on behalf of their constituents in favour of India Exim Bank. Such fronting of guarantees could also be done in favour of Indian exporter/ bank for meeting financial obligations of the importer's bank.
- **Risk Participation:** If a bank/financial institution is not able to partner with the importer's bank, to support a trade transaction, due to insufficient exposure limits on the importer's bank, India Exim Bank may consider sharing of the risk with the confirming/negotiating bank, under a Master Risk Participation Agreement, in select cases. Such risk participation under TAP is done for eligible transactions, covering export of eligible goods/ services from India.

## Support to Small and Medium Enterprises

As discussed earlier, challenges for accessing trade finance are particularly acute in case of SMEs. ECAs have increased their support to the SME segment during the pandemic. ECAs are maintaining high level of engagement in the SME segment in line with the focus of Governments in positioning this segment at the fulcrum of growth in output and employment.

The amount and method of supporting SMEs is wide and varied. In Europe, ECAs continue to develop substantial short-term exposure to non-marketable risks around their small business products. One innovative way in which the Japan Bank for International Cooperation (JBIC) is supporting SMEs is through local currency denominated loans. Many SMEs, when trying to procure local currency funds in developing countries, face the problems of short repayment periods and high interest rates. In order to solve these problems, JBIC extends long-term fixed-rate local currency loans, a preferential measure for SME, and provides co-financing with private financial institutions directly to the local subsidiaries of Japanese companies who are the clients of those financial institutions. Since 2012, JBIC has provided loans in various local currencies including the Thai baht, Indonesian rupiah, Chinese yuan, Mexican peso and Indian rupee.

Export Development Canada (EDC) has long been one of the leading ECAs working to embed SMEs into the supply chains of larger multinational companies, primarily through its untied pull loan programme, which it reports mainly serves Canadian SMEs. EDC participation in financing facilities for key foreign buyers helps create opportunities for Canadian exporters, in particular, small businesses. EDC pairs its financing with matchmaking between Canadian suppliers and foreign buyers.

During the pandemic, several ECAs further enhanced their support for SMEs. For SMEs and mid-tier companies, Bpifrance increased its cover for credit institutions from 80 percent to 90 percent for the entire duration of the COVID-19 pandemic. In addition, Bpifrance made available unsecured 3 to 5-year loans of value from 10,000 euros to 5 million euros for SMEs, with suitable moratorium.

During 2020, SACE (Italy) announced an additional US\$ 5 billion in guarantees to contribute to Italy's plan for the Promotion of Made in Italy. Of this, roughly US\$ 2 billion was allocated for guarantees that would facilitate Italian exporters' access to bank loans, approximately US\$ 2.5 billion was allocated for insurance cover of new credit lines, and about US\$ 600 million for guaranteeing SME support for new business in emerging markets in South America, Africa and the Middle East.

India Exim Bank also launched the Ubharte Sitaare Programme to identify and nurture future export champions in the MSME sector. Typical export credit and trade finance products may not be sufficient for MSMEs to fulfil their export aspirations, and they require across-the-board financing and advisory support to realise their potential. Recognising the constraints faced by small and mid-sized companies in realising their export ambitions, the Government of India announced the Ubharte Sitaare Programme (USP) to be anchored by the India Exim Bank together with the Small Industries Development Bank of India. The programme aims to identify Indian companies that can emerge as future export champions. The identified Indian company should have potential advantages by way of technology, product or process, but may currently be under-performing or lacking the ability to tap their latent potential to emerge bigger. The programme helps companies realise their full potential through a mix of structured support, both financial and advisory services, including (a) investments in equity / equity like instruments; (b) debt (funded and non-funded facilities) at competitive rates and elongated tenors; and (c) technical assistance (including advisory services, grants and soft loans). Under the programme, an Alternative Investment Fund, christened 'Ubharte Sitaare Fund' has also been launched, to identify and invest in small and mid-size ventures with good export potential, by way of equity and equity like products. The programme has gained significant traction despite the pandemic associated disruptions.

Clearly, ECAs have significantly expanded their horizons, focusing not just on the high value project exports, but also on the relatively lower value exports from the SME segment. Both these segments characterised by high risks are important for driving growth. ECAs through their support to these segments are providing much needed support to businesses and national economies.

## MULTILATERAL DEVELOPMENT BANKS

Multilateral Development Banks have set up several programmes which provide risk mitigation capacity (guarantees) to both issuing and confirming banks and allow for rapid endorsement of letters of credit— the main instrument used to finance trade transactions. The demand for trade finance support from MDBs witnessed an increase in the light of COVID-19, and accordingly the major MDBs enhanced their support towards trade finance (Box 2).

### **Box 2: Support by Multilateral Institutions for Trade Finance During the COVID-19 Pandemic**

In July 2020, the heads of the World Trade Organization, International Finance Corporation (IFC), European Bank for Reconstruction and Development (EBRD), Asian Development Bank (ADB), African Development Bank Group, International Islamic Trade Finance Corporation, and the Inter-American Development Corporation (IDB Invest) released a joint statement promising to address shortages in trade finance, given the financial market stresses arising from the COVID-19 crisis. They also urged other institutions to join their ongoing efforts to provide vital financing support for cross-border trade. Some of the initiatives taken by the multilateral development banks for trade finance since the onset of the crisis include:

- IFC launched a US\$ 6 billion trade and working capital finance initiative, comprising US\$ 2 billion from each of the Global Trade Liquidity Program/Critical Commodities Finance Program and the Working Capital Solutions program and US\$ 2 billion from the existing US\$ 5 billion of Global Trade Finance Program.
- ADB ramped up its US\$ 2.45 billion trade and supply chain programs as part of the US\$ 20 billion comprehensive support package to assist its developing member countries in their fight against COVID-19.
- The EBRD launched two Solidarity Packages for a massive increase in trade finance support. In the first 5 months of 2020 alone, the EBRD provided amplified financing for trade of record € 1.5 billion.



- The African Development Bank (AfDB) earmarked up to US\$ 1 billion in trade finance liquidity and risk mitigation support to local banks in all 54 eligible African member countries.
- The International Islamic Trade Finance Corporation launched a US\$ 850 million intervention, as part of the Islamic Development Bank Group's US\$ 2.3 billion COVID-19 economic recovery program.
- IDB Invest committed to increase its guarantee and lending program by US\$ 1.5 billion for a total of US\$ 3 billion under the Trade Finance Facilitation Program.

*Source: Asian Development Bank (2022), Toward Inclusive Access to Trade Finance: Lessons from the Trade Finance Gaps, Growth, and Jobs Survey*

## **Trade Finance Facilities of Major MDBs**

The trade finance programmes of multilateral development banks have substantial benefits for trade and overall growth in developing countries, without entailing any concomitant cost for the taxpayers. These are private sector based, demand-led programmes, with a special focus on clients in developing countries, particularly the poorest and marginalised ones. Not only are these programmes serving their mandate of facilitating trade from the remotest regions of the world and meeting the aim of financial and trade inclusion, most of them are also financially viable and registering net operating profits.

### European Bank for Reconstruction and Development

Trade Facilitation Programme of EBRD began in 1999 with the aim to promote foreign trade to, from and amongst the EBRD countries of operations. A range of products are offered under the programme to facilitate trade from and within Central and Eastern Europe, the Commonwealth of Independent States, and the Southern and Eastern Mediterranean region. Under the programme, the following instruments issued or guaranteed by participating banks may be secured by guarantees:

- Documentary letters of credit; trade-related standby L/Cs from issuing banks; deferred payment L/Cs; and L/Cs with post-financing advance payment bonds and payment guarantees

- Bid and performance bonds and other contract guarantees
- Trade-related promissory notes or bills of exchange

Trade financing by the EBRD remained strong in 2021, with 1,883 trade deals worth € 3.2 billion completed under the Trade Facilitation Programme, down just slightly from the record 2,090 transactions worth € 3.3 billion completed in 2020, when the Bank stepped up trade support in response to the COVID-19 crisis.

### International Finance Corporation

The Global Trade Finance Program (GTFP) of the IFC is available for emerging markets across all regions. In markets with limited availability of trade lines, the GTFP enhances the capacity of banks to provide trade finance by offering risk mitigation. The GTFP provides transaction-specific guarantees for:

- letters of credit
- trade-related promissory notes and bills of exchange
- bid and performance bonds
- advance payment guarantees
- supplier credits for the import of capital goods

In addition, IFC provides funding to banks for short term pre-export financing. Technical training is also provided to issuing banks under the programme, with the aim to transfer international best practices in trade finance to local markets, upgrade the operational and technical skills of trade finance back offices, improve trade finance risk mitigation techniques, and upgrade skills in structuring trade finance transactions.

As of end of FY20, the GTFP has covered over 68,000 trade transactions and supported over US\$ 66.5 billion in emerging market trade, without a single loss since inception in 2005. In FY21, IFC had a commitment of US\$ 6 billion in trade finance, more than half of which was committed in International Development Association (IDA) countries and fragile and conflict-affected situations. In fiscal 2022, IFC's commitments reached US\$ 9.7 billion in

trade finance, the highest level ever; nearly 75 percent of which was in IDA countries and countries affected by fragility, conflict, and violence<sup>50</sup>.

### Asian Development Bank

The Trade and Supply Chain Finance Program (TSCFP) of the ADB supports trade transactions in various markets of Asia through its network of over 200 partner banks. A significant portion of the support is extended to SMEs, and for intra-regional transactions. In 2021, TSCFP's trade finance business supported 6,800 transactions worth a total of US\$ 8 billion, including US\$ 5.4 billion in co-financing, and helped 2,858 small and medium-sized enterprises, and 2,300 trades between developing Asian countries<sup>51</sup>.

Credit Guarantee product of the programme covers up to 100 percent of bank risk, and accounts for nearly 75 percent of the total portfolio of the programme. The Risk Participation Agreement offered under the programme provides a sharing of 50 percent of bank risk in support of trade transactions. Under a Risk Distribution Agreement, the ADB enters into agreements with insurers, export credit agencies, and other entities developing credit appetite in ADB Trade Finance Programme countries, with the purpose of distributing and sharing Issuing Bank risk with them to leverage capital resources and credit limits. Apart from these risk mitigation products, a Revolving Credit Facility provides loans to banks for supporting pre and post shipment transactions. Knowledge products and dissemination of knowledge are also crucial areas for the programme.

### Inter-American Development Bank Group

The trade finance facilitation programme (TFFP) of IDB was launched in 2005 for supporting the access of trade finance for Latin American and Caribbean countries (LAC) through guarantees, loans, technical cooperation and knowledge creation. The programme aims to strengthen trade finance support, thereby facilitating the region's integration in global and intraregional supply chains.

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<sup>50</sup> IFC Annual Reports 2021 and 2022

<sup>51</sup> ADB

Credit Guarantees are issued in favour of banks to cover commercial and political risks on the eligible trade instruments issued by the issuing banks. Coverage of up to 100 percent is provided for the following eligible instruments:

- Documentary and standby letters of credit
- International guarantees (bid, performance, etc.)
- Promissory notes
- Banker's acceptances
- Bills of exchange

Bilateral and syndicated loans are also provided to LAC borrowers for financing international trade portfolio. Import and export loans originated by the borrower for 180 days prior and/ or 90 days after the disbursement date are provided.

Since 2005 through October 31, 2020, the TFFP facilitated a total of 16,596 underlying transactions of trade finance in LAC for approximately US\$ 12.3 billion in value<sup>52</sup>.

### African Development Bank

In response to the Global Financial Crisis, the AfDB had launched the Trade Finance Initiative, which was rechristened as the AfDB's Trade Finance Program in 2013. The programme aims to reduce the trade finance gap in the African continent by "crowding in" global banks and strengthening local financial institutions. Emphasis is also placed on promotion of regional integration.

AfDB's trade finance programme consists of three major products—risk participation agreement, trade finance line of credit, and soft commodity finance facility. Under the risk participation agreement with confirming banks, AfDB typically takes a 50 percent risk share. The trade finance line of credit are short-term lines of credit which are offered to financial institutions in

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<sup>52</sup> 15 years of Trade Finance Facilitation Program (TFFP), IDB Invest

Africa to facilitate their trade finance operations. The soft commodity finance facility is targeted at commodity aggregators and export marketing agencies for soft and agri-based commodities.

### Islamic Trade Finance Corporation

The International Islamic Trade Finance Corporation (ITFC) was created within the Islamic Development Bank Group for promoting trade in the Islamic countries. Beginning operations in 2008, the ITFC streamlined trade financing by confirming letter of credit and eliminating the need for using intermediary banks. By removing intermediaries, it also aimed to reduce trade costs.

Since 2008, ITFC has provided US\$ 61.4 billion to Organisation of Islamic Cooperation (OIC) member countries, making it the leading provider of trade financing in these markets. Despite several challenges caused by COVID-19, the ITFC approvals and disbursements in 2021 reached new heights of US\$ 6.5 billion and US\$ 5.1 billion, respectively<sup>53</sup>. In addition, as part of the recovery response phase, a total of US\$ 763 million was approved in 2021 as contribution to the Islamic Development Bank Group's US\$ 4.67 billion response package to help member countries contain and mitigate the impact of COVID-19 and achieve sustainable recovery.

Many of the aforementioned trade finance programmes had started much before the crisis of 2008, but the post-crisis period and the pandemic period more recently has seen significant increase in the lending limits and resources of several programmes. This has helped trade financing in emerging markets and SMEs, and promoted inclusive financing. Several of the MDBs with regional focus have also imparted a fresh resonance to intra-regional trade through their trade finance programmes.

## **CONCLUSION**

Trade finance plays a crucial role in facilitating global trade by providing the necessary financial instruments to ensure transactions between buyers and

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<sup>53</sup> Annual Development Effectiveness Report 2021, ITFC

sellers can take place securely and efficiently. The role of ECAs, MDBs and DFIs in the global trade finance market has gained salience during periods of crisis. As the global economy continues to face uncertainty and challenges, the role of ECAs, MDBs, and DFIs is likely to become even more important in ensuring the stability and growth of the trade finance market. It is essential for these institutions to continue to adapt to changing circumstances and to work closely with other stakeholders to develop innovative solutions that address the evolving needs of the global trade finance market.

## 5. Way Ahead

Trade finance plays a vital role in facilitating international trade transactions, but faces several challenges, as noted earlier in the Study. As highlighted in the previous chapter, MDBs, ECAs and DFIs are playing a crucial role in alleviating some of the challenges and facilitating trade finance. These institutions are providing the necessary support to facilitate cross-border trade transactions through financial assistance and risk mitigation instruments.

The present chapter focuses on the various strategies that could be adopted by countries individually and collectively for bridging the trade finance gaps. The chapter delves into areas where the G20 countries could collaborate including harmonisation of compliance standards for improving access to finance for all businesses, particularly MSMEs; leveraging automation and digitalisation for reducing regulatory burdens and transaction costs; enhancing collaboration among ECAs; exploring alternative trade financing; creating a trade finance facility; and bridging the data gaps.

### ESTABLISHING HARMONISED KYC STANDARDS

Banks' inability to distinguish between legitimate and fraudulent transactions is a major factor for failed cross-border payments, as banks may not be able to conduct required due-diligence. While there are several reasons for the frictions in cross-border payments, including fragmented and truncated data formats, the complex processing of compliance checks, legacy technology platforms, among others<sup>54</sup>, lack of uniformity in due diligence process across different jurisdictions can be an immediate action area for minimising impediments to cross-border payments.

<sup>54</sup> Finextra (2022), When KYC is the reason for cross-border payment failure and how to fix it?

The pandemic and restrictions on movement of individuals have led countries around the world to swiftly adopt e-KYC. However, currently, several forms of e-KYC models are being adopted across the world. While India and Germany have adopted the Video-based Customer Identification Process (V-CIP), countries like Hong Kong, Malaysia and the EU, for example, are using the 'Identity Authentication and Matching Model'. The V-CIP is a method of customer identification with facial recognition and customer due diligence by an authorised official of the regulated entity through an audio-visual interaction with the customer to obtain identification information required for customer due diligence purpose, and to ascertain the veracity of the information furnished by the customer through independent verification and maintaining audit trail of the process. The Identity Authentication and Matching Model, on the other hand, requires that the technology adopted for remote onboarding purposes should cover both identity authentication/verification and identity matching (e.g. facial recognition, liveness detection). The upside of the latter model, which relies on identity documents plus liveness detection, is its relative flexibility as it results in a broad ecosystem of solutions that is not prone to any one attack that could work across the whole financial system. A downside would be the uncertainties that relatively vague requirements cause for responsible compliance teams that want to adopt innovative new technologies.

The varying national requirements for conduct of enhanced due diligence and the inconsistencies in the quality of information obtained from the different e-KYC standards can be challenging for trade finance and trade. In order to strengthen cross-border exchange of financial services including trade finance, the G20 countries can collaborate to harmonise e-KYC standards. Establishing consistent e-KYC standards would help ease the screening and risk assessment requirements, and in turn reduce administrative processes and lower costs.

## **LEVERAGING DIGITALISATION**

Digitalisation can help with issues like information asymmetry, regulatory compliance, and process inefficiencies in trade and trade finance transactions. Electronic trade documentation and automation can boost process efficiency



by expediting transactions and reducing human error. Big data, AI, and distributed ledger technologies can be used to confirm a company's identity and financial standing, enabling banks to more efficiently adhere to regulatory requirements like AML/KYC regulations. Businesses and banks that are digitally connected to one another would also have lower fixed operational costs, which may encourage the participation of smaller companies and finance providers. There are four potential areas of collaboration that the G20 can explore in order to leverage digitalisation for bridging trade finance gaps viz. adoption of the legal entity identifier (LEI); harmonising reporting standards; adoption of the Model Law on Electronic Transferable Records; and bridging the digital divide.

### **Adoption of the Legal Entity Identifier (LEI)**

Reliable counterparty identification is essential for international trade operations and makes it simpler to adhere to AML and KYC procedures. The need for trustworthy counterparty identification has been acknowledged at the G20 level. The FSB was requested by the G20 to make proposals for a Global Legal Entity Identifier (LEI) and a supporting governance framework in the wake of the 2008 global financial crisis. The regulators in G20 countries then accepted the LEI as a way to identify counterparties in over-the-counter derivatives markets.

The LEI is a worldwide unique identifier based on the ISO standard 17442. The LEI has well surpassed its original applications in the futures and securities markets and is now being used to identify stakeholders in any financial transaction. The LEI improves interoperability in digital finance applications and payments by providing legal organisations with a global, digital identity.

Given that it is an open and non-proprietary standard, it can enable more efficient counterparty identification and verification on a global level by offering a globally recognised identifier combined with crucial entity data, rigorous verification processes, and high data quality, which helps increase transparency and traceability.

There are currently more than 200 jurisdictions with at least one registered LEI. However, the adoption of LEI has been uneven around the world, and even among G20 countries. While countries like the USA, China, India, Germany, Italy, Spain and France have significantly high numbers of active LEIs, several other G20 countries such as Brazil, Argentina, Mexico, South Africa, Indonesia, South Korea, Saudi Arabia and Türkiye, have relatively much lower number of active LEIs, as of March 8, 2023. The G20 could work together to further strengthen LEI as a global identification standard for financial transactions. Bolstering the role of the LEI as the global standard for entity identification and verification for cross border transactions can simplify procedures and increase transparency and traceability for trade finance.

The G20 could also collaborate to help reduce or eliminate the costs associated with obtaining the LEI for businesses. Obtaining and maintaining an LEI costs businesses nearly US\$ 50 to US\$ 220 annually, depending on the fees in a particular jurisdiction<sup>55</sup>. There are instances where the LEI Issuing Organisations (LOUs) do not charge a fee for the LEI registration, such as the LOU with its headquarters in China, the China Financial Computerization Corporation. Such model can be promoted by the G20, for ensuring greater adoption of the LEI.

## **Harmonising Reporting Standards**

Harmonising reporting standards also remains an unfinished agenda that requires global cooperation. The FSB 'Report on Market Fragmentation' (June 2019) noted that while there has been progress in harmonising standards for data fields by standard-setters e.g. the LEI, more efforts are needed to implement standards to obtain comparability of information to allow data aggregation and to streamline reporting processes. Harmonised reporting standards would be important for the use of artificial intelligence and big data in trade finance transactions.

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<sup>55</sup> B20 Italy (2021), Trade Finance, a flywheel effect to boost the economic recovery post COVID-19 pandemic

## Promote the Adoption of MLETR

Technology by itself may not be sufficient to enable trade digitalisation. A harmonised legislative reform and common standards, including from invoicing to financing product, from identity to security, are vital enablers of digitalisation of trade and trade finance. Adopting uniform documentation standards for the import, export, and transit of goods could present a significant opportunity for enterprises involved in international trade to tackle documentation related non-tariff barriers and thereby ease their access to foreign markets. Processes and systems communicate with one another more efficiently in the presence of a simpler and more harmonised digital environment, which not only reduces the overall time taken in trade and trade finance but also significantly reduces the associated cost. To that end, the adoption of the UNCITRAL's MLETR or its equivalent legislation could foster an atmosphere that is smooth for the electronic interchange of documents.

As noted in the previous chapter, the adoption of the UNCITRAL's MLETR is currently limited. Among the G20 countries, the UK and the USA have introduced legislations that are MLETR-equivalent. In the UK, the Electronic Trade Documents Bill (2022), which seeks to formally recognise digital trade documents, has already been introduced in the Parliament and will become law after it has been approved by both the House of Lords and the House of Commons. Likewise, the USA's Amendments to the Uniform Commercial Code of the United States (ULC 2022) were also approved in 2022. Amendments stipulate rules for electronic negotiable instruments, which will allow the use of promissory notes and bills of exchange in electronic form, and update terminology to account for electronic signatures and digital documents, among others<sup>56</sup>.

Nevertheless, other G20 countries are yet to adopt similar measures to harmonise digital documentation. The G20 could actively promote an increased usage and acceptance of digital documentation relevant to cross border exchanges by encouraging the alignment of national laws and legal frameworks to the MLETR, consistent with other international standards.

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<sup>56</sup> ADB (2022), Driving Inclusive Digitalization in Trade and Trade Finance

The alignment should address documents of transport, bills of lading, bills of exchange, promissory notes, and warehouse receipts, among others. Such cross-border alignments can further boost digitalisation of trade finance.

## **Bridging the Digital Divide**

Enabling businesses and financiers to make use of the digital economy allows for better resource allocation, boosts productivity and makes growth more inclusive. For enterprises, especially those in developing nations, new digital technologies such as Cloud Computing, Blockchain and Distributed Ledger Technology (DLT), Big Data, Artificial Intelligence, Robotics, and the Internet of Things (IoT), and a robust digital infrastructure presents unparalleled opportunities to access international markets and manage supply chains cost-effectively. These technologies also have the potential to narrow the trade financing gap in developing countries. However, advanced technologies such as AI, blockchain and DLT, and IoT require the development of ICT infrastructure and wireless technologies to enable continuous connectivity. Successful and uniform adoption of digitalisation in trade and trade finance would therefore require bridging the digital divide by building capacity and strengthening the digital infrastructure, to help increase the adoption of digitalisation and paperless trading among businesses. According to a recent joint study by the IOE-ILO-KAS<sup>57</sup>, the absence of digital infrastructure and insufficient digital competences are the main barriers preventing enterprises, particularly SMEs, from taking advantage of the opportunities presented by digitalisation.

It would therefore be important to close the digital divide in terms of access, bandwidth, and skills. In this regard, collaborative efforts among developed and developing countries for enhancing investments for augmenting digital infrastructure, and technological and organisational know-how would be critical.

Policies that lower barriers to broadband deployment and help communication operators make investments more easily and affordably would be important

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<sup>57</sup> ILO (2021), Small goes digital: How digitalization can bring about productive growth for micro and small enterprises

drivers of upgrading and expanding communication networks and closing connectivity gaps. One approach for developing countries to incentivise such investments would be through reduction in network deployment costs. This could be done by increasing the speed of deployment through a reduction in the network approval and construction times. When deploying communication networks in the last mile, rights of way are essential. Many G20 nations are already aiming to streamline rights of way, in particular with respect to the deployment of 5G networks which, in many cases, require installing a large amount of small cells across countries<sup>58</sup>. For instance, the USA's Federal Communications Commission issued an Order titled, "Accelerating Wireless and Wireline Broadband Deployment by Removing Barriers to Infrastructure Investment," which was adopted in September 2018. The decision concerns the amount that municipalities may reasonably charge for small cell deployment. Likewise, in 2020, the European Commission adopted the regulation specifying the physical and technical characteristics of small cells for 5G networks within the EU<sup>59</sup>. In India, the Rights of Way application procedure for deploying small cells has been simplified and allows service providers to use street infrastructure to deploy the network at a nominal cost. These initiatives could serve as a learning template for other countries to enhance their digital connectivity.

It would also be important for developing country DFIs, commercial banks and other financial institutions to collaborate with their counterparts in the developed countries for financing projects related to enhancing digital connectivity as also for leveraging technology solutions for digitalising trade and trade finance.

Recognising the increasing global significance of digitalisation, the G20 created the G20 Digital Economy Working Group in 2022, to streamline the digital issues of other working groups under the G20 and generate a stronger commitment to discussing and resolving issues related to digitalisation. Continuing on these efforts, the G20 as well as multilateral institutions should become a driving force for enhancing global investment to build quality

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<sup>58</sup> OECD (2021), Bridging digital divides in G20 countries

<sup>59</sup> Ibid.

and affordable digital infrastructure<sup>60</sup>. The G20 would also need to promote platforms to stimulate network-development and connectivity, leveraging cross-industry exchanges of best practices and making available mentorship programmes. The G20 countries would need to also significantly scale up and enhance coordination of existing trade-related capacity-building programmes to bridge digital skill gaps including in the financial services sector.

## **COLLABORATION AMONG DEVELOPMENT FINANCE INSTITUTIONS**

MDBs, ECAs and DFIs have contributed significantly to the facilitation of trade finance for underserved markets and players. Their strong financial standing enables flow of additional funding and guarantees to lower transaction risks for commercial banks and support trade transactions for enterprises that are otherwise unattractive for private lenders to support. The role of MDBs, ECAs and DFIs in supporting trade finance has been even more crucial during economic downturns and crises like the COVID-19 pandemic, as highlighted in the previous chapter.

The support from these institutions would be critical to help improve access to trade finance and close trade finance gaps, particularly for SMEs. According to the ADB Trade Finance Survey 2021, nearly 25 percent of respondent firms believed that the intermediating capacity of banks and development finance institutions could help create SME trade-financing guarantee schemes, which could help smaller firms overcome regulatory hurdles and constraints they encounter when seeking financing. Meanwhile, nearly 24 percent of the respondent firms thought that collaboration among national, regional and multilateral institutions could be instrumental in expanding access to technology-based financing platforms, especially for SMEs and women-owned businesses. Clearly, the support from these institutions will remain critical for supporting trade finance transactions till the time alternative local capacities can be augmented.

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<sup>60</sup> ADB (2022), Driving Inclusive Digitalization in Trade and Trade Finance

As discussed in the previous chapter, ECAs across the world are enhancing their focus on project finance. Large size of financing requirements in projects often makes it difficult for a single lender to finance the entire project on its own. Further, globalisation has also made projects increasingly depend on multi-country sourcing of goods and services. Considering these aspects, collaboration among MDBs, ECAs and national DFIs can meet the growing infrastructure requirements, while concomitantly sustaining trade flows in a period of declining merchandise trade. There has been substantial increase in such co-financing transactions by MDBs, ECAs, and national DFIs.

One such collaborative coincidental financing of project was undertaken in the case of Itezhi - Tezhi Hydro Power Project in Zambia, which involved the development, construction, operation and maintenance of a 120 MW base load hydro power plant. This was a first-of-a-kind public private partnership in the power sector of Zambia, wherein several development finance institutions such as the AfDB, the European Investment Bank, Development Bank of Southern Africa, Dutch development bank FMO, India Exim Bank and French development financial institution PROPARCO, came together to finance the project. Although coincidental in nature, the project is an insignia of converging interests of development financiers towards co-financing arrangements. Another example of co-financing is the Nikachhu Hydro Power Project in Bhutan, wherein part funding of the debt portion of the project was through low cost and long tenure financing from the ADB, and the remaining project debt was raised by a consortium of State Bank of India and India Exim Bank.

More such collaborations in terms of co-financing/ parallel financing could be envisaged by MDBs, ECAs and DFIs, to meet the financing needs for development projects in partner countries, and in turn create project export opportunities for companies. Such financing would also help these institutions manage their country-specific exposure limits.

According to the US Exim Competitiveness Report 2021, all G7 ECAs have co-financing framework agreements with each other and increasingly with a wider scope of ECAs that includes non-OECD ECAs. On similar lines, the G20

ECAs could also enter into such co-financing arrangement among themselves. Support may also be required from the G20 governments to make the co-financing approach effective, by aligning the differences in funding structures and cost of fund among their MDBs/ DFIs.

Another way in which ECAs, MDBs and national DFIs can collaborate is through information sharing and creation of an enabling environment for financing. All institutions face challenges in terms of financing projects which may originate on account of regulatory issues, structural challenges, public sector inefficiencies, etc. Structural exchange of information can reap substantial benefits for these institutions. These institutions can also collaborate in the sphere of creation of bankable projects through initiatives such as project preparation facilities.

Further, MDBs, ECAs and DFIs can also collaborate through creation of liquidity pools. The COVID-19 pandemic saw a drying up of liquidity with the impact being particularly adverse in case of small firms and smaller geographies. Establishment of targeted liquidity pool by MDBs, national DFIs and ECAs can help ensure that adequate funds are available to SMEs, new exporters and firms in smaller geographies during times of contraction in liquidity and credit.

Brahima Sangafowa Coulibaly and Eswar Prasad (2021) proposed the creation of a new global liquidity insurance mechanism to fill the gap in systematic provision of foreign exchange liquidity among a broader set of countries. Under this, each country would pay a modest entry fee, depending on its economic size to provide an initial capital base for the GLIM. The country would then pay an annual premium depending on the level of insurance desired, as also on the quality of its policies based on simple and transparent rules. The initial contribution and the annual premiums would be invested in government bonds of countries such as the USA, EU, UK, Japan, and China. In return, the central banks of those countries would be obliged to backstop the pool's lines of credit in the event of a global crisis. The insurance payout would be in the form of a credit line open for one year, rather than an outright grant, with the interest rate based on the yields on short-term



government securities in the countries backstopping the insurance pool<sup>61</sup>. The G20 can consider such mechanisms for a more robust and resilient global financial system.

## ALTERNATIVE TRADE FINANCING

Alternative finance players are increasingly providing direct matching mechanism between borrowers and lenders through platforms such as peer-to-peer lending, crowdfunding and invoice trading for trade finance. Going forward, the role of Fintechs and alternative finance providers will be crucial in bridging the trade finance gaps. Fintech companies seek to supplement the existing pool of bank intermediated trade finance. Partnerships among DFIs, banks and Fintechs can help drive efficiency and improve the capacity of financial systems to extend trade finance.

One area where such collaboration can be fostered is supply chain financing (SCF). The Global SCF Forum defines SCF as the “use of financing and risk mitigation practices and techniques to optimise the management of working capital and liquidity invested in supply chain processes and transactions”. Supply chain finance is basically a set of solutions that optimises cash flow by allowing businesses to lengthen their payment terms to their suppliers while providing the option for their suppliers to get paid early<sup>62</sup>.

Fintechs can supplement conventional sources of trade financing, mostly banks, by using digital interfaces and electronic invoice systems. SCF solutions provided by fintechs can be an alternative to bank-intermediated financing. They are built on inter-firm open account trading and allow suppliers to raise money based on the creditworthiness of the business at the top of the supply chain while a third party bridges the gap for early payment. A fintech SCF streamlines the supply chain’s access to working capital by using an online portal and accounting software.

Fintechs also access the securitization markets for SME financing. SMEs can utilise the technology platforms of fintechs to sell their trade receivables. As

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<sup>61</sup> Brahim Sangafowa Coulibaly and Eswar Prasad (2021), A new proposal for the G20 to strengthen the global financial safety net, European Financial Review, September 22, 2021

<sup>62</sup> IMF (2019), Statistical Coverage of Trade Finance – Fintechs and Supply Chain Financing

intermediaries, fintechs select and structure eligible receivables, and match them with investors. Such securitization could enhance the financial base by enabling risk-transfer from banks to a wider pool of investors beyond the banking sector<sup>63</sup>.

SCF products have the potential to improve the prospects for millions of entrepreneurs who are held back by a lack of fixed collateral and limited offerings of appropriate credit products by financial institutions. Owing to its unique structure, SCF enables suppliers to larger customers to receive faster payment of invoices raised via a finance facility that is supported by using the strength of the buyer's business as security for the lender, making it a win-win situation for all parties. Yet, financial institutions in many emerging economies find it difficult to offer the SCF products because of lack of financial infrastructure, technological capability, resources, and awareness<sup>64</sup>. To that end, MDBs and DFIs can be instrumental in narrowing this funding gap.

MDBs around the world already use partial credit guarantees for private lenders to originate, fund and collect credit. These institutions can further catalyse financial institutions' use of supply chain finance to support small and medium-sized enterprises in several ways. Firstly, MDBs and DFIs could develop and operate multi-funder, blended finance platforms to incentivise the participation in SCF of lenders who may otherwise be unable or unwilling to develop their own SCF programme. This can be particularly helpful in developing countries where the penetration of SCF is currently low. These institutions can be the central stakeholder to launch SCF initiatives, facilitating and promoting the SCF ecosystem more efficiently in these countries<sup>65</sup>.

Besides, these institutions could also initiate dialogue with regulators and policy makers to develop the enabling framework for SCF, and advise and support commercial banks in developing new products. Among other things, national DFIs and MDBs can support legal, regulatory and policy frameworks,

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<sup>63</sup> Ibid.

<sup>64</sup> World Bank (2021), Supply chain financing: An effective way for development banks to support small entrepreneurs

<sup>65</sup> Ibid.

and provide technological platforms, supply-level advisory and demand-level awareness building. This may include supporting the development of secured transactions and factoring laws, publicity systems and public registries, enforcement of rights transferred via purchase/assignment of receivables, e-invoicing strategies, e-signatures, know-your-customer compliance processes, and clear guidelines for SCF multi-funder programmes<sup>66</sup>.

DFIs of several G20 countries are already undertaking SCF-related interventions in collaboration with the private sector. For instance, Mexico's Nacional Financiera (NAFIN) is offering reverse factoring services to SMEs through a public sector-led online platform and its "Cadenas Productivas" financing initiative. Likewise, Argentina's Bank for Investment and Foreign Trade's (BICE) "e-Factoring" product aims to foster integration between SME suppliers, large companies and financial intermediaries, strengthening long-term links by creating productive chains that improve competitiveness<sup>67</sup>. At the multilateral level, IDB Invest, a member of the Inter-American Development Bank Group, has also unveiled a joint effort with the Mexican Business Council that seeks to develop reverse factoring lines of credit for up to 30,000 small and medium enterprises affected by the COVID-19 pandemic.

Some ECAs and DFIs are also enhancing their focus on factoring services for MSMEs. For example, India Exim Bank is launching a factoring subsidiary in the GIFT City in Gandhinagar, Gujarat. The Bank has also signed a Master Agreement with RXIL Global IFSC Ltd. (RXIL Global), to finance exports receivables through the International Trade Financing Services (ITFS) platform situated in GIFT City. The ITFS is an initiative of the Government of India to build an electronic platform for facilitating trade financing for exporters and importers by providing access to multiple financiers.

Other MDBs and DFIs could learn from the experiences of these institutions for tailored solutions for segments such as MSMEs where the trade finance gap is particularly large.

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<sup>66</sup> Ibid.

<sup>67</sup> Ibid.

## TRADE FINANCE FACILITY

As noted in Chapter 2, trade finance is a relatively low-risk asset class. In spite of the relatively low default rates and high recovery rates, commercial banks across the world consider trade finance business to be fraught with wide array of risks viz., payment risk, political risk, commodity risk, currency risk and production risk. Under such circumstances, risk mitigation instruments are crucial for catalysing private finance from commercial banks and non-bank financial institutions. Demand for risk mitigation instruments has grown manifold over the recent years, as they reduce the risk aversion of operations in developing countries by closing the gap between the actual level of risk and its perception. Several MDBs provide such facilities which ensure that the bank accepting to confirm an L/C will be paid even if the issuer defaults. However, availability, adequacy and size of risk mitigation instruments are currently not as per the demand. Moreover, there are several risks such as those associated with currency, which may emerge as less easy and more costly to hedge. Clearly, there is need for innovative solutions to address the challenges posed by heightened risks in an increasingly volatile world.

National DFIs and ECAs from developing countries, with support from MDBs can explore the prospects for a trade finance facility to enhance the access to trade finance by companies and banks from participating countries. While many MDBs already have risk mitigation instruments, the scope and reach of such instruments can be significantly enhanced with the involvement of national developmental agencies. These facilities can be established at the regional level, and can provide non-funded guarantee to enhance the international confirming banks' appetite for dealing with local issuing banks by substitution of risk from the local bank to the facility. The facility can also extend trade finance loans, structured around a company's trade cycle period—starting from the import/ purchase of raw materials to the receipt of sale proceeds. Loans can be provided against evidence of invoices/ trade activity. For example, payment obligations in intermediation instruments such as L/Cs and bills may take time to discharge. Banks may discharge such obligations ahead of time based on a straight discount basis, with discount rate based on the market price of the obligation party. The facility can also

provide training and capacity building support to banks. Further, a subsidy can be provided by the respective Governments to cover the cost of compliances which may be associated with on-boarding of banks.

Existing trade finance facility such as the OPEC Fund for International Development's (OFID) Trade Finance Facility, already provide a host of such funded and non-funded trade finance products for developing countries. OFID's Trade Finance Facility aims at facilitating trade activities and addressing working capital requirements of firms in developing countries. Under the facility, products such as import-, export- and pre-export financing, warehouse receipt financing, working capital finance and non-funded risk participation are available to Governments, private entities, commercial banks, regional DFIs and any other institution which is active in OFID partner country.

To further enhance the availability of trade finance products, such dedicated trade finance facilities can be formed through cooperation amongst the G20 countries. The facility will be especially beneficial in case of countries that have seen a precipitous decline in correspondent banking relationships.

## **MITIGATING DATA GAP IN TRADE FINANCE**

Currently, there is not yet a single, comprehensive source for data on international trade financing, though information on the amount and composition of trade finance transaction by type, as well as other trade finance information at an aggregated level are periodically published by major market participants. These organisations include the SWIFT, the International Union of Credit and Investment Insurers (Berne Union), Factoring International, and the International Credit Insurance & Surety Association etc.

Although trade finance metrics have progressed over the years, there still remains considerable scope for improvement, particularly in terms of consistent and uniform availability of trade finance data. While the availability of survey-based data provides practical information on trends, these only gives a partial glimpse of the trade finance market. The absence of a globally consistent and comprehensive set of trade finance statistics

makes it difficult to undertake granular analysis of trade finance trends and gaps, which would be crucial for policy prescription. Innovations in the trade finance market also raise the challenge of measuring new financial instruments routed through digital channels. Therefore, collaborative efforts at the national and international levels to create timely, official trade finance statistics is imperative. This can also offer essential insights to support and facilitate early warning analysis of potential liquidity crises. In this regard, G20 countries could collaborate for promoting compilation and research on trade finance data, in order to monitor the actual level of trade finance, as also improve trade finance policy design and operation for more inclusiveness.

## **CONCLUSION**

Global trade finance gaps have been exacerbated due to the heightened global uncertainties in the recent years. The gaps have emerged not just from the dearth of liquidity in the system, but also from the stringent regulations and compliances over the years. The financial sector has responded to this by reducing exposure to firms and geographies which are small and have higher risk perception. The response of MDBs and ECAs, as highlighted in the Study, has been pivotal in restoring balance, and financing transactions which would otherwise not have been financed. Going forward, inter-governmental collaboration among countries, including the G20 countries, as well as the interventions by the MDBs, ECAs and national DFIs will be crucial in bridging the trade finance gap, as also in catalysing private finance. Alongside, leveraging emerging technology will also be crucial to augment the availability and reduce the cost of trade finance.

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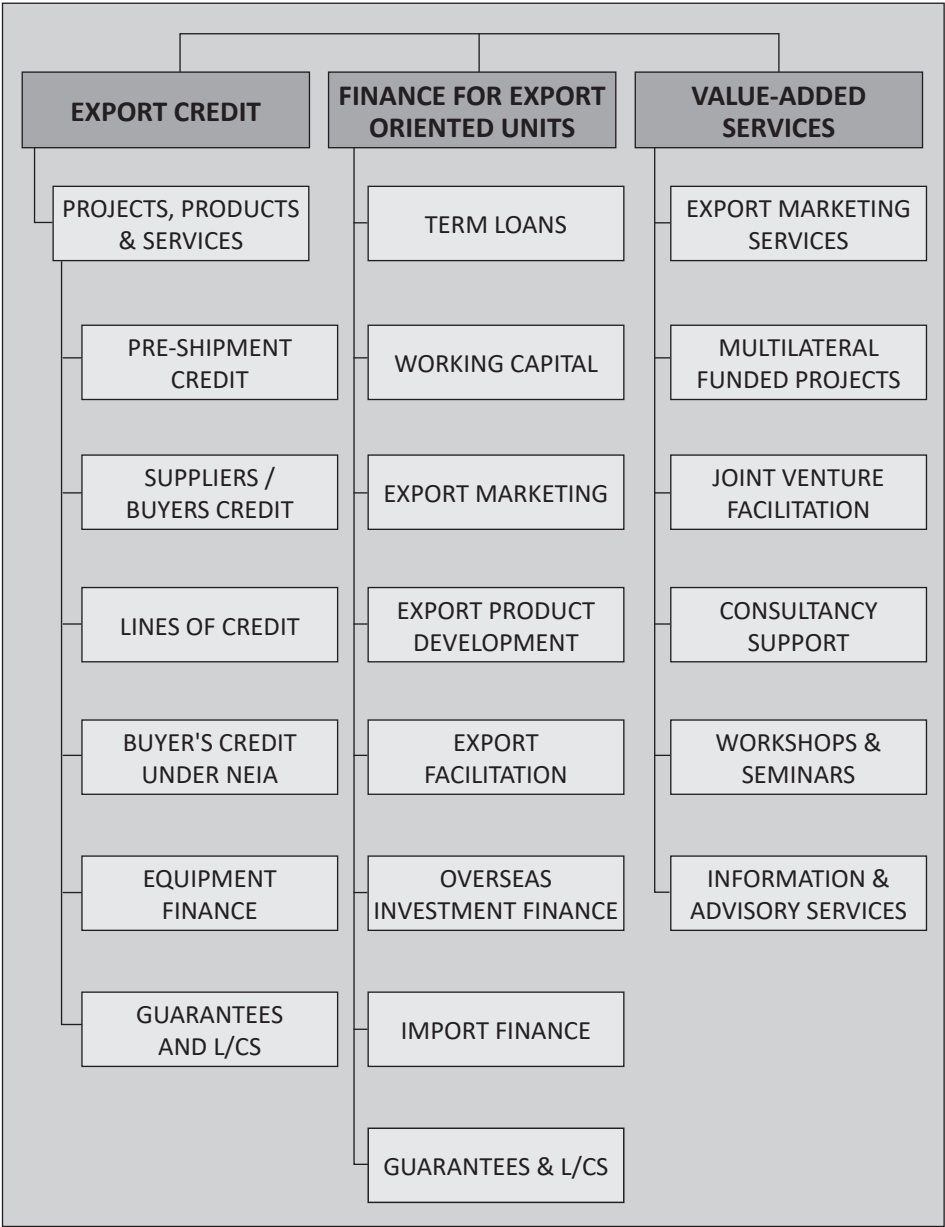
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