REVITALISING TRADE FINANCE: DEVELOPMENT BANKS AND EXPORT CREDIT AGENCIES AT THE VANGUARD

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CONTENTS

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LIST OF FIGURES

LIST OF TABLES

LIST OF BOXES

Executive Summary

The Global Financial Crisis highlighted the fault lines in financial architecture across countries. The multi-layered disruptions adversely impacted the international trade flows, with deteriorating credit conditions emerging as one of the key transmission channels. In fact, the adverse effect on trade finance, which was more pronounced in the case of emerging economies, still lingers on. The constraints to trade finance have not only emerged from the crisis itself, but also from the response to the crisis, in particular, from the general regulatory tightening.

Currently, the global trade finance gap is estimated at nearly US$ 1.5 trillion, with 40 percent of the gap originating in the Asia Pacific[1]. Given that trade accounts for more than half of the world's output, this 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. According to estimates, an increase in access to trade finance by nearly 5 percent increases the production by 15 percent and induces the firms to hire 12 percent more staff.

Clearly, there is a 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, 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 and ECAs will be paramount, especially from a developing country perspective.

TRENDS IN TRADE FINANCE

Most of the trade finance products have witnessed a slowdown in the recent period. During 2016, SWIFT trade finance traffic, which is a good indicator of overall use of Letter of Credit (L/C) product, registered a decline of 4.7 percent to reach its lowest levels since 2008. Both Category 4 and Category 7 messages witnessed a decline in volume of 8.6 percent and 4.7 percent, respectively. A greater concern is that the year 2016 was not an outlier but followed a trend – that of a secular decline in trade finance traffic ever since 2010.

International factoring business witnessed a different trend wherein the year 2016 was a deviation from the increasing trend in volumes. International factoring volumes registered a decline of (-) 4.2 percent in 2016. However, over a larger time horizon, during the period 2010-16, international factoring volumes witnessed a Compound Annual Growth Rate (CAGR) of 12.8 percent.

The global export credit and insurance business has also seen a similar trend. A comparison of new business of Berne Union members with the world exports indicate that credit insurance has shown remarkable resilience in the face of global crisis, as new business volumes increased from US$ 1364 billion in 2009 to US$ 1880 billion in 2016.

Going forward, revenues from trade finance products are expected to witness moderate growth rate, and are expected to increase from the level of US$ 38.9 billion in 2015 to US$ 46.8 billion in 2020. While the growth in trade finance is expected to remain below the global trade growth during 2017 and 2018, it is expected to grow at a faster pace in the following two years.

[1]DiCaprio, A., Kim, K., and Beck, S. (2017) ADB Trade Finance Gaps, Growth, and Jobs Survey

CHALLENGES TO TRADE FINANCE

Trade finance, like all other facets of the financial sector, was impacted during the Global Financial Crisis. Liquidity disruptions during the crisis had an adverse impact on availability and cost of trade finance. Research indicates that cross-border loans for the same borrower in the same morning (or day) had higher interest rates during the crisis, even after controlling for different loan volumes and other conditions[2]. The credit spread on trade finance activities increased to 200-300 bps above LIBOR from the pre-crisis levels of 10-20 bps above LIBOR[3].

While liquidity conditions have improved over the years, trade finance continues to face several challenges, some of them arising on account of the regulations in the post-crisis period. Overcoming such challenges will be critical for building resilience in trade financing and scripting a new chapter of resurgence in global trade.

AML/KYC Requirements

One of the most important 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. These requirements have significantly increased the compliance costs for banks and financial institutions, and adversely impacted the availability of trade finance.

According to a Thompson Reuters Survey in 2016, financial firms are incurring an average cost of US$ 60 million for meeting their obligations, with some firms spending as high as US$ 500 million on compliance with KYC and customer due diligence. The same survey noted that KYC procedures are making it more difficult to bring a new client on board. As compared to the previous year, an increase of 22 percent was noted at the outset of 2016 in the time taken to bring a new client on board, which was further expected to increase by another 18 percent over the next year[4]. Compliance cost for banks also rises on account of the substantial incongruities in regulations across geographies.

Increasing compliance cost, coupled with diminishing profitability and higher capital requirement under Basel III, 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, which is integral for ensuring availability of trade finance in less developed regions.

Going forward, compliance costs are expected to further increase. According to a study by Accenture, 89 percent of institutions expect investment in compliance-related capabilities to rise over the next two years[5]. The necessity of these requirements is undeniable, but there is a need to ensure that these do not lead to financial exclusion of businesses and markets.

Impact of Basel III

With growing capital requirements under Basel accord, banks and financial institutions have to allocate scarce resources towards more profitable activities. As a result, low return and/or high risk activities are likely to be discontinued by banks, a trend which has already started gaining momentum. Consequently, trade finance business is expected to be adversely impacted.

[2]Abbassi, P, F Bräuning, F Fecht, and J-L Peydró (2014), "Cross-Border Liquidity, Relationships and Monetary Policy: Evidence from the Euro Area Interbank Crisis", Bundesbank Discussion Papers 45/2014

[3]WTO (2012), Trade Finance

[4]Thomson Reuters 2016 KYC Challenges Survey

[5]Regan, Samantha, et al. "Compliance: Dare to be Different – 2017 Compliance Risk Study", Accenture Consulting, 2017.

While several issues which disproportionately affect trade finance business have been resolved by the Basel Committee, there are many others which continue to persist. For example, Basel III introduced an asset value correlation multiplier of 1.25 for exposures to large regulated financial institutions or unregulated financial institutions, regardless of their size. This could increase cost of trade finance and limit its availability, particularly in emerging markets. Moreover, the surcharge introduced on globally systemically important financial institutions (GSIFI) may also impact trade finance business, given that many of the largest trade finance providers are GSIFIs.

According to initial estimates in 2010, implementation of Basel III was projected to have resulted in a 2 percent decline in global trade and a 0.5 percent decline in global GDP[6]. Trade finance pricing was expected to increase by 15-37 percent as a result of the Basel III proposals, leading to a 6 percent reduction in overall trade finance volumes[7]. Revisions in the Basel III regulations have reduced the likely impact on trade and trade finance, but the adverse impact has not been completely mitigated.

Challenges for MSMEs

Lack of access to trade finance is one of the major reasons for the low participation of Micro, Small and Medium Enterprises (MSMEs) in international trade. Rejection rates for trade finance applications are as high as 56 percent in case of MSMEs, as compared to a low 7 percent for multinational corporations[8]. The challenge is even more acute in case of developing countries. In case of Africa, for example, small and medium enterprises account for only 28 percent of trade finance portfolio of banks[9].

There are several reasons that impede access to trade finance by MSMEs. The KYC/AML regulations are key bottlenecks which disproportionately impact MSMEs. High risk perceptions of MSMEs are also a major reason for lack of access to not just trade finance, but finance in general as well. The high risk perception eventually translates into lost opportunities for firms in developing countries. According to a survey, nearly 71 percent of firms facing rejection reported that when a bank declines to finance a trade transaction, they do not seek alternative financing for that transaction[10]. While some of these transactions are then self-financed, it can be assumed that some proportion of them do not go forward.

Another major reason for lack of trade finance availability is the lack of capacities in local banks to service the demand emanating from the sector. According to Auboin and DiCaprio (2016), there are two issues pertaining to bank capacity, one of which is the regulatory requirements of confirming banks. The other is the lack of ability of banks to service the demand for more sophisticated instrument. This latter aspect is not related to the risk attached with trade transactions, and this is one of the areas which trade finance programs of MDBs target[11]. Capacity building of local financial sector is therefore crucial for ensuring adequate trade finance flows.

Challenges for Smaller Developing Countries

Basel guidelines are expected to have increased the cost of trading exposure in emerging countries. To assess the risk of foreign sovereign exposure, global credit ratings are used, which adversely impacts the cost of trading exposures of banks to emerging markets[12]. Countries with high risk ratings are expected to suffer the most on account

[6]Sibos (2010) Banks voice Basel III fears. Sibos Issues

[7]SWIFT (2013) Observations on the evolution of trade finance and introduction to the bank payment obligation

[8]WTO (2016), Trade Finance and SMEs: Bridging the Gaps in Provision

[9]AfDB (2017), Trade Finance in Africa: Overcoming Challenges

[10]ADB (2016), Trade Finance Gaps, Growth, and Jobs Survey

[11]Marc Auboin and Alisa DiCaprio (2017), Why Trade Finance Gaps Persist: Does it Matter for Trade and Development?, Asian Development Bank Institute

[12]BCBS (2014), Impact and Implementation Challenges of the Basel Framework for Emerging Market, Developing and Small Economies. Working Paper 27. Prepared by the Basel Consultative Group

of retrenchment of trade financing as banks and financial institutions would be induced to reduce the overall risk of their trade finance portfolio. The sovereign default risk of countries would directly affect the ability of exporters in availing of trade finance as the country risk is an important parameter for pricing by financial institutions.

The impact of trade finance gaps and de-risking are most severe in case of small state countries[13], which rely significantly on cross-border funding for trade. These countries usually import a considerable share of their basic necessities and are beneficiaries of substantial remittance inflows. Reduced access to cross-border payment systems can therefore have severe consequences for these countries.

Lack of Knowledge of Products

Several non-traditional financing mechanisms such as supply chain finance and bank payment obligation exist, but the knowledge about these products is limited. Lack of familiarity with these products compounds the problems in trade financing. In case of rejections, lesser number of firms will look for alternative financing options if the level of knowledge about existing products is low.

Role of Export Credit Agencies and Multilateral Banks

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 in the post-crisis scenario. ECAs played an important stabilizing 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 characterized by heightened risk.

While market liquidity has recovered from the lows during the global financial crisis, the ability of banks and financial institutions to support trade finance remains restricted on account of the regulatory environment. Countries therefore continue to increase focus on ECA activity.

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 have also started specific programs to boost project exports. ECAs also continue to maintain 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. This is evident from the fact that nearly 89 percent of ECAs were developing or maintaining a SME support scheme in 2015, as against 69 percent of ECAs in 2013. Moreover, nearly 71 percent of ECAs had specialised products for SMEs in 2015, as against only 65 percent in 2013. While adhering to their mandate of export promotion, ECAs are also making an attempt to promote domestic investments in the face of global economic slowdown.

MDBs have also set up several programs 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. As the global financial institutions are cutting down their lines of credit for trade, the demand for trade finance support from MDBs has witnessed an increase. An analysis of trade finance facilities of MDBs indicate that the trade finance programs of major MDBs supported nearly US$ 109.8 billion of transactions in 2016.

Many of the trade finance programs had started much before the crisis, but the post-crisis period has seen significant increase in the lending limits

[13]Small states are sovereign countries with a population of 1.5 million people or fewer

and resources of several programs. This bode well for trade financing in emerging markets and SMEs, thereby facilitating inclusive financing. Several of the MDBs with regional focus have also imparted a fresh resonance to the intra-regional trade.

WAY AHEAD

The overwhelming role of trade in the multi-faceted interactions among developing countries, and the role of trade finance in harmoniously welding the South-South trade links, behoves developing countries to adopt collective, concerted and coherent initiatives for developing an efficient trade financing framework. The present section delves into the various solutions for a resilient trade finance system.

Collaboration among Development Finance Institutions

Collaboration among MDBs, ECAs and national Development Finance Institutions (DFIs) can substantially enhance the trade financing capabilities, while concomitantly meeting the growing infrastructure requirements. There has been a substantial increase in such transactions. An example of such collaboration is the financing of Itezhi - Tezhi Hydro Power Project in Zambia, which was co-financed by several lenders including multilateral banks, DFIs and ECAs. There have also been cases, where co-financing has enabled ECAs to finance transactions and support domestic companies which they otherwise could not.

Another way through which some of these institutions are already collaborating is through insuring of loan exposures and reinsuring of guarantee exposure. Multilateral Investment Guarantee Agency (MIGA) reinsures approximately 40 percent of its gross exposure with ECAs and Political Risk Insurers. Paul Mudde in his article estimates that if leading MDBs follow MIGA's practice, US$ 169 billion of additional finance can be made available for development[14].

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. Export-Import Bank of India has made an attempt in this direction, and along with the African Development Bank, Infrastructure Leasing and Financial Services Ltd. and State Bank of India, has floated the Kukuza Project Development Company to facilitate private sector participation in infrastructure projects in Africa.

Another way in which the development finance institutions can collaborate is through creation of liquidity pools. Establishment of targeted liquidity pool by MDBs, national DFIs and ECAs can help ensure that adequate funds are available to MSMEs, new exporters and firms in smaller geographies during times of contraction in liquidity and credit.

Capacity Building of Domestic Financial Sector

Remedying the knowledge and technology gaps, while simultaneously addressing the regulatory aspects related to cross-border financial services can significantly reduce the risk of marginalization of developing countries in trade transactions. While North-South knowledge sharing has been the norm, the growth of South-South sharing of knowledge has exponentially grown over the past several years. South-South cooperation can play an important role in equipping local banks with basic to complex trade finance solutions and adopting international best practices, establishing self-sustainable ECAs, and regional regulatory cooperation, thereby making the trade finance architecture more resilient.

[14]Berne Union Yearbook 2016

Market Information

Collaborative partnerships can help mitigate the market information gaps. Partnerships among countries for developing and disseminating trade finance data can help in better understanding of the markets, and an accurate pricing of risks. This shall also help understand the disruptions in trade finance markets during periods of shock and crisis, and help devise responsive solutions.

While durable solutions may take time to be established, interim solutions can help improve information flows between correspondent and respondent banks. This includes use of "Know Your Customer" software utilities which store customer due-diligence information in a single repository and allows easy access to bank customer information. Legal and contractual issues can also be streamlined to facilitate information sharing across institutions and countries. Compliance related costs can be substantially reduced through technological intervention. According to the ICC Global Survey 2017, appropriate application of technology to compliance-related processes and procedures could reduce the compliance costs by 30 percent or more.

Alternative Trade Financing

Going forward, the role of fin-techs and alternative-finance providers will be crucial in bridging the trade-finance gaps. 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. Fin-tech companies also seek to supplement the existing pool of bank-intermediated trade finance. Hedge funds have also been active in trade financing. Partnerships among DFIs, banks and fin-techs can help drive efficiency and improve the capacity of financial systems to extend trade finance.

Trade Finance Facility

National DFIs and ECAs from developing countries, with support from MDBs can explore the prospects for setting up 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.

Trade Enhancement Facility for Small States

A special Trade Enhancement Facility can also be set up for Small States, which have been disproportionately impacted in the post-crisis period. The proposed facility for Small States could comprise a credit enhancement mechanism which enables confirmation of L/C opened on behalf of importers by banks in the countries participating in the Facility. The confirmations would be enabled by guaranteeing the credit risk of L/C opening banks in these countries. The guarantee may be backed by pool of cash collateral contributed by member states into a Fund, which can be managed by an independent Facility Manager, who, inter alia, can identify banks in the member countries who would be interested in participating in the program, and assign credit limits to these banks depending on parameters such as credit profile, potential usage, etc.

The Fund can receive revolving grant contributions from member states which can form the core capital of the Fund. These contributions may be invested in high quality liquid assets which can be drawn in the event of defaults to honour the claims. Support from bilateral and multilateral development finance agencies, and private sources of capital may also be considered for contributions to the Fund.

Regional Financing Mechanism for Asia

In much of the developing Asia, the financing mechanisms, which are taken for granted in industrial nations, are rudimentary and sub-optimal. Information networks and policy environments required for banks to carry out international transactions with a fair deal of confidence are also yet to stabilise. A regional mechanism which pools funds and risks across countries can benefit the intra-regional trade in Asia. In this context, an Asian Exim Bank can be set up, as a key agency for refinancing trade and investment in the region, with a focus on enhancing intra-regional trade. It can contribute towards recovery of short-term trade finance, and also enable importers to access medium and long term finance for capital goods and project imports from other Asian countries. The basic objective of the Asian Exim Bank would be to improve the access to trade finance for Asian economies through credit enhancement and risk mitigation measures and thereby, contribute to enhance intra-regional trade and investment. The Asian Exim Bank can draw its resources from equity capital subscription from member countries supplemented by borrowings in international capital markets, lines of credit from multilateral financial agencies. Equity contribution can be decided in proportion to economic indicators such as weighted average GDP, per capita GDP, trade indices, etc.

CONCLUSION

Trade finance gaps in developing countries have been exacerbated in the aftermath of Global Financial Crisis. This has emerged not just from the dearth of liquidity in the system, but also from the stringent regulations and compliances during this period. 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 has been pivotal in restoring balance, and financing transactions which would otherwise not have been financed. Going forward, the role of MDBs, ECAs and national DFIs will be crucial in bridging the trade finance gap, as also in catalysing private finance. These institutions can expand the scope of existing collaborations in areas such as co-financing, insuring of loan exposures, and reinsurance of guarantee exposure, and also deliberate upon the prospects for cooperation by way of new initiatives such as establishment of regional trade finance facilities, and regional financing mechanisms like Asian Exim Bank, while suitably leveraging emerging technology platforms such as blockchain 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 the merchandise or service on terms that satisfy both the exporter and the importer.

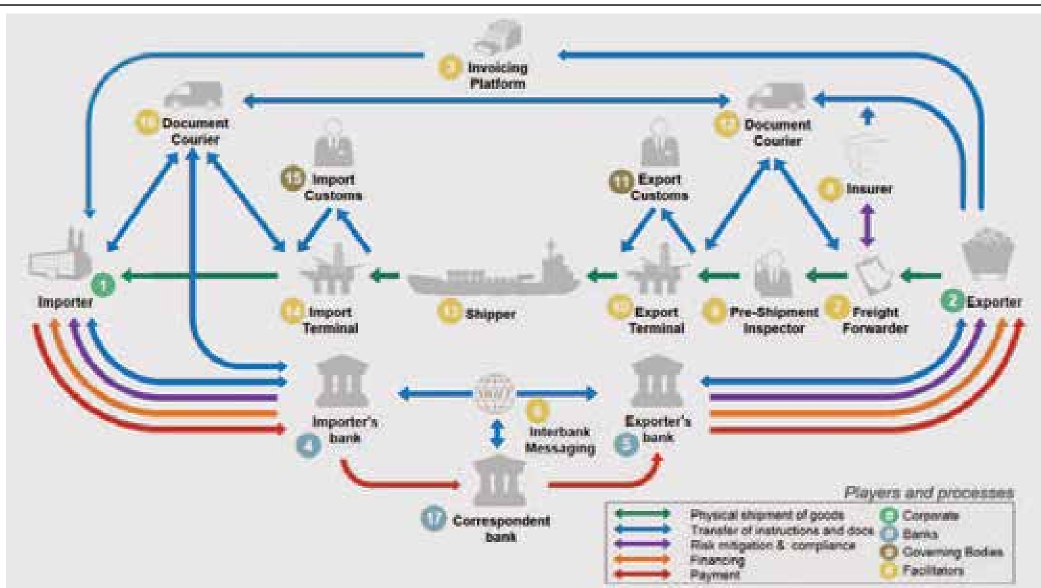
According to the International Trade Centre (2009), trade finance mechanism provides support primarily in the following four areas:

- 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[15].

The trade finance ecosystem is spread across several players and processes. The corporates which includes 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 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 (Figure 1).

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"

Figure 1: Trade Finance Ecosystem



Source: Boston Consultancy Group Analysis

[15]ITC (2009), How to Access Trade Finance: A Guide For Exporting SMEs, International Trade Centre

transactions in the form of short-term trade finance loans. The financing needs of companies involved in international trade transactions are usually characterized 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 one-time 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 a weak growth of 1.6 percent, the year 2016 marked the sixth consecutive year of trade growth (in volume terms) being below the 3 percent mark. Alongside, trade finance volumes have 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, it has also become more expensive and less available, thereby exacerbating the trade finance gap. Currently, the global trade finance gap is estimated at nearly US$ 1.5 trillion, with 40 percent of the gap originating in the Asia Pacific[16].

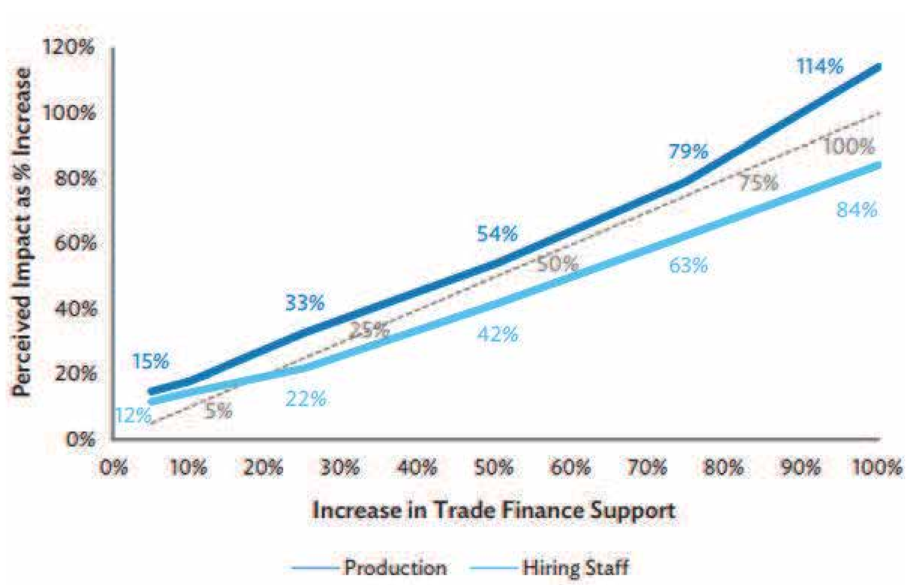
Given that trade accounts for more than half of the world's output, this trade finance gap is a major constraint for the overall output growth. A well-functioning trade finance market allows the firms with higher risk perceptions to link into global value chains and thereby contributes to employment and productivity growth. According to estimates, an increase in access to trade finance by nearly 5 percent increases the production by 15 percent and induces the firms to hire 12 percent more staff (Figure 2).

Clearly, there is a need to bridge the unmet demand for trade finance in order to revive the faltering global trade and output growth. 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 exacerbating the already precarious position of 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, especially from a developing country perspective.

Set against this backdrop, the current Study attempts to analyse the recent trends in trade finance, challenges pertaining to trade finance flows, and strategies which can be adopted to reduce the large deficit in global trade finance. MDBs and ECAs shall form the cornerstone of strategies for augmenting the local capacities and enhancing access to trade finance. According to the International Chamber of Commerce (ICC) 2016 Global Survey on Trade Finance, nearly 75 percent of respondents reported that MDBs and ECAs help narrow trade finance gaps. The Study highlights the various ways in which ECAs 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.

Figure 2: Impact of Trade Finance on Production and Employment



Source: DiCaprio, A., Beck, S., and J. Daquis (2014), ADB Trade Finance Gap, Growth, and Jobs Survey

[16]DiCaprio, A., Kim, K., and Beck, S. (2017) ADB Trade Finance Gaps, Growth, and Jobs Survey

2. Review of Trade Finance Market

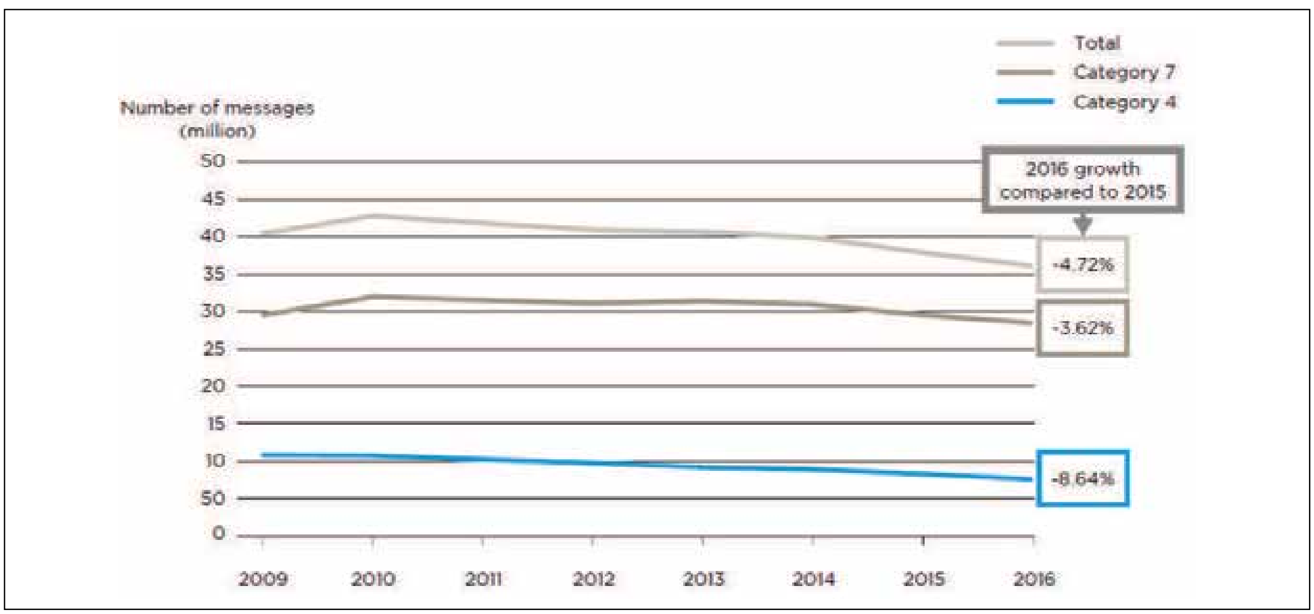
Finance has a significant bearing on the export performance of a country. The extent of finance-trade relationship can be adjudged from the fact that nearly 80-90 percent of world trade today relies on some form of trade finance. Research also indicates that countries with higher level of financial development have higher shares of manufactured exports in GDP[17]. Export-led economic growth in developing countries therefore critically hinges on the development of a robust trade finance architecture.

Trade Finance products are characterized 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. Even in MLT trade finance, the default rates are low, with the exposure-weighted customer default rate amounting to a mere 0.26 percent during the period 2007-2014[18]. 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.

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 2016, SWIFT trade finance traffic registered a decline of 4.7 percent to reach its lowest levels since 2008. Both Category 4 and Category 7 messages witnessed a decline in volume of 8.6 percent and 4.7 percent, respectively (Figure 3). A greater concern is that the year 2016 was not an outlier but followed a trend – that of a secular decline in trade finance traffic ever since 2010 – as evident in the downward sloping

Figure 3: Global SWIFT Trade Traffic: Recent Trends



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 Rethinking Trade and Finance 2017

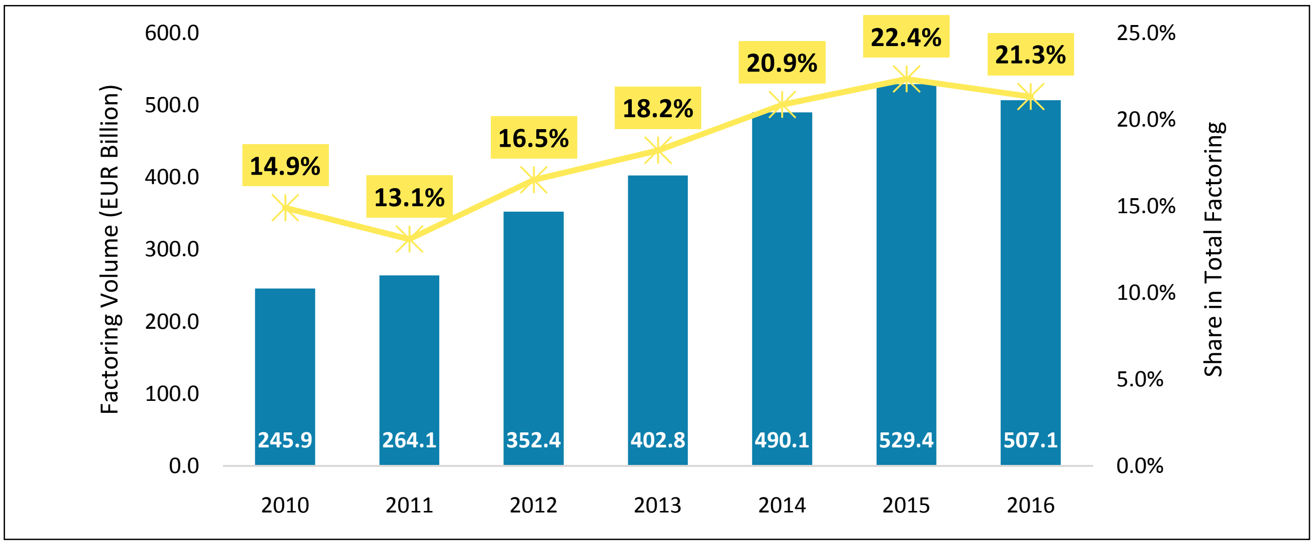
[17]Beck, T. (2002), "Financial development and international trade: is there a link?", Journal of International Economics 57(1): 107-131.
[18]ICC Global Trade and Finance Survey 2015

curves of the total as also Category 4 and Category 7 SWIFT messages.

International factoring business witnessed a different trend wherein the year 2016 was a deviation from the increasing trend in volumes. International factoring volumes registered a decline of (-) 4.2 percent in 2016. However, over a larger time horizon, during the period 2010-16, international factoring volumes witnessed a Compound Annual Growth Rate (CAGR) of 12.8 percent, as its share in total factoring volumes (i.e. including domestic factoring)increased from 14.9 percent in 2010 to 21.3 percent in 2016 (Figure 4).

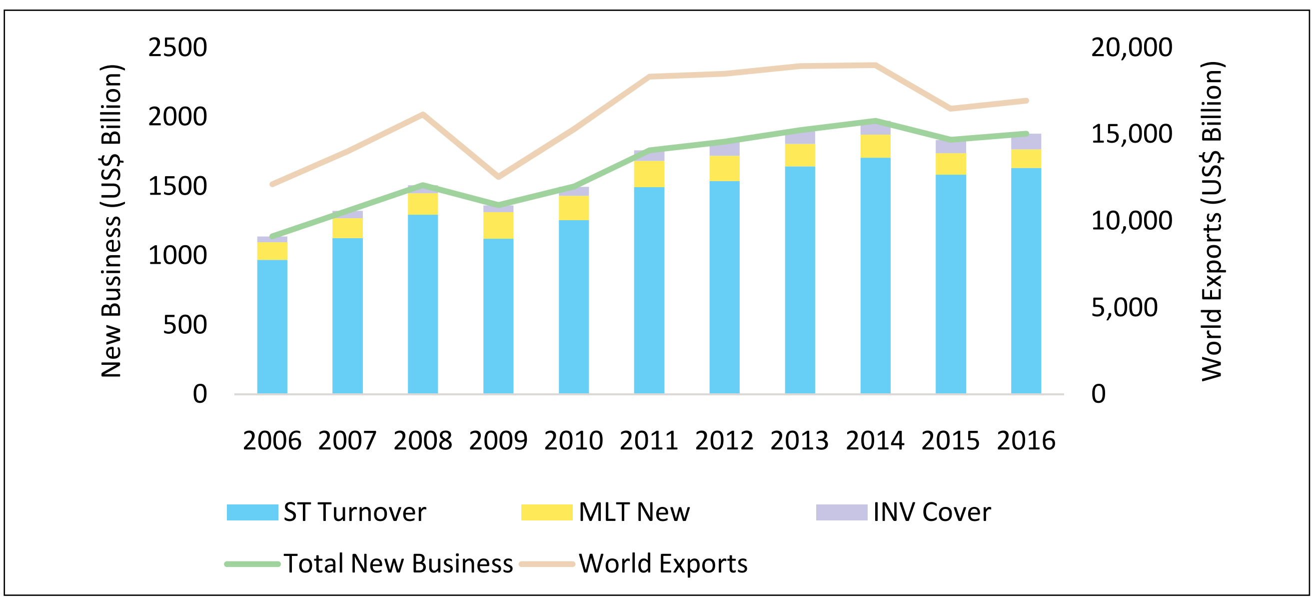
The global export credit and insurance business has also seen a similar trend as international factoring, with the blip year being 2015. A comparison of new business of Berne Union members with the world exports indicate that credit insurance had shown remarkable resilience in the face of global crisis (Figure 5), as new business volumes increased from US$ 1364 billion in 2009 to US$ 1880 billion in 2016.

Figure 4: International Factoring Volumes



Source: Factoring Chain International, Exim Bank Research

Figure 5: New Business of Berne Union Members and Global Exports



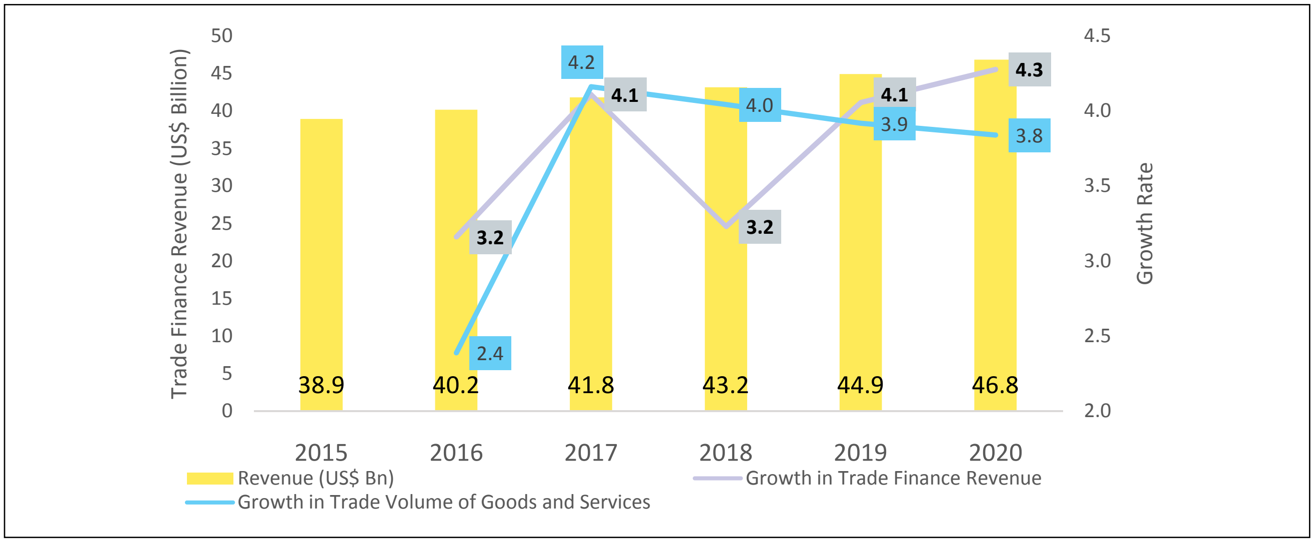
Source: Berne Union, Exim Bank Research

Going forward, revenues from trade finance products are expected to witness moderate growth rate, and are expected to increase from the level of US$ 38.9 billion in 2015 to US$ 46.8 billion in 2020 (Figure 6). While the growth in trade finance is expected to remain below the global trade growth during 2017 and 2018, it is expected to grow at a faster pace in the following two years.

TRADE FINANCE GAP

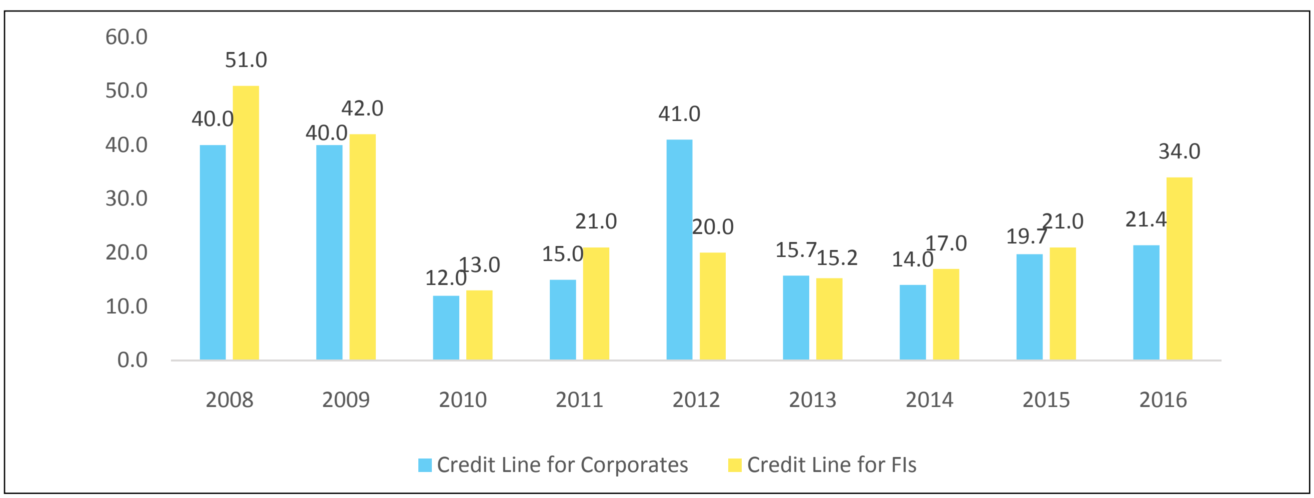
Data from the ICC Global Trade and Finance Survey indicates that availability of trade finance was constrained during the Global Financial Crisis of 2008, but the percent of responding banks reporting a decrease in trade finance credit lines had reduced by 2010, indicating a recovery in availability of trade finance. However, percent of banks reporting a decline in trade credit lines has started to increase in the recent period (Figure 7), necessitating an enquiry into the various factors leading to the decline in supply of finance.

Figure 6: Global Trade Finance Market



Note: All growth figures are forecasts except for growth in trade volume of goods and services during 2016.
Source: Global Trade Finance Market 2016-20, Technavio, Exim Bank Research

Figure 7: Trade Finance Availability
(Percent of Responding Banks Reporting a Decrease in Trade Finance Credit Lines Offered)



Note: Based on an unbalanced sample of banks
Data on corporates for the year 2015 is an average across the categories of small/ medium sized, commercial clients, and corporate; and for the year 2016 is an average across the categories of mid-market/ mid cap, micro and SMEs, and multinational and corporates
Source: International Chamber of Commerce Global Trade and Finance Survey, Exim Bank Research

The decline in availability of trade finance has led to substantial mismatch in the demand and supply for trade finance products, with the trade finance gap standing at US$ 1.5 trillion in 2016. Nearly 40 percent of this trade finance gap originated in the Asia Pacific[19]. Value of bank-intermediated trade finance gap was also significant in case of Africa at an estimated US$ 91 billion in 2014[20].

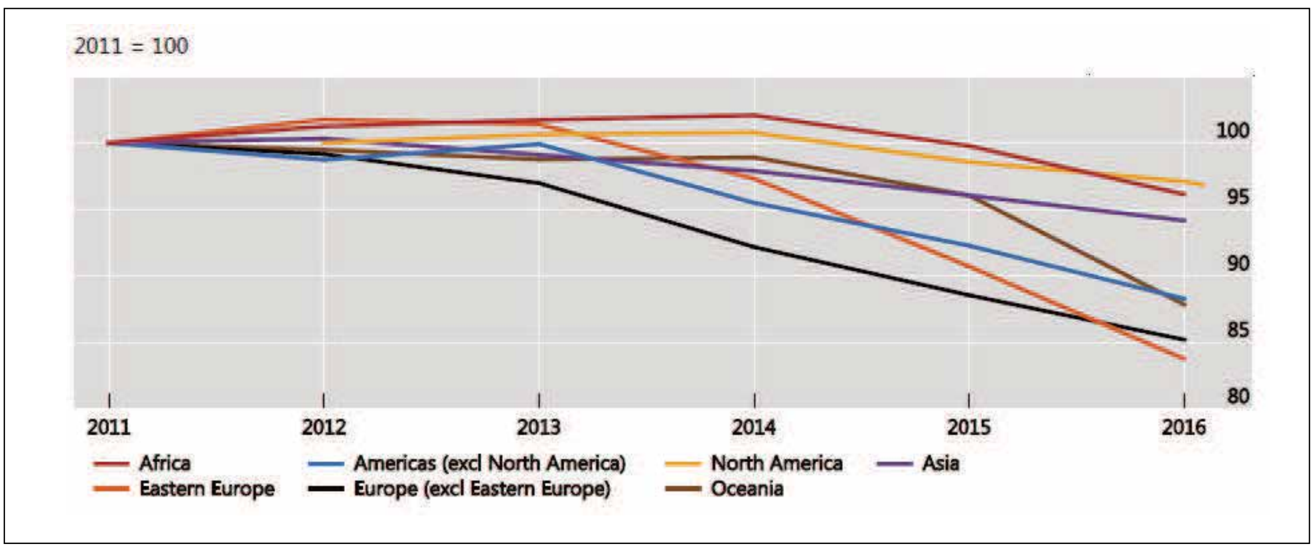
DECLINE IN CORRESPONDENT BANKING RELATIONSHIP

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 SWIFT data, during the period 2011-2016, the number of active correspondents declined in most regions (Figure 8). Only Africa witnessed a slight increase between 2011 and 2014. The maximum decline in number of active correspondents was witnessed by Eastern Europe (-16 percent), followed by Europe excluding Eastern Europe (-15 percent), Oceania (-12 percent), and the Americas excluding North America (-8 percent). While Europe experienced a high rate of decline, it still has the highest number of correspondent banking relations. Lower number of correspondent banking relations in Europe can be attributed to the consolidation in the banking sector after the crisis. During this period, there was also a decline in the number of active corridors in all the regions (Figure 9). Oceania registered the greatest decline in the number of corridors per jurisdiction during this period (15 percent), followed by Africa (9 percent) and the Americas excluding North America (7 percent).

According to the 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 2016, the latest year for which data is available. During 2016, all regions except Southern Asia witnessed a reduction in the

Figure 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

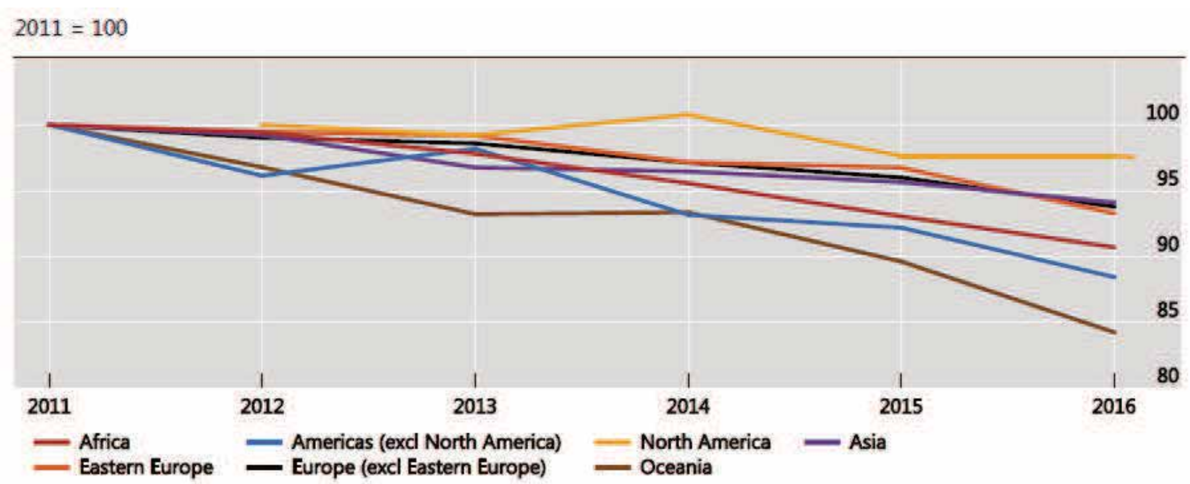
[19]ADB (2017), Trade Finance Gaps, Growth, and Jobs Survey
[20]African Development Bank (2017), Trade Finance in Africa: Overcoming Challenges

average number of active correspondents across all currencies. The Caribbean and the small states of the Pacific (Melanesia, Micronesia and Polynesia) registered highest rates of declines, close or above 10 percent. The Pacific regions are already the ones with the smallest number of active correspondents and the decline in the number of relationships would therefore have a greater impact[21].

TRADE FINANCE IN ASIA-PACIFIC

Asia is the single largest contributor to global output growth, estimated at 60 percent. It also accounts for the largest share in global trade. This makes the region most in need of increased liquidity. It is unsurprising therefore that the region relies heavily on trade finance products. In 2016, the highest number of L/Cs was received by Asia-Pacific (Figure 10),

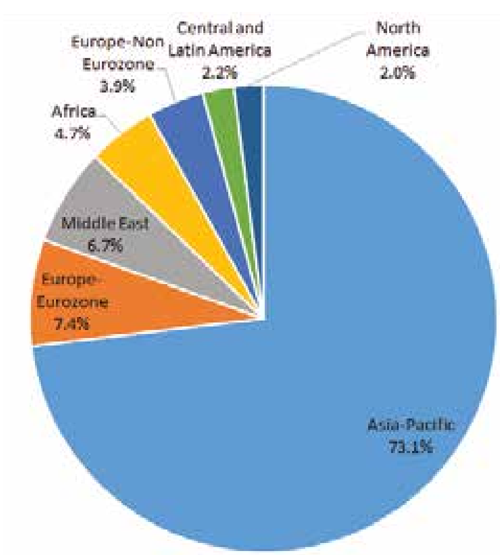
Figure 9: Average Number of Counterparty Countries by Region



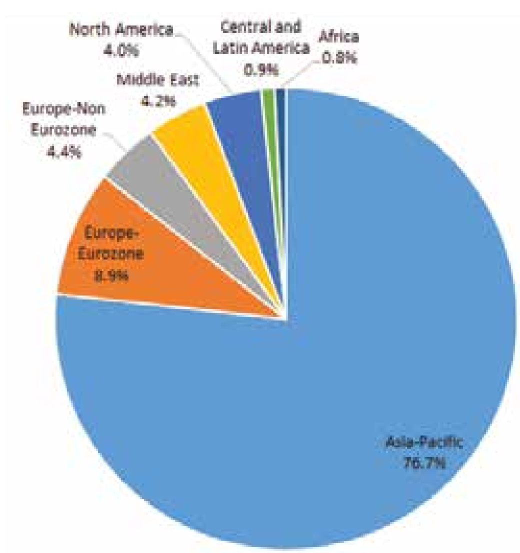
Source: SWIFT Watch, National Bank of Belgium, Bank of Mexico, FSB Correspondent Banking Data Report

Figure 10: Region-wise Volume of L/Cs

Volume of L/Cs sent by Regions



Volume of L/Cs received by Regions

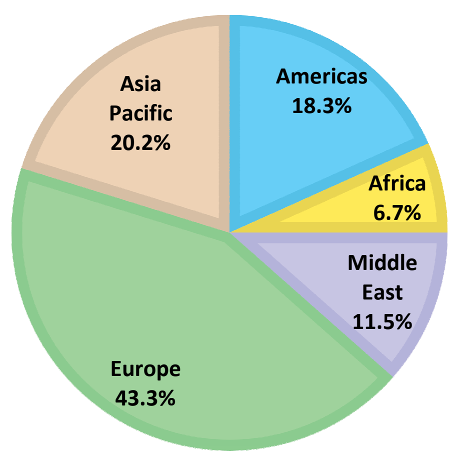


Source: ICC Rethinking Trade and Finance 2017, Exim Bank Research

[21]FSB Correspondent Banking Data Report

and most of this traffic was intra-regional. Asia-Pacific also had the second highest share of nearly 20.2 percent in the new business reported by the Berne Union members in 2016 (Figure 11). The region also accounted for 23 percent of global factoring business.

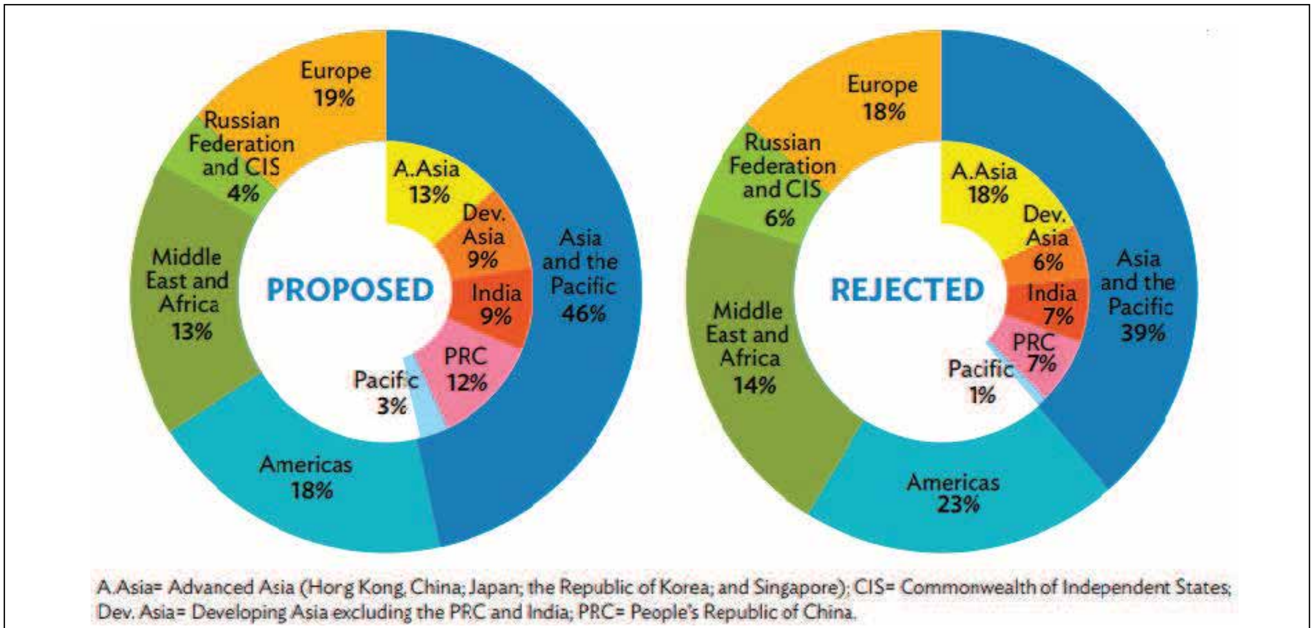
Figure 11: Regional Distribution of New Business of Berne Union Members (2016)



Source: Berne Union, Exim Bank Research

While the region is among the largest users of trade finance products, it also accounts for the largest share in global trade finance gap. According to the 2017 Asian Development Bank (ADB) survey, developing countries in Asia Pacific (including India and China) accounted for nearly 21 percent of the global trade finance rejections, while they accounted for 33 percent of the proposals (Figure 12). The rejection rates for trade finance transactions is relatively higher in the Asia-Pacific. A region-wise analysis of the rejection rates indicates that the rejection rate was the highest at 29 percent during 2014 in case of Asia-Pacific, indicative of higher level of risk perception for such transactions. Europe and America, on the other hand, had a rejection rate of 12 percent and 8 percent, respectively during the year. Ironically, the actual level of risk, as reflected in the default rates during 2007-2014, was substantially lower at 0.3 percent for Asia Pacific as compared to 0.4 percent in case of Europe (Figure 13). This gap between actual and perceived risks tends to increase in the periods of crisis, even though the payment record does not differ much[22].

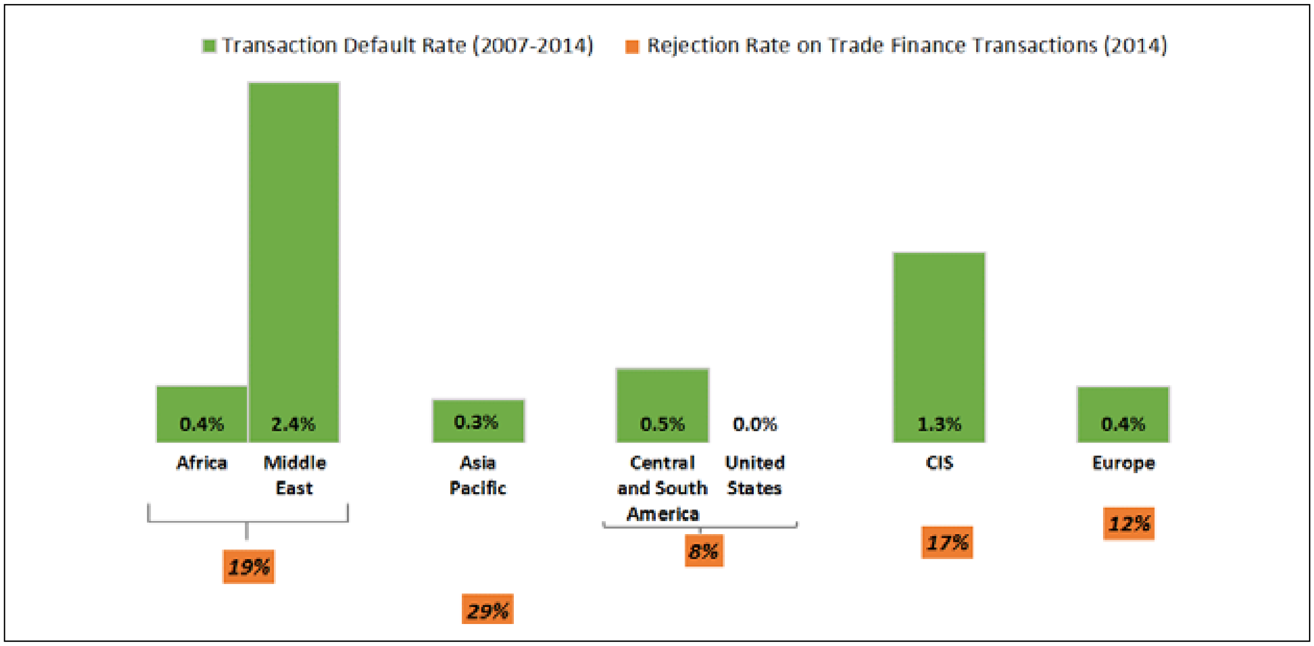
Figure 12: Proposed and Rejected Trade Finance Transactions by Region



Source: ADB (2017), Trade Finance Gaps, Growth, and Jobs Survey

[22]Marc Auboin and Alisa DiCaprio (2017), Why Trade Finance Gaps Persist: Does it Matter for Trade and Development?, Asian Development Bank Institute

Figure 13: Actual Risk of Trade Finance (Default Rates) vs Perception of Risk (Rejection Rates for Trade Finance Requests)



Source: Marc Auboin and Alisa DiCaprio (2017), Why Trade Finance Gaps Persist: Does it Matter for Trade and Development, Asian Development Bank Institute, Exim Bank Research

3. Challenges to Trade Finance

Trade finance, like all other facets of the financial sector, was impacted during the Global Financial Crisis. Liquidity disruptions during the crisis had an adverse impact on availability and cost of trade finance. Research indicates that cross-border loans for the same borrower in the same morning (or day) had higher interest rates during the crisis, even after controlling for different loan volumes and other conditions[23]. The credit spread on trade finance activities increased to 200-300 bps above LIBOR from the pre-crisis levels of 10-20 bps above LIBOR[24].

While liquidity conditions have improved over the years, trade finance continues to face several challenges, some of them arising on account of the regulations in the post-crisis period. This chapter seeks to analyse such challenges, which will be critical for building resilience in trade financing and scripting a new chapter of resurgence in global trade.

AML/KYC REQUIREMENTS

One of the most important 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 80 percent of the respondents of the ICC Global Survey on Trade Finance 2017 said that AML/ KYC requirements are a potential barrier for servicing trade finance needs. These requirements have significantly increased compliance costs for banks and financial institutions, and adversely impacted the availability of trade finance.

The Financial Action Task Force (FATF) was founded in 1989 to develop and coordinate policy efforts to combat money laundering at a global level. In 2012, the FATF proposed global standards for AML and CFT that follow a risk-based approach. This approach provides banks with flexibility to develop their own processes for identifying and addressing money laundering/ terrorist financing risks. Banks are now not required to complete certain pre-determined compliance activities but have to ensure that their policies and procedures are efficacious in assessing, monitoring and managing their risk. This shift from process standard to incident-based standard introduces immense subjectivity and ambiguity, and renders banks vulnerable to large fines in case of incidents. According to a report by Boston Consulting Group (BCG), banks have paid US$ 321 billion in fines since 2008 on account of failures pertaining to money laundering, market manipulation and terrorist financing, among others[25]. 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.

KYC norms and customer due diligence (CDD) processes have also increased the costs for financial institutions. According to a Thompson Reuters Survey in 2016, financial firms incurred an average cost of US$ 60 million for meeting their obligations, with some firms spending as high as US$ 500 million on compliance with KYC and CDD. The same survey noted that KYC procedures make it more difficult to bring a new client on-board. As compared to the previous year, an increase of 22 percent was noted at the outset of 2016 in the time taken to bring a new client on-board, which was further expected to increase by another 18 percent over the next year[26].

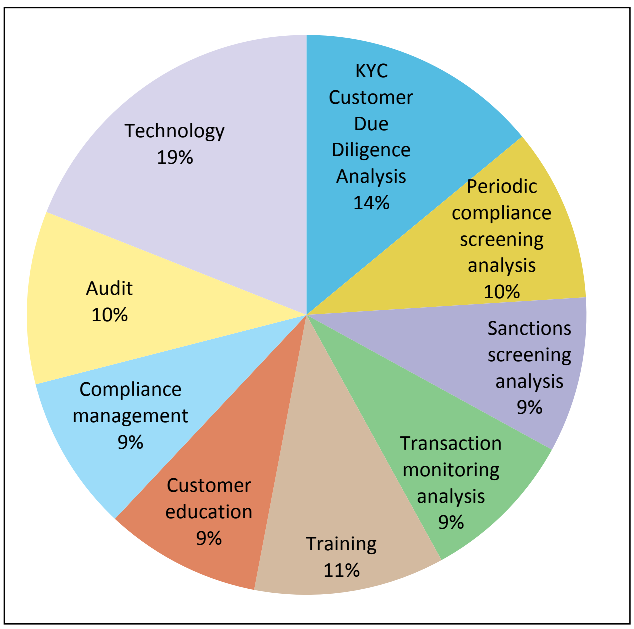
Compliance cost for banks also rises on account of the substantial incongruities in regulations across geographies. National regulators have implemented the international standards after adapting them to local conditions, and there is considerable difference

[23]Abbassi, P, F Bräuning, F Fecht, and J-L Peydró (2014), "Cross-Border Liquidity, Relationships and Monetary Policy: Evidence from the Euro Area Interbank Crisis", Bundesbank Discussion Papers 45/2014
[24]WTO (2012), Trade Finance
[25]Grasshoff, Gerold, et al. "Global Risk 2017: Staying the Course in Banking." Boston Consulting Group, 2017
[26]Thomson Reuters 2016 KYC Challenges Survey

in these regulations. Lack of harmonization in compliance requirements compel banks to incur additional cost in understanding and adapting to local requirements. These differences are so pronounced that in some cases requirements in one country are in direct conflict with those in another[27]. According to International Financial Corporation (IFC), at least nine emerging markets had made one or more significant changes in their national AML/CFT regulations in 2015 alone[28].

Increasing compliance cost, coupled with diminishing profitability and higher capital requirement under Basel III, 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

Figure 14: Breakdown of AML Compliance Cost by Area



Source: Uncover the True Cost of Anti-Money Laundering & KYC Compliance, LexisNexis® Risk Solutions

the correspondent banking system, as was highlighted in the previous chapter, which is integral for ensuring availability of trade finance in less developed regions.

In six Asian countries, China, Hong Kong, Indonesia, Malaysia, Singapore and Thailand, AML and KYC compliance is costing banks more than US$ 1.5 billion annually[29]. Nearly 33 percent of the AML compliance cost is on watchlist activities such as KYC processes, periodic screening and sanctions operations. As against this, only 9 percent of cost is on transactions monitoring. Technology use in Asia is still at low levels. As a result only 19 percent of the cost is technology related (Figure 14).

Going forward, compliance costs are expected to further increase. According to a study by Accenture, 89 percent of institutions expect investment in compliance-related capabilities to rise over the next two years[30]. The necessity of these requirements is undeniable, but there is a need to ensure that these do not lead to financial exclusion of businesses and markets.

IMPACT OF BASEL III

Basel Accords have been integral to the financial regulatory reform agenda since 1988, when the Basel Committee on Banking and Supervision first published Basel I with an aim to strengthen stability of the banking system. This was followed by Basel II in 2004 which corrected the deficiencies in Basel I and significantly widened the scope and focus of these regulations. After the financial crisis, the scope was further expanded in Basel III which put stricter requirements on banks. While these regulations are important for resilience of the banking sector, it has adversely impacted trade finance, and made it more expensive. With growing capital requirements under Basel accord, banks and financial institutions have to allocate scarce resources towards more profitable activities. As a result, low return and/or high risk activities are likely to be discontinued by banks, a trend which has already started gaining momentum.

[27]Results of the IFC 2017 Survey on Correspondent Banking in Emerging Countries
[28]Ibid.
[29]Uncover the True Cost of Anti-Money Laundering & KYC Compliance, LexisNexis® Risk Solutions
[30]Regan, Samantha, et al. "Compliance: Dare to be Different – 2017 Compliance Risk Study", Accenture Consulting, 2017.

Consequently, trade finance business is expected to be adversely impacted.

The low-risk character of trade finance was evident in the lower rate of capitalization for international trade credit such as L/Cs and similar securitized instruments under the Basel I regulatory framework which were introduced in the late 1980s and early 1990s. Under Basel I, the on-balance sheet trade finance products entailed capital requirement of 8 percent. For off-balance sheet items, credit conversion factors (CCF) were used to get their on-balance sheet equivalents. The CCF ranged from 0-100 percent, depending on the trade finance product. Short-term self-liquidating trade-related contingencies such as documentary credits collateralised by the underlying shipment had a CCF of 20 percent. The framework took cognizance of the low risk associated with trade finance products, and instruments such as letter of credit entailed moderate rate of capitalization.

According to Cornford (2014), Basel II and Basel III requirements gave lesser consideration to product or performance risk, and overemphasized counterparty risk[31]. Under the Internal Ratings Based approach, a general one-year maturity floor was set for calculation of risk weighted asset. Trade finance products are mostly short-term in nature, and a one-year maturity floor would require a higher than warranted capital requirement. Moreover, under Basel II, claims on an unrated bank could not receive a risk weight lower than that applied to claims of the country where the banks were incorporated. Both these issues were resolved in the 2011 Basel III amendment. One year-maturity floor was waived for issued and confirmed trade finance instruments with a maturity of less than a year. Maturity floor could also be waived for other trade finance products based on the discretion of national regulators. Sovereign floor was also removed for trade finance products.

Under Basel III, leverage ratio was defined as a new component of Pillar 1 capital requirement. The initial off-balance sheet CCF for leverage ratio calculation was 100 percent, which was extremely high for trade finance products given their low default rates. According to Auboin and Blengini (2014), if CCF does not reflect the low riskiness of trade finance, banks will substitute these for more risky assets. 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.

Basel III also defined two new minimum quantitative measures intended to address the liquidity risk for banks— Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). LCR was intended to enhance the level of liquid assets, while NSFR was introduced to align the maturities of assets and liabilities in portfolios. Banks were required to maintain a 50 percent LCR for corporate trade finance transactions, which basically meant that banks should assume that only 50 percent of such exposures will be repaid. This again inflated the risk profile of trade finance products. The Basel Committee made some revisions in 2013. According to the update, in case of contingent funding obligations stemming from trade finance instruments, national authorities could apply a relatively low run-off rate, in the range of 0-5 percent. Another revision was made in 2014 with regard to the NSFR, which reduced the required stable funding factor for short-term lending to SMEs from 85 percent to 50 percent.

In the Basel 4 guidelines, trade finance will continue to be risk weighed at 20 percent (for short-term self-liquidating trade letters of credit arising from the movement of goods), although for other types of less than one-year maturity commitments, the risk weight will increase from 20 percent to 40 percent. This also reads across to the CCFs used in the calculation of off-balance sheet exposures for the leverage ratio. Short-term interbank exposures (up to three months, and exposures to banks that arise from the movement of goods across national borders with an original maturity of six months or less) will receive a preferential risk weight[32].

While some of the issues were resolved by the Basel Committee, there are many others which continue

[31]Cornford, A. (2014) Enhanced attention for trade finance. International Development Economics Associates Paper.
[32]KPMG (2017), Basel Committee revised standards on the output floor, credit risk and operational risk.

to persist. For example, Basel III introduced an asset value correlation multiplier of 1.25 for exposures to large regulated financial institutions or unregulated financial institutions, regardless of their size. This could increase cost of trade finance and limit its availability, particularly in emerging markets. Moreover, the surcharge introduced on globally systemically important financial institutions (GSIFI) may also impact trade finance business, given that many of the largest trade finance providers are GSIFIs.

According to initial estimates in 2010, implementation of Basel III was projected to have resulted in a 2 percent decline in global trade and a 0.5 percent decline in global GDP[33]. Trade finance pricing was expected to increase by 15-37 percent as a result of the Basel III proposals, leading to a 6 percent reduction in overall trade finance volumes[34]. Revisions in the Basel III regulations have reduced the likely impact on trade and trade finance, but the adverse impact has not been completely mitigated.

The strain of regulatory requirements on correspondent banking relations is clear, as banks are modifying their business models. The lower margins typically associated with correspondent banking activities are more susceptible to supply pressure. This is evident from various surveys which report that global banks are terminating or limiting their correspondent banking activities in emerging markets. In an IIF and EY survey, more than 48 percent of banks noted that they have exited or intend to exit business lines, and another 27 percent said that they are exiting from some specific countries[35].

CHALLENGES FOR MSMES

The challenges related to trade finance are more pronounced in the case of Micro, Small and Medium Enterprises (MSMEs). MSMEs are the key drivers of trade, output, and job creation. Growth constraints for MSMEs therefore have a far reaching impact on the development objectives of countries. For the long term growth prospects of developing countries to remain resolutely positive, focus on MSMEs will be a sine qua non.

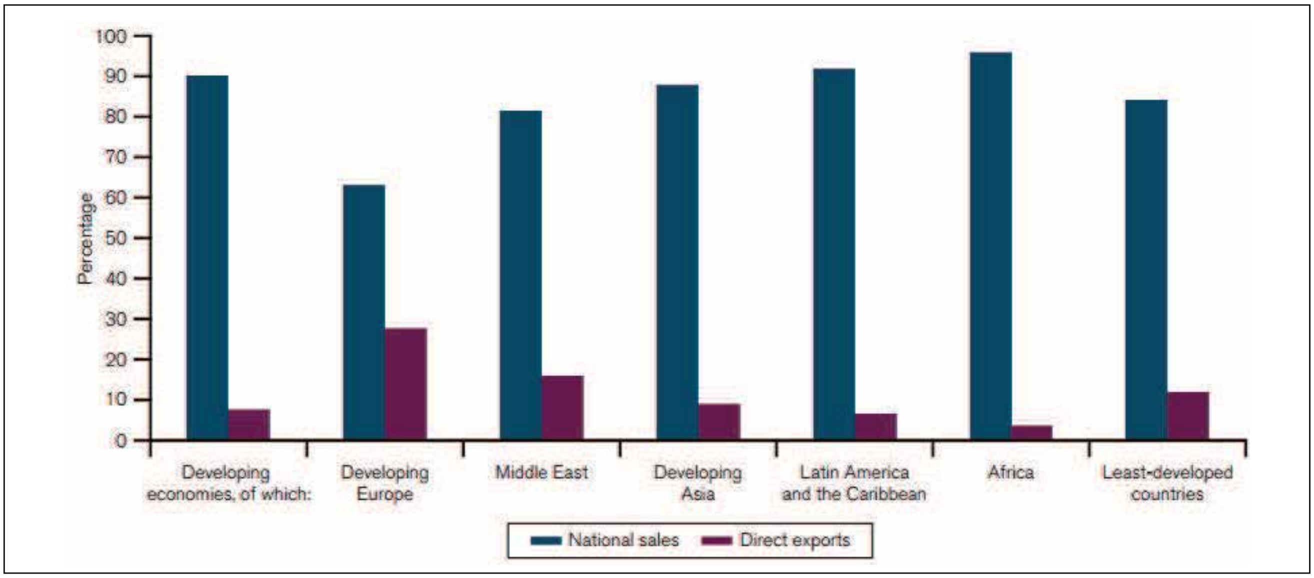
Nearly 90 percent of all enterprises in most Asia-Pacific economies, and about 80 percent in Africa, are MSMEs. However, their level of involvement in exports is low. According to WTO, direct exports account for only 7.6 percent of total sales of Small and Medium Enterprises (SMEs) in the manufacturing sector of developing economies. As against this, large manufacturing firms in these economies export nearly 14.1 percent of their total sales. The shares of exports in SME manufacturing vary vastly across regions. For developing Europe, exports account for around 28 percent of overall sales, while in developing Asia and Africa, the share is 8.7 percent and 3 percent, respectively (Figure 15). Clearly, there is substantial latent potential to export.

Lack of access to trade finance is one of the major reasons for the low participation of MSMEs in international trade. Rejection rates for trade finance applications are as high as 56 percent in case of MSMEs, as compared to a low 7 percent for multinational corporations[36]. The challenge is even more acute in case of developing countries. In case of Africa, for example, SMEs account for only 28 percent of trade finance portfolio of banks[37].

There are several reasons that impede access to trade finance by MSMEs. The KYC/AML regulations highlighted as key bottlenecks in the earlier section, disproportionately impact MSMEs. Nearly 75 percent of the banks in the ADB 2016 Trade Finance Survey reported that AML regulations will adversely impact SMEs. As against this, only 20 percent and 5 percent of the banks reported AML regulations as a constraint in case of large corporates and MNCs, respectively. About 84 percent also perceived Basel III regulations as an impediment, but almost an equal number also perceive it as a challenge in other segments (large corporates: 83 percent; MNCs: 78 percent) (Figure 16).

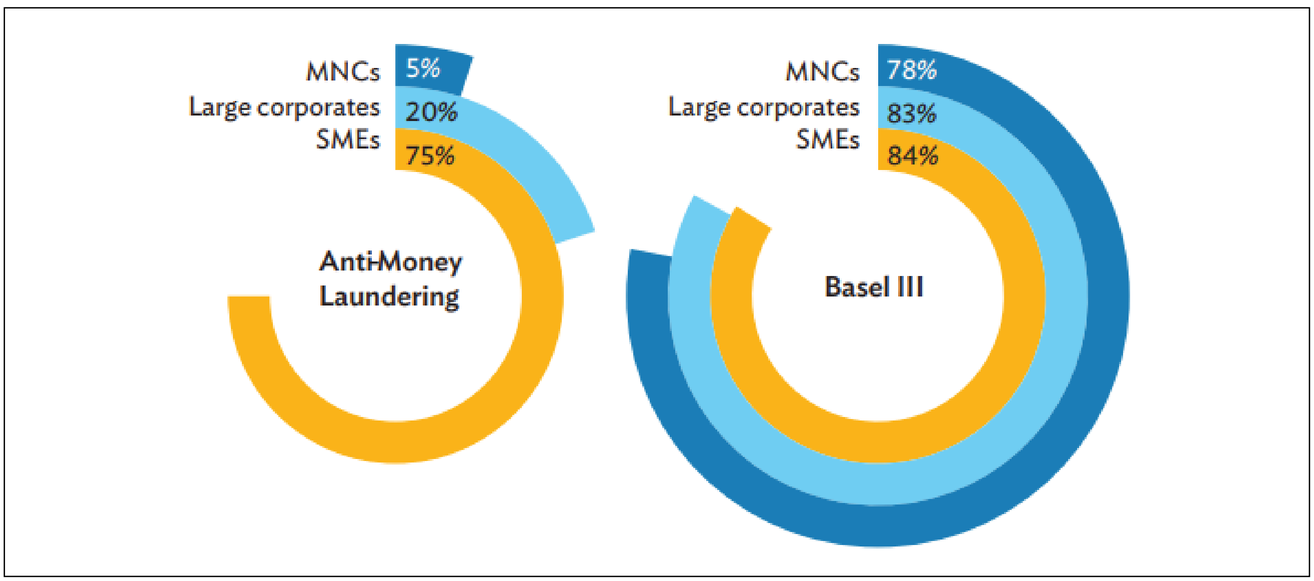
[33]Sibos (2010) Banks voice Basel III fears. Sibos Issues
[34]SWIFT (2013) Observations on the evolution of trade finance and introduction to the bank payment obligation
[35]IIF and EY (2016), Seventh Annual Global Bank Risk Management Survey
[36]WTO (2016), Trade Finance and SMEs: Bridging the Gaps in Provision
[37]AfDB (2017), Trade Finance in Africa: Overcoming Challenges

Figure 15: SMEs' Shares of Direct Exports in Total Sales in the Manufacturing Sector



Note: SMEs' shares of indirect export are not included. Developing Europe comprises Albania, Bosnia and Herzegovina, Montenegro, Serbia, Former Yugoslav Republic of Macedonia and Turkey; Developing Asia includes all members of the WTO's Asia region minus Australia, Japan and New Zealand; Latin America and the Caribbean includes all members of the WTO's South and Central America and the Caribbean region plus Mexico.
Source: World Trade Report 2016

Figure 16: Expected Impact of Regulatory Requirements by Client Segments



Source: ADB. 2016 Trade Finance Gaps, Growth, and Jobs Survey

High risk perceptions of MSMEs are also a major reason for lack of access to not just trade finance, but finance in general as well. The high risk perception eventually translates into lost opportunities for firms in developing countries. According to a survey, nearly 71 percent of firms facing rejection reported that when a bank declines to finance a trade transaction, they do not seek alternative financing for that transaction[38]. While some of these transactions are then self-financed, it can be assumed that some proportion of them do not go forward. This has repercussions on the trade flows and consequently on the overall growth and development.

[38]Asian Development Bank

Another major reason for lack of trade finance availability is the lack of capacities in local banks to service the demand emanating from the sector. Bank density, defined as commercial bank branches per 100,000 adults, is lower than the global average in case of regions such as South Asia and Sub-Saharan Africa (Figure 17). Moreover, local financial system may not even possess adequate ability and skill set for handling trade finance instruments efficiently. In an ADB survey, nearly 37 percent of banks reported that staff knowledge of trade finance was a limitation for trade finance activities. Specifically, banks reported that they were either not providing the most appropriate type of instrument, or rejecting the proposals on account of lack of knowledge about processing[39].

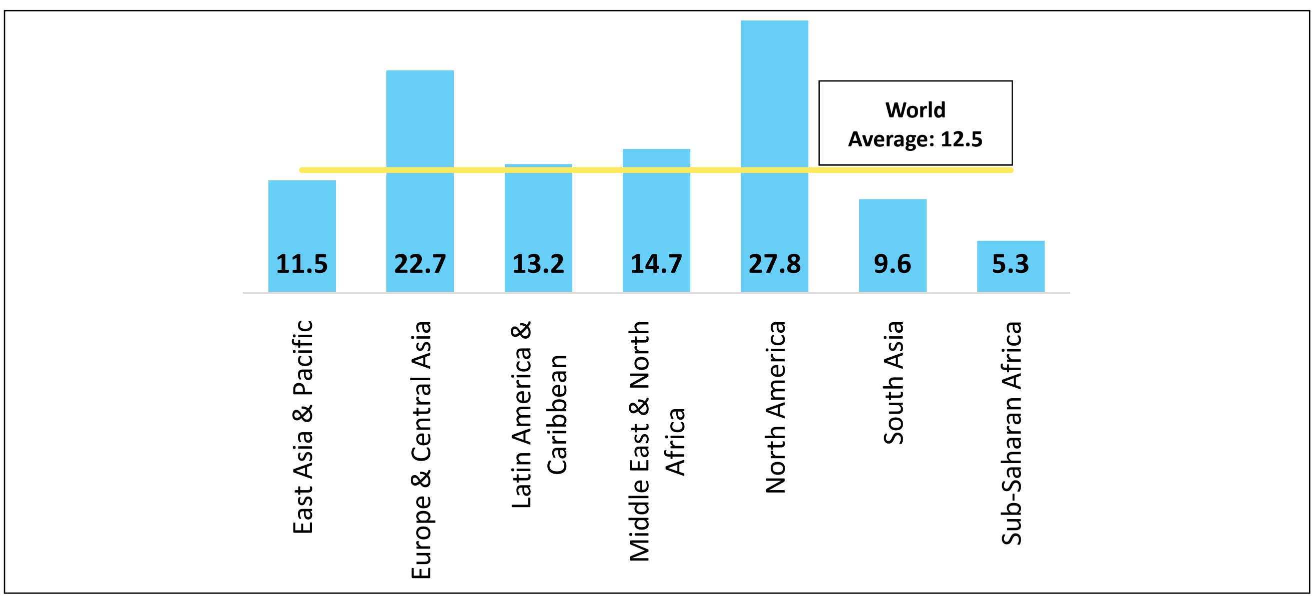
According to Auboin and DiCaprio (2016), there are two issues pertaining to bank capacity, one of which is the regulatory requirements of confirming banks. The other is the lack of ability of banks to service the demand for more sophisticated instrument. This latter aspect is not related to the risk attached with trade transactions, and this is one of the area which trade finance programs of multilateral development banks target[40]. Dollar liquidity is also a constraint for local banks. Capacity building of local financial sector is therefore crucial for ensuring adequate trade finance flows in developing countries.

CHALLENGES FOR SMALLER DEVELOPING COUNTRIES

The impact of de-risking and reduction in correspondent banking relationships is more likely to be felt in smaller developing countries and on smaller firms. As mentioned in Chapter 2, trade financing gaps are among the largest in case of countries in Africa and developing Asia.

Basel guidelines are expected to have increased the cost of trading exposure in emerging countries. To assess the risk of foreign sovereign exposure, global credit ratings are used, which adversely impacts the cost of trading exposures of banks to emerging markets[41]. Some developing economies may face risk weighting of 150 percent, as against a 20 percent risk weighting in case of developed countries.

Figure 17: Commercial Bank Branches (per 100,000 adults)



Source: World Bank Development Indicators, Exim Bank Research

[39]Marc Auboin and Alisa DiCaprio (2016), Why do Trade Finance Gaps Persist: and does it Matter for Trade and Development?
[40]Ibid.
[41]BCBS (2014), Impact and Implementation Challenges of the Basel Framework for Emerging Market, Developing and Small Economies. Working Paper 27. Prepared by the Basel Consultative Group

Countries with high risk ratings are expected to suffer the most on account of retrenchment of trade financing as banks and financial institutions would be induced to reduce the overall risk of their trade finance portfolio. The sovereign default risk of countries would directly affect the ability of exporters in availing of trade finance as the country risk is an important parameter for pricing by financial institutions.

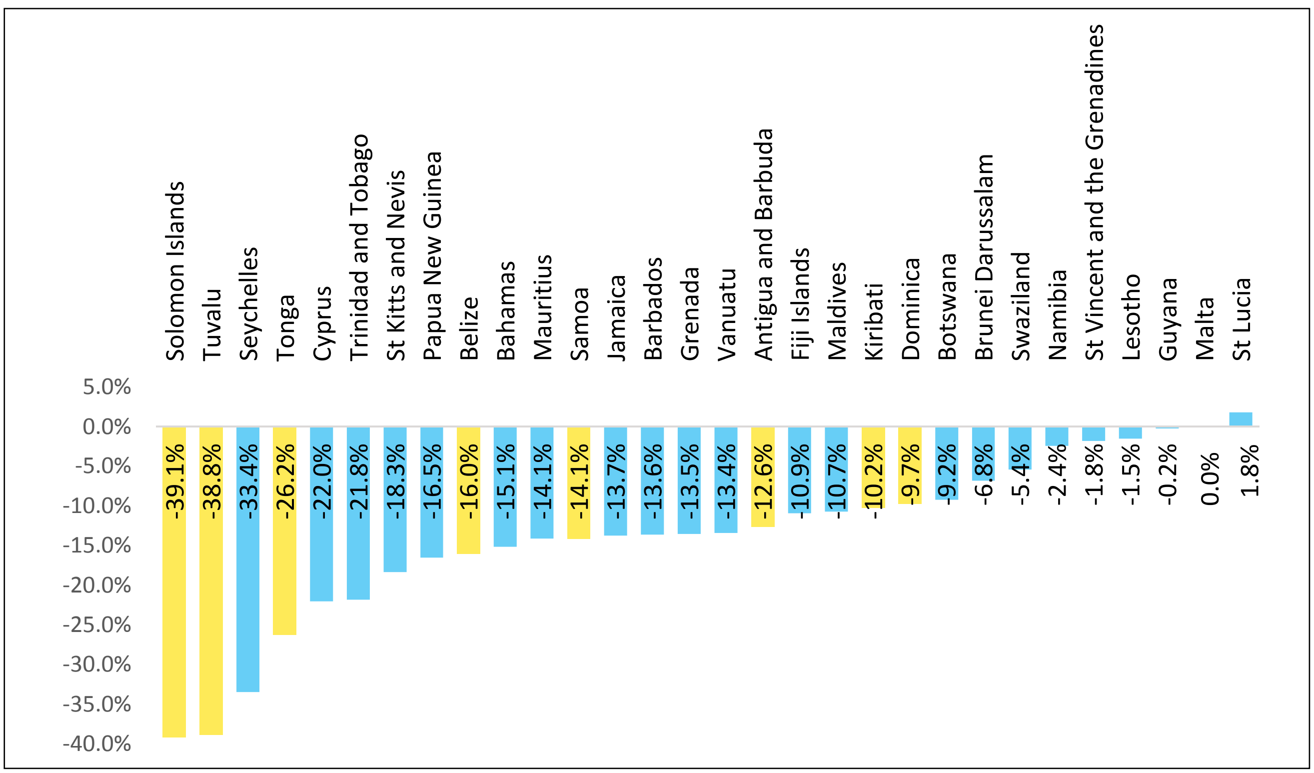
The impact of trade finance gaps and de-risking are most severe in case of small state countries[42], which rely significantly on cross-border funding for trade. These countries usually import a considerable share of their basic necessities and are beneficiaries of substantial remittance inflows. Reduced access to cross-border payment systems can therefore have severe consequences for these countries. According to the FSB Correspondent Banking Data report, almost all the small state countries registered a decline in the number of active correspondents during the period 2012-16 (Figure 18). These correspondent relationships underpin trade, and severing them exacerbates the trade financing gap.

LACK OF KNOWLEDGE OF PRODUCTS

There are a wide range of financial instruments available for trade. Several non-traditional financing mechanisms such as supply chain finance and bank payment obligation exist, but the knowledge about these products is limited. Lack of familiarity with these products compounds the problems in trade financing. In case of rejections, lesser number of firms will look for alternative financing options if the level of knowledge about existing products is low.

In an ADB survey, only 40 percent or lesser companies reported familiarity with non-traditional financing products such as bank payment obligation, supply chain finance, factoring and forfaiting (Figure 19). In fact, in case of traditional financing products as well, familiarity with certain products such as credit insurance was low.

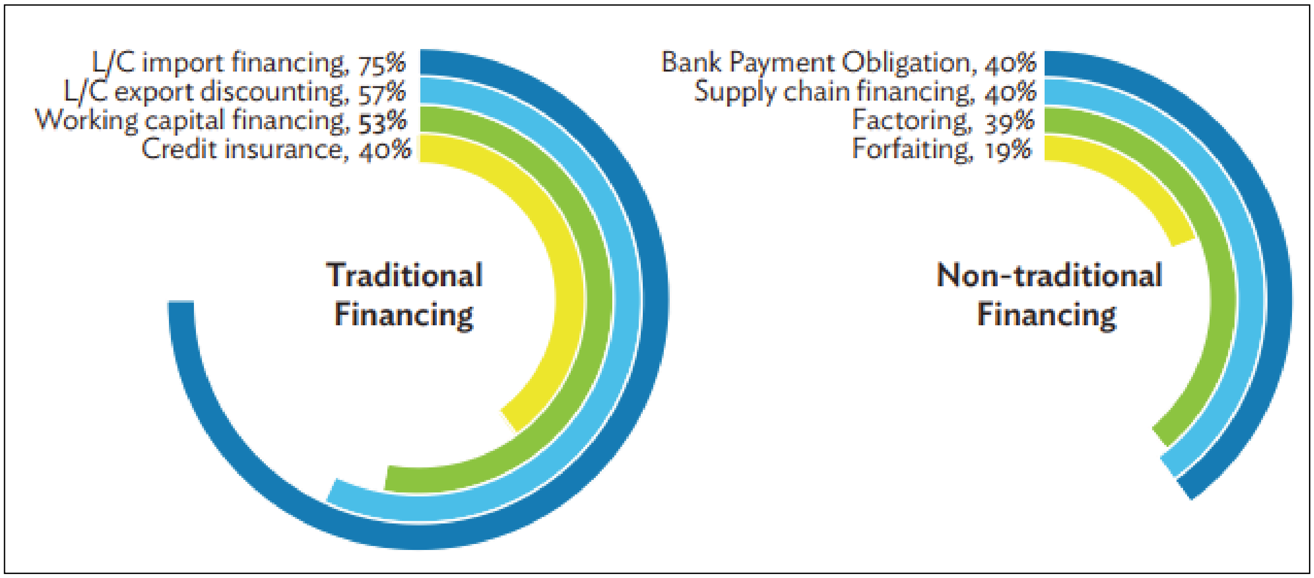
Figure 18: Change in Number of Active Correspondents in Small States (2012-16)



Note: Countries in yellow were served in June 2016 by less than 4 banks from the FSB-CBCG survey sample
Source: FSB Correspondent Banking Data Report

[42]Small states are sovereign countries with a population of 1.5 million people or fewer

Figure 19: Familiarity with Traditional and Non-Traditional Financing Products (% of Respondents)



Source: Asian Development Bank

Supply Chain Finance (SCF) has been growing rapidly, with annual revenues of nearly US$ 2 billion. However, the potential for SCF is much higher at US$ 20 billion[43]. Bank payment obligation is another product which is relatively new and offers the advantages of speed, flexibility and reduced complexity. It is a framework endorsed by the ICC and SWIFT, and acts as a middle ground between traditional Letters of Credit and Open Account trade (Box 1). Greater use of these financing options can significantly reduce financial frictions.

Box 1: Bank Payment Obligation

Launched in 2013, the Bank Payment Obligation (BPO) is a standardised, irrevocable payment instruction which offers buyers and sellers a way to secure and finance their trade transactions, regardless of size, geography or industry. The BPO is a new payment term alongside existing ones such as letters of credit, advance payments and open account payments. Unlike traditional instruments, the BPO combines legally binding rules with electronic messaging and matching capabilities.

The BPO is facilitated by the Trade Services Utility, which is SWIFT's inter-bank messaging and transaction matching cloud application. For banks, the BPO is convenient to use as it is integrated into the correspondent banking agreements that the banks have in place for international payment and trade transactions. The use of BPO is detailed in a dedicated ICC rulebook. The BPO integrates into eDocumentation and eCommerce platforms, thereby enabling trade flows to be digitised further.

Banks' proprietary supply chain finance solutions tend to provide finance at the penultimate stage of a trade transaction, when an invoice is approved. However, suppliers may require financing and risk mitigation tools at a much earlier point in the transaction – such as when a purchase order is raised. Unlike supply chain finance, the BPO allows banks to provide risk and financing services when the sale contract is agreed between the buyer and the seller. As such, the BPO supports both pre-shipment and post-shipment finance. Other benefits for corporations include: working capital and cash flow improvements; increased automation of payment, reconciliation and forecasting processes; and win-win relationships between buyers and suppliers.

Source: SWIFT (2015), Whitepaper on 'The Bank Payment Obligation: A New Payment term to Secure and Finance Trade'.

[43]McKinsey (2015), Supply Chain Finance: Emergence of a New Competitive Landscape

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[44]. 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 Europe cannot provide short-term public export guarantees of less than two-year maturity 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. Sinosure, which provides short, medium, and long-term export credit insurance in China, had the largest new commitment in 2016, amounting to nearly US$ 375.2 billion. ECAs in Korea, Japan, and India were also among the top providers of short-term official cover for export credit and working capital volumes in 2016 (Table 1).

Table 1: New Short-Term Official Support by ECAs, 2016

Country (ECA)	New Commitments (US$ Bn)
China (Sinosure)	375.2
Korea (K-sure)	119.4
Japan (NEXI)	52.9
Canada (EDC)	47.6
India (ECGC)	39.8
Germany (Euler Hermes)	12.0
Russia (EXIAR)	8.2
United States (EXIM)	3.7
Italy (SACE)	1.8
United Kingdom (UKEF)	0.1

Source: 2016 Exim Competitiveness Report

Response to Crisis

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 in the post-crisis scenario. ECAs played an important stabilizing

[44] OECD Glossary of Statistical Terms

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 characterized by heightened risk.

OECD Countries

After the crisis, the European Commission in 2008 had introduced several changes in the Commission State Aid Guidelines on short-term export credits. Flexibility was provided in an existing escape clause which allowed the official ECAs to cover short-term export risks in the OECD if the private sector cannot provide for it. Until 31st December 2011, the escape clause could be applied if four national exporters stated the refusal from insurers to cover specific operations, or one international and one national export-credit insurer declared the lack of private market for those risks.

A total of 13 member countries benefitted from the temporary exception provided for export credit insurance by the European Commission (Table 2). Several countries submitted detailed quantitative data showing unavailability of cover from the private sector, which highlighted the need for ECA intervention during such crisis situations. According to the European Commission, Austria provided an estimate that premiums for private insurance had increased by 40-90 basis points per year depending on the underlying risk profile. The estimate for withdrawal of insurance coverage of private credit insurers in Austria was up to 15-30 percent. The corresponding withdrawal rate in Sweden was up to 20-30 percent. The Lithuanian authorities estimated that due to the financial crisis total export credit insurance supply had decreased by around 20-40 percent[45].

Table 2: Temporary Exceptions Granted for Export Credit Insurance by European Commission

Applying Country	Date of Submission	Date of Decision	Date of Expiration	Buying Countries Covered
Austria	20-Jul-09	17-Dec-09	31-Dec-10	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, The Netherlands, Portugal, Spain, Sweden, The UK, Australia, Canada, Iceland, Japan, Norway, Switzerland, The USA
Belgium	25-Sep-09	6-Nov-09	31-Dec-10	All EU and OECD Countries
Denmark	27-Feb-09	6-May-09	31-Dec-10	All EU and OECD Countries
Finland	29-Apr-09	22-Jun-09	31-Dec-10	All EU and OECD Countries
France	23-Jul-09	5-Oct-09	31-Dec-10	All EU and OECD Countries
Germany	30-Mar-09	5-Aug-09	31-Dec-10	All EU and OECD Countries
Hungary	18-May-10	5-Jul-10	31-Dec-11	All EU and OECD Countries
Latvia	2-Apr-09	10-Jun-10	31-Dec-10	All EU and OECD Countries
Lithuania	11-Nov-09	21-Dec-10	31-Dec-11	All EU and OECD Countries
Luxembourg	23-Jan-09	20-Apr-09	31-Dec-10	All EU and OECD Countries
The Netherlands	8-Jul-09	2-Oct-09	31-Dec-10	All EU and OECD Countries
Slovenia	21-Dec-09	16-Mar-10	31-Dec-10	All EU and OECD Countries except Japan
Sweden	3-Nov-09	25-Dec-09	31-Dec-11	All EU and OECD Countries

Source: European Commission

[45]The effects of temporary State aid rules adopted in the context of the financial and economic crisis, European Commission, October 2011

There were several other changes immediately after the crisis which had an effect on the ECA activities. In January 2009, participants in the OECD's Arrangement on Officially Supported Export Credits also changed some of the rules of the Arrangement to facilitate the financing of projects. This included changes in the definition of countries in Category I for maximum repayment term purposes. This change enabled a wider range of countries, including emerging economies to benefit from ten-year repayment terms instead of a maximum of 8.5 years. The limit on share of officially supported export credit in intra-OECD project finance was also temporarily increased from 35 percent to 50 percent to contribute towards the recovery/ stimulus plan of several OECD countries. Apart from these, more flexibility was also provided in the repayment profile for officially supported export credits in the renewable energy and water sector. In July 2009, OECD countries had also agreed to enhance official support to exports of renewable energy and nuclear power equipment by offering more generous terms.

Non-OECD Countries

According to the 2015 Competitiveness Report of the Export- Import Bank of the United States, more than two third of global trade-related support now falls outside the OECD Arrangement. The countries outside the OECD arrangement also enhanced support to trade finance after the crisis. The policy response for supporting trade finance was varied and involved a host of stakeholders including development banks, ECAs, and Central Banks.

Several developing economies considered establishment of ECAs for meeting the financing requirement of exports sector. For example, in December 2008, Indonesia approved a law to establish Indonesia Eximbank, for providing export-related financing, guarantees, insurance and consultancy services. Similarly, in Russia, Russian Agency for Export Credit and Investment Insurance was established in 2011 as the country's first ECA. Brazil also opened the Agência de Crédito à Exportação do Brasil S.A. (Exim Brasil), an export credit agency, as a subsidiary of BNDES. Some other countries enhanced their existing focus on ECAs. For example, the Parliament in Ukraine passed a law on export insurance and crediting in August 2008, which granted the Ukreximbank the status of official export credit agency. The law also contained plans for establishing the Ukrainian Export Insurance Company, a state insurance company. In Sierra Leone, the Government revamped the Sierra Leone Investment and Export Promotion Agency, a government agency which has been mandated to, inter alia, provide export finance and export credit guarantees.

Several ECAs also received substantial capital infusion from their Governments. In December 2008, the Ministry of Finance in Thailand injected 1.3 billion baht in the capital of Export-Import Bank of Thailand, and further increased it by another 5 billion baht in September 2009. The capital of Compagnie Tunisienne pour l'Assurance du Commerce Extérieur, which is the quasi-government export credit and guarantee entity in Tunisia was also increased.

During the financial turmoil, access to finance was particularly hit for SMEs. Recognizing this, several ECAs took steps to strengthen their support for SMEs. The Hong Kong Export Credit Insurance Corporation, for example, increased its insurance cover, waived annual policy fee, expedited the processing of small credit limit applications, and undertook free credit checks. In 2009, Export-Import Bank of Korea (KEXIM) announced a higher target of 13 trillion won for supporting smaller local trading companies. This was nearly double the trade finance support to these companies in the previous year. La Corporación Financiera de Desarrollo in Peru expanded insurance coverage to US$ 6 million under its export credit insurance program for SMEs.

Several ECAs also began new programs, especially in the short-term space. New Zealand Export Credit's Office began a short-term trade credit guarantee product in 2009 for exporters and their banks where overseas buyers offered repayment terms of less than 360 days. The Government in Turkey also initiated a new credit program, managed by its Export-Import Bank, to promote exporters in international trade fairs.

In some countries, institutional collaboration led to establishment of new, innovative financing mechanisms. The Buyer's Credit under the National Export Insurance Account (BC-NEIA) program is a pioneering innovation led by the Ministry of Commerce and Industry, Government of India, in conjunction with the two state-owned ECAs- the ECGC Ltd. and the Export- Import Bank of India (Exim India). National Export Insurance Account (NEIA) was a trust set up by the Ministry of Commerce and is being administered by ECGC Ltd. Exim India provides Buyer's Credit under NEIA for promoting India's project exports to traditional as well as new markets in developing countries which need deferred credit on medium or long-term basis. While Exim India extends the credit facility, it obtains credit insurance cover under NEIA through ECGC Ltd. and the insurance premium is borne by the project exporter.

Current Role of ECAs

According to the World Trade Organization, the recent slowdown in trade growth was on account of pervasive slowdown in the economic activity, as also structural changes in the relation between trade and output. This weakness in global demand has reinforced the need for ECAs to address the financial constraints for growth in national exports.

While market liquidity has recovered from the lows during the global financial crisis, the ability of banks and financial institutions to support trade finance remains restricted on account of the regulatory environment. Countries therefore continue to increase focus on ECA activity. Several countries such as Georgia, Sri Lanka and Ghana are planning to set up new ECAs. Capital infusion has also been undertaken in case of several ECAs such as Exim China and Exim India.

<u>Focus on Project Finance</u>

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. Within the OECD, ECAs are now increasingly providing products outside of the Arrangement to finance projects abroad. Some of the temporary measures such as the escape clause for easing the availability and the cost of export credit in OECD are now withdrawn, and have been replaced by 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, Korea, provide substantial trade-related support through these programs.

- Market Window: Under this financing, an ECA takes a market-based approach and provides finance on terms which are comparable to those that the recipient may receive in the market. ECAs adopt a market based pricing under these programs. The terms offered under these programs 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. Export Development Canada provides finance under such a program.

- 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.

Apart from these, ECAs have also started specific programs to boost project exports. In 2016, Japan

Bank for International Cooperation (JBIC) introduced a Special Operations account, aimed at facilitating higher-risk projects, such as projects offered by local governments in emerging countries with lower credit. Unlike its traditional lending operations, JBIC is exempt from the requirements for certainty of repayment for individual projects under Special Operations account, and the focus will be on long-term break-even of the whole portfolio. According to JBIC, the Special Operations account will enable the country to become more competitive in projects in the emerging markets.

Exim India has also enhanced its focus on project exports as an important channel for expansion of exports from the country. Guidelines for existing programs have been fine tuned to streamline the processes and strengthen project monitoring. Several new programmes have also been introduced to enhance competitiveness of Indian project exporters (Box 2).

Box 2: New Initiatives for Project Exports by Exim India

Change in Guidelines for Lines of Credit: Exim India extends Lines of Credit (LOCs) at the behest of the Government of India (GOI), under the Indian Development and Economic Assistance Scheme, for supporting export of projects, equipment, goods and services from India, and creating a positive and sustainable socio-economic impact in the LOC-recipient country. A new set of guidelines for the Scheme was issued on December 07, 2015, streamlining the process and enhanced the monitoring by Exim India.

The LOCs finance exports from India and execution of infrastructure projects by Indian companies in developing countries. Besides offering a risk-free, non-recourse export financing option to Indian exporters, Exim India's LOCs demonstrate Indian expertise and project execution capabilities in emerging markets. The LOCs enable the recipient developing countries to set up developmental and institutional projects and augment local capacities and skills.

Buyer's Credit under National Export Insurance Account: Exim India's strong emphasis on increasing project exports from India has been enhanced with the introduction of the BC-NEIA programme. BC-NEIA is a unique financing mechanism that provides a safe mode of non-recourse financing option to Indian exporters and serves as an effective market entry tool to the traditional as well as the new markets in developing countries, which need deferred credit on medium or long term basis.

Concessional Financing Scheme to Support Indian Companies Bidding for Strategically Important Infrastructure Projects Abroad: A new concessional financing scheme has been approved which enables Exim India to offer concessional finance to support Indian companies bidding for strategically important infrastructure projects overseas. Under GOI's Concessional Financing Scheme, Exim India has extended a term loan of US$ 1.60 billion to the Bangladesh India Friendship Power Company Pvt. Ltd., a 50:50 joint venture between the Bangladesh Power Development Board, Bangladesh and NTPC Ltd., India, for financing the 1320 MW [2*660 MW] ultra-super-critical strategically important Maitree Super Thermal Power Project in Rampal, Bangladesh.

Export Development Fund: The Export Development Fund (EDF), a special fund created by the Government of India and administered by Exim India was operationalized in FY 2016-17. On May 04, 2016, the EDF concluded an umbrella Framework Agreement with seven Iranian banks to enhance a Buyer's Credit facility to finance the export of goods and services from India to Iran, from Rs. 900 crore to Rs. 3000 crore.

The Framework Agreement of Rs.3000 crore is earmarked for two steel rail contracts and Chabahar Port Development project.

Project Development Fund for CLMV countries: Exim India has been partnering the GOI under the GOI's "Look East Act East Policy" by way of a Project Development Fund for the CLMV Region. The Fund, with a corpus of Rs. 500 crore, has been created under the Department of Commerce, Ministry of Commerce and Industry and is being managed by Exim India, which is the Empowered Institution under the initiative. Under the initiative, Exim India will identify opportunities for investment by Indian companies in the CLMV region, so as to help companies integrate into the Regional Value Chain. Presently, 4 project opportunities, one in Cambodia, two in Myanmar and one in Vietnam in the Healthcare Sector, Education Sector and Pharmaceuticals Sector have been identified, wherein preparation of Detailed Project Reports is being undertaken post which SPVs will be set up in the respective countries for implementing the identified projects.

Support to Small and Medium Enterprises

The challenges for accessing trade finance are particularly acute in case of SMEs. As discussed in the previous section, ECAs had increased their support to the SME segment in the post-crisis period. Even after considerable restoration in global liquidity, ECAs continue to maintain 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. This is evident from the fact that nearly 89 percent of ECAs were developing or maintaining a SME support scheme in 2015, as against 69 percent of ECAs in 2013. Moreover, nearly 71 percent of ECAs had specialised products for SMEs in 2015, as against only 65 percent in 2013 (Figure 20).

Figure 20: Survey of ECA Support to SMEs

	2013	***2015***
Percentage of respondents who have or are developing a SME support scheme	69%	89%
Percentage of respondents who support SMEs due to policy or mandate	75%	79%
Percentage of respondents who support SMEs through insurance support	95%	97%
Percentage of respondents who support SMEs through financing support	35%	44%
Percentage of respondents who support SMEs directly	60%	74%
Percentage of respondents who have special SME products (differences in process, coverage and risk appetite)	65%	71%
Percentage of respondents who have a special SME team	44%	57%

Source: Berne Union Yearbook 2015

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. In Japan, JBIC had announced support to SMEs as one of the five key action plans to be undertaken between 2015 and 2017. One innovative way in which JBIC supports SMEs is through local currency-denominated loans. Many SME, 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 prepares 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 and Indian rupee.

KEXIM, another major Asian ECA, introduced the 'Hidden Champions Initiative' in 2009 and 'Shared Growth Program' in 2011 to empower domestic SMEs. Under the Hidden Champion Initiative, selected companies receive both financial and non-financial forms of assistance from KEXIM which seeks to incubate globally competitive SMEs. In 2016, the Bank selected four SMEs as Hidden Champion candidates adding to a total of 249 as of the end of 2016. The Shared Growth Program is designed to foster an economic environment where large companies and SMEs can grow together as genuine partners. In 2016, a total of 816 companies participated in the Shared Growth Program and KEXIM extended KRW 2.1 trillion to the participating large companies and SMEs.

Finnvera in 2016 supplemented its existing selection of financing services with a new loan product, the Growth Loan, intended for financing SMEs and midcap companies in major growth and internationalisation projects or corporate reorganisation. The Growth Loan is a debt-based mezzanine financing product that combines the features of both equity and debt financing. The company's self-financing portion must always be at least 20 percent and the share contributed to the total financing by financiers other than Finnvera must be at least 50 percent. The idea is that the loan would attract other financiers in the market to invest in projects where risks are high but profitability and effectiveness are deemed to be good.

In the insurance/guarantee segment as well, there has been significant traction in SME products. The Eksport Kredit Fonden (EKF) (Denmark) established a new SME department in 2010, and over the past several years introduced new products for its SME clients. One of the products is SMV Guarantee, which is a buyer credit guarantee for small businesses with lesser documentation and easier approvals. In 2015, Agência Brasileira Gestora de Fundos Garantidores e Garantias (ABGF) in Brazil started an SME export credit insurance scheme.

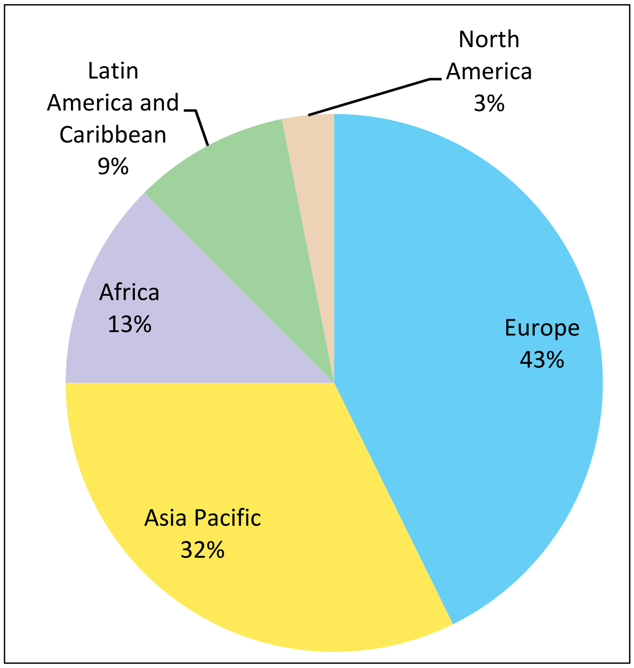
These are just some examples of the increasing support by ECAs for SMEs. Clearly, ECAs have significantly expanded their horizons, focusing not just on the high value project exports, but also on the relatively lower value exports from the SME segment. Both these segments characterized by high risks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

While adhering to their mandate of export promotion, ECAs are also making an attempt to promote domestic investments in the face of global economic slowdown. Finnvera, for example, has introduced guarantee program for financing of domestic investments with a link to exports. EXIAR has also introduced a new program which allows it to support projects in Russia that are export-oriented. EXIAR's involvement in these projects reduces the risk perception of foreign ECAs and banks, thereby encouraging more foreign involvement in projects.

ECA Lending in Asia Pacific

With a share of 32 percent in total, Asia- Pacific has the second largest number of active ECAs; second only to Europe. These ECAs, however, account for a much larger share in total ECA business volumes. In 2015, it was estimated that more than 50 percent of worldwide ECA business was covered by Asian ECAs[46] (Figure 21).

Figure 21: Geographical Distribution of Active ECAs



Source: 2016 Export Competitiveness Report, Exim Bank Research

A clear dichotomy emerges from the analysis of trade finance in the Asia Pacific region. The region is the largest user of some of the key trade finance products. It also accounts for a significant number of ECAs which have expanded their business volume in the post-crisis period and now accounts for nearly half of ECA business worldwide. In spite of these, the region has the largest share in global trade finance gap. This is not quite surprising. Data indicates that while the number of ECAs active in Asia Pacific has remained roughly constant over the last few years, the number of commercial banks declined sharply in 2016. Though banks still dominate the lending landscape, the pace of growth in bank lending has been low in 2016, while that of ECAs has grown[47].

Going forward, the role of ECAs will be critical in bridging the trade finance gap in the Asia Pacific region. It is also important to note that ECAs can only complement trade finance activities, and not supplement the roles of other entities in a financial system. Therefore, there will be a need for concerted action from all stakeholders for building resilient trade finance architecture. The next chapter explores some of the strategies which can help create such an architecture, and will also highlight the role which ECAs can play towards this end.

MULTILATERAL DEVELOPMENT BANKS

Multilateral Development Banks have set up several programs 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. As the global financial institutions are cutting down their lines of credit for trade, the demand for trade finance support from MDBs has witnessed an increase.

These trade finance programs have substantial benefits for trade and overall growth in developing country, without entailing any concomitant cost for the taxpayers. These are private sector based, demand-led programs, with a special focus on clients in developing countries, particularly the poorest and marginalized ones. Not only are these programs 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.

Trade Finance Facilities of Major MDBs

European Bank for Reconstruction and Development

Trade Facilitation Programme of the European Bank for Reconstruction and Development (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

[46]Ralph Lerch, The Era of Regulation– Part Two, Berne Union Yearbook 2016
[47]Trade Finance Briefing, Trade Finance Analytics, 21 March 2017

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 issued under the Programme:

- 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.

International Finance Corporation

The Global Trade Finance Program (GTFP) of 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 programme, with the aim to transfer international best practices in trade finance to local markets, upgrading the operational and technical skills of trade finance back offices, improving trade finance risk mitigation techniques, and upgrading skills in structuring trade finance transactions.

Asian Development Bank

The Trade Finance Program (TFP) 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. During 2009-2016, a total of 9,204 SMEs were supported under the program.

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

Inter-American Development Bank Group

The trade finance facilitation program of Inter-American Development Bank (IDB) was created in 2000 for supporting the access of Latin American and Caribbean countries (LAC) to finance the trade through guarantees, loans, technical cooperation and knowledge creation. The program aims to strengthen trade finance support, thereby facilitating the region's integration in global and intraregional supply chains.

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 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.

African Development Bank

In response to the Global Financial Crisis, AfDB had launched the Trade Finance Initiative, which was rechristened as the AfDB's Trade Finance Program in 2013. The program 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 program 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 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. ITFC consolidated all its trade finance business handled within the Islamic Development Bank Group. Beginning operations in 2008, the ITFC streamlines trade financing by confirming letter of credit and eliminating the need for using intermediary banks. By removing intermediaries, it also aims to reduce trade costs.

A comparison of trade finance facilities of MDBs (Table 3) indicate that the trade finance programs of major MDBs (EBRD, IFC, ADB, IDB, AfDB, ITFC) supported nearly US$ 109.8 billion of transactions in 2016. Among the MDBs, the trade finance programs of IFC, EBRD and ADB are comparatively larger.

Many of the trade finance programs had started much before the crisis, but the post-crisis period has seen significant increase in the lending limits and resources of several programs. This bode well for trade financing in emerging markets and SMEs, thereby facilitating inclusive financing. Several of the MDBs with regional focus have also imparted a fresh resonance to the intra-regional trade.

Table 3: Comparison of Trade Finance Facilities of Multilateral Development Banks

Program Title	EBRD	IFC	ADB	IDB	AfDB	ITFC
Number of Countries	27	90	20	21	54	50
Program Commencement	1999	2005	2004	2005	2013	2008
Number of Transactions since commencement	19,600	46,000	14,312	1,571	1,300	550
Value of Transactions in 2016 (US$ billion)	14.7	53	26.18	6.45	5	4.5
Number of Correspondent Banks	800	1,300	More than 200	More than 100	329	265**
Claims to Date	2	0	0	0	US$ 850,000 (Value)*	N/A

*Claims relate to 9 L/C confirmation transactions of a local bank that went into receivership
**includes large and small banks, companies and 25 governments
Source: ICC Rethinking Trade and Finance 2017, Islamic Trade Finance Corporation, Exim Bank Research

5. Way Ahead

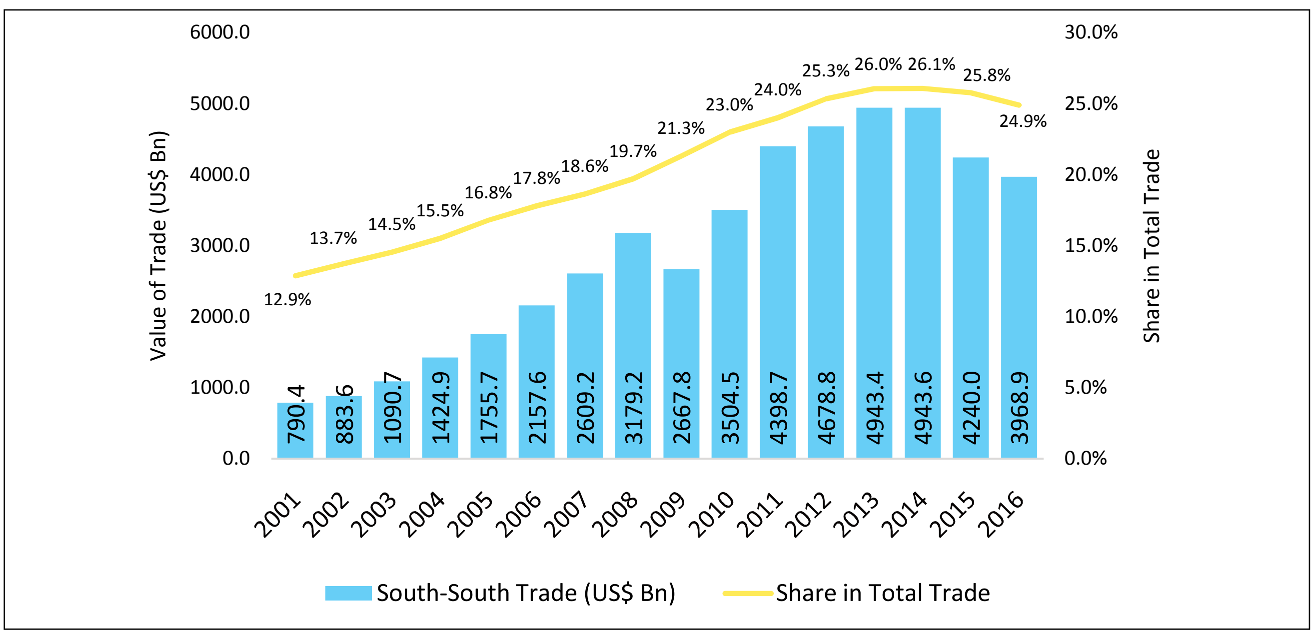
The Global Financial Crisis highlighted the fault lines in financial architecture across countries. The multi-layered disruptions adversely impacted the international trade flows, with deteriorating credit conditions emerging as one of the key transmission channels. In fact, the adverse effect on trade finance, which was more pronounced in the case of emerging economies, still lingers on. The constraints to trade finance have not only emerged from the crisis itself, but also from the response to the crisis, in particular, from the general regulatory tightening.

Financial regulations have witnessed unprecedented strengthening since the crisis, but not necessarily for the most efficient outcomes. Recalibration of capital charges have led to low-risk trade finance products being treated at par with much more complex financial products. Such regulatory treatment has adversely impacted bank-intermediated trade finance, and as a corollary, global trade and economic growth.

In case of developing countries, structural snags in the financial systems, typically characterised by a frail trade finance architecture, further compounds the vulnerabilities and risks. Veritably, the financial sector of several developing economies is still at an early stage of development, and needs capacity building to support trade. Lack of access to international financial system further restricts trade finance availability in these countries.

In a world of deeply integrated economies, solutions to such intrinsic and extrinsic challenges lie in mutual cooperation. The interconnectedness of trade finance markets necessitates development of effective, cooperative partnerships in the financial sphere, to foster resilience and support growth in international trade. Trade finance has been an important conduit for the expansion of international trade during the past century. As the centre of global demand gradually inclines towards the South, substantive upgrade in trade finance architecture will be required to not only support the increase in trade flows emanating from the South but more importantly, also encourage and finance South-South trade flows, which now account for nearly one-fourth of global trade (Figure 22).

Figure 22: Increase in South-South Trade



Source: UNCTAD, Exim Bank Research

The overwhelming role of trade in the multi-faceted interactions among developing countries, and the role of trade finance in harmoniously welding the South-South trade links, behoves developing countries to adopt collective, concerted and coherent initiatives for developing an efficient trade financing framework. The present section delves into the various solutions for a resilient trade finance system.

COLLABORATION AMONG DEVELOPMENT FINANCE INSTITUTIONS

There is a need to address the mix of structural and developmental factors which are hindering the growth in trade finance, and in turn international trade. An essential first step will be to coalesce the efforts of development partners to enhance the existing trade facilitation programs. This includes MDBs such as the IFC, the ADB, the AfDB, the IDB, Islamic Development Bank and the EBRD, ECAs, as well as the national Development Finance Institutions (DFIs). The role of MDBs and ECAs has been crucial in ensuring that trade-finance gap does not incapacitate trade. According to the ICC 2016 Global Survey on Trade Finance, nearly 75 percent of respondents reported that MDBs and ECAs help narrow trade finance gaps. Going forward, the support from these entities will remain critical for supporting trade finance transactions till the time alternative local capacity can be augmented.

As discussed in the previous chapter, ECAs across the world are enhancing their focus on project exports on the one hand, and MSMEs on the other. In the context of project exports, large size of financing requirements often makes it difficult for a single lender to finance the entire project on its own. Globalization has also made projects increasingly depend on multi-country sourcing of goods and services. Collaboration among MDBs, ECAs and national DFIs can substantially enhance the trade financing capabilities, while concomitantly meeting the growing infrastructure requirements. There has been substantial increase in such transactions by MDBs, ECAs, and national DFIs. An example of such collaboration is the financing of Itezhi - Tezhi Hydro Power Project in Zambia. The project involved the development, construction, operation and maintenance of a 120 MW base load hydro power plant, and was a first-of-a-kind public private partnership in the power sector of Zambia. The project was co-financed by several lenders including multilateral banks such as the AfDB and the European Investment Bank; DFIs such as the Development Bank of Southern Africa, Dutch development bank FMO, and French development financial institution PROPARCO; and ECAs such as Exim India.

There have also been cases, where co-financing has enabled ECAs to finance transactions and support domestic companies which they otherwise could not. For example, on account of lack of sufficient scale, the Hungarian Export-Import Bank (Exim Hungary) could not support many Hungarian companies in large-scale transactions on a standalone basis. However, a collaborative approach by Exim Hungary opened up large-scale project opportunities for the domestic companies. Exim Hungary entered into an international deal with the General Electric, Indonesian Power Utility 'Perusahaan Listik Negara', and the Export Development Canada (EDC). The project involved installation of mobile power plants in Indonesia, and the total project value was more than US$ 575 million, of which nearly US$ 453 million was co-financed by the two ECAs—Exim Hungary and EDC in a 50:50 ratio. The project had substantial cross- country benefits. Not only did the project generate exports worth more than US$ 276 million from the Hungarian economy, it also provided nearly 4 million Indonesian homes with electricity[48]. Clearly, smaller ECAs can benefit substantially by networking with other ECAs, DFIs, and MDBs.

There is also substantial evidence of collaboration among ECAs and MDBs. One way through which some of them are already collaborating is through insuring of loan exposures and reinsuring of guarantee

[48]Berne Union Yearbook 2017

exposure. Multilateral Investment Guarantee Agency (MIGA) reinsures approximately 40 percent of its gross exposure with ECAs and Political Risk Insurers. Paul Mudde in his article estimates that if leading MDBs follow MIGA's practice, US$ 169 billion of additional finance can be made available for development[49].

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. Exim India has made an attempt in this direction, and along with the AfDB, IL&FS and State Bank of India, has floated the Kukuza Project Development Company to facilitate private sector participation in infrastructure projects in Africa (Box 3)

Region-specific collaboration can also be encouraged among these development institutions. The Asian region has been particularly active in establishing such frameworks. The Asian Exim Banks Forum (AEBF) is one such platform which has facilitated interactions among the ECAs in the Asian region. At the initiative of Exim India, the AEBF was formed with the purpose of developing and enhancing regional cooperation, forging stronger links among member institutions, and exchanging information and sharing ideas in a structured manner. Given the significance of the platform, Asian Development Bank has been a permanent observer at the AEBF Annual Meetings since 2003. The AEBF members have signed Memorandum of Understanding to utilize credit line, enhance cooperation in cofinancing, and local currency loans, amongst others. The AEBF platform serves as a remarkable example of cooperation among ECAs at a regional level.

Taking the learnings from the AEBF experience, Exim India, along with the United Nations Conference on Trade and Development launched a Global Network of Exim Banks and Development Finance Institutions (G-NEXID) in March 2006 in Geneva. The Annual Meetings of G-NEXID provide an opportunity to deliberate upon measures to foster long-term relationship, share experience and strengthen

Box 3: Kukuza Project Development Company

Addressing the limited institutional capacity in Africa on conceptualization, management, execution of projects and imparting project development capabilities, Indian institutions such as Exim India, IL&FS, and State Bank of India have joined hands with the AfDB, and promoted a Project Development Company for infrastructure development in Africa — 'Kukuza Project Development Company (KPDC)'.

The KPDC has been incorporated in Mauritius in July 2015. 'Kukuza' in Swahili means 'a cause to growth'. Reflect¬ing the name, the KPDC is expected to provide specialist project development expertise to take the infrastruc¬ture project from concept to commissioning in the African Continent. The KPDC will provide the entire gamut of project development expertise to various infrastructure projects, such as project identification, pre-feasibility/ feasibility studies, preparation of detailed project reports, environmental and social impact assessment, etc.

The KPDC shall utilize the domain expertise of each partner during the project development process to establish a bankable and sustainable implementation format based on an in-depth understanding of the concerns of all the stake holders - public authority, users community, developers/ investors and lenders.

[49]Berne Union Yearbook 2016

financial cooperation to promote trade and investment relations among developing countries. Apart from this, the Association of Development Financing Institutions in Asia and the Pacific has also been an important platform for the DFIs in Asia- Pacific to voice their inputs and share their insights, and benefit from the experience of other institutions.

The BRICS countries have also made an attempt to enhance collaboration among their ECAs and DFIs. Five export credit agencies of BRICS countries, namely the ABGF (Brazilian Fund and Guarantee Management Agency), EXIAR (Export Insurance Agency of Russia), ECGC Ltd. (India), SINOSURE (China Export and Credit Insurance Corporation) and ECIC (Export Credit Insurance Corporation of South Africa Ltd) have signed a Memorandum of Understanding to strengthen collaboration among ECAs of BRICS countries by establishing a framework of co-operation among them to support and encourage international trade among the BRICS countries, and wherever appropriate, to facilitate the supply of goods and services from their respective countries as part of a project in any of the BRICS countries. The countries are also collaborating under the BRICS Inter-Bank Cooperation Mechanism (BICM). The BICM serves as a platform for multi-faceted engagement between member development banks — Brazilian Development Bank, Vnesheconombank, Exim India, China Development Bank, and Development Bank of Southern Africa. In less than eight years of its existence, the Mechanism has concluded more than ten agreements, and formed five Working Groups in key cooperation areas such as innovation, training, and financing in local currencies.

Another way in which the development finance institutions can collaborate is through creation of liquidity pools. The Global Financial Crisis 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.

CAPACITY BUILDING OF DOMESTIC FINANCIAL SECTOR

Capacity building of the local financial sector will form the cornerstone of initiatives for improving trade financing infrastructure in developing countries. The growing role and influence of emerging-market firms in international trade need to be supported through multi-faceted intervention. To begin with, a reform of the domestic institutions will be required. Financial markets in several developing economies remain risk averse, and a large proportion of bank deposits in these economies are invested in low-risk low-yield instruments. Companies that are creditworthy but do not have strong banking relations face higher interest rates, fees and capital requirements, which in turn restricts their prospects for growth and diversification. Technical assistance, aid, and policy advice will be required to equip developing countries with the necessary tools to counter the existing challenges and risks to trade finance. Greater adoption of technology will also be essential for removing the frictions in the domestic financial sector.

Technological Capacity

The constraints in developing countries are not only with respect to the knowledge gap, but also in relation to the growing technology gap which results from innovations in advanced economies. The increasing usage of technology is making it an important competitiveness factor. According to Auboin (2007), technology gaps can increase the risk of marginalization of poor countries in trade transactions, and technology networks will have an important role in determining the access to liquidity by developing countries[50].

[50]Auboin, Marc (2007), Boosting trade finance in developing countries: What link with the WTO?, WTO Staff Working Paper, No. ERSD-2007-04

The way of conducting trade finance business needs to undergo an overhaul, with digitalisation and automation forming the linchpin of this transformation. This shall ensure that the processes are streamlined, and become more effective and reliable. This shall also accelerate the process of providing trade finance, thereby leading to overall operational improvements. Currently, the technology uptake in developing countries has been slow due to considerable scale and complexity of digitalisation.

Automation of key processes such as due diligence processes can significantly reduce the costs and complexity of trade finance. Compliance related costs can be substantially reduced through technological intervention. According to the ICC Global Survey 2017, appropriate application of technology to compliance-related processes and procedures could reduce the compliance costs by 30 percent or more[51].

Recognizing the benefits of technology and automation, several initiatives have been taken in this regard. For example, in 2015, commodity exporter Cargill along with Wells Fargo made an attempt to digitalize its trade finance processes. The two companies collaborated on the first electronic L/C along the US-Taiwan shipping route, using the essDOCS digital platform. Under this, Cargill tied up with shipping line and its agents to create the electronic bill of landing. Cargill then presented the documents to Wells Fargo electronically. Wells Fargo upon necessary examination forwarded the documents to issuing bank in Taiwan, which retrieved and reviewed the documents from the essDOCS platform for final processing and payment[52]. As a result of this, the process time was reduced from more than 10 days to five days or less.

Several fin-tech companies have also made an attempt to ease the regulatory burden on banks through technology and automation. One of the fin-tech firms, Traydstream, has launched a trade digitalization and compliance screening solution. The Optical Character Recognition engine of Traydstream scans and extracts paper-based information digitally, and serves as the initial step towards conversion of trade documents into a digital format. The second part of Traydstream's solution is a compliance engine, which uses machine learning algorithms to quickly scrutinize the digital transaction data for wide array of issues, such as blank fields, inconsistency of names, industry-specific legislation, sanctions and country restrictions. This helps banks and corporations to better handle AML and compliance issues.

Blockchain technology is also set to revolutionize trade finance businesses. It is a decentralized software system which enables a public distributed ledger system. The system allows for tracking and recording of assets and transactions without the presence of a central trust authority such as bank. The system enables peer-to-peer exchange of data, assets and currencies through rules-based smart contracts in a more efficient, transparent and cost-effective manner[53]. There are several advantages of blockchain technology which can help ease the trade finance process:

- The technology allows for greater transparency, and helps lower the cost of L/C transactions as third party verification is not required;
- In absence of any intermediary, transaction time is substantially reduced;
- There is no need for manual processing or authentication through intermediaries. This enhances the process time, and also offers the possibility of self-executing contracts;
- Internet of Things can allow monitoring and tracking of physical assets across countries.

Several companies have engaged in development and testing of blockchain based trade finance applications. For example, IBM along with five large banks, is working on a blockchain based global trade platform known as Batavia. The new platform is built

[51] ICC (2017), Rethinking Trade and Finance
[52] Cargill and Wells Fargo in trade digitisation first, Global Trade Review
[53] Demystifying Blockchain, Cognizant

to be openly accessed by organizations of all sizes anywhere in the world, and can support trade finance for transactions across all modes of transport.

Going forward, it will be important for governments in developing countries, development finance institutions, commercial banks and other financial institutions to collaborate with technology firms for leveraging technologies for trade finance. These stakeholders also need to develop common standards and systems which can allow efficient integration of information and allow seamless operations. The World Trade Board's Digital Standards in Trade Initiative aims to create a common set of standards for digital trade by filtering existing standards and merging those which overlap. Stakeholders should pursue such initiatives to ensure that technology interventions in trade transactions become actionable and contribute towards reduction of the trade financing gaps.

Bridging Knowledge Gaps

Technical assistance for strengthening schemes and mechanisms offered by financial institutions in both private and public sector will be pivotal for enhancing trade finance. Bulk of the trade finance is provided by commercial banks, necessitating capacity building of these institutions for better cross-border transaction risk assessment and lower trade finance costs. The role of MDBs, ECAs and national DFIs will be crucial in such institutional capacity building. Many of them are already engaged in providing such technical assistance. Technical training for issuing banks constitutes an integral part of the trade finance programs of MDBs. Global Trade Finance Program of IFC, for example, has technical assistance modules comprising basic and intermediate courses on trade finance. At times, IFC also places experienced trade finance bankers with issuing banks to help enhance their expertise. Going forward, the role of MDBs through their trade finance program will remain crucial in capacity building activities.

Alongside commercial banks, which are the prime agents of trade finance, technical assistance to ECAs will also be important for effectively bridging knowledge gaps. Institutional capacity building of ECAs will be important in order to position them as key drivers of export growth, especially in scenarios where the commercial sector is unable to efficiently meet the demand for trade finance. Already, ECAs in several countries are proactive in rendering technical assistance for institutional capacity building to other ECAs in developing countries. Exim India, for example, has provided consulting services for institution capacity building in several countries. This, inter alia, includes consulting services for institution capacity building for export credit and insurance to enhance trade competitiveness in Ghana and Rwanda; establishing an Export Credit Guarantee Company in Zimbabwe; feasibility study to establish an Exim Bank in Malaysia; blueprint for setting up an Exim Bank in Zimbabwe; and technical assistance for creation of international financial products for Industrial Development Corporation of South Africa. The Italian ECA, Servizi Assicurativi del Commercio Estero (SACE), has also been active in extending capacity-building support. SACE has provided assistance to Serbia and Montenegro ECA, Russian Agency for Export Credit and Investment Insurance, and Georgian ECA.

There remains substantial scope for further collaboration among ECAs for development of new lines of business and increasing market coverage. ECAs can also increase cooperation for enhancing staff knowledge and expertise. Existing ECAs can also assist other countries in conducting feasibility studies and setting up ECAs. The utility of these institutions in times of crisis when market is not functioning efficiently is now well documented, and it shall be important for countries to undertake feasibility studies for establishing government-backed, self-sustainable organizations focusing exclusively on promoting international trade of their respective countries.

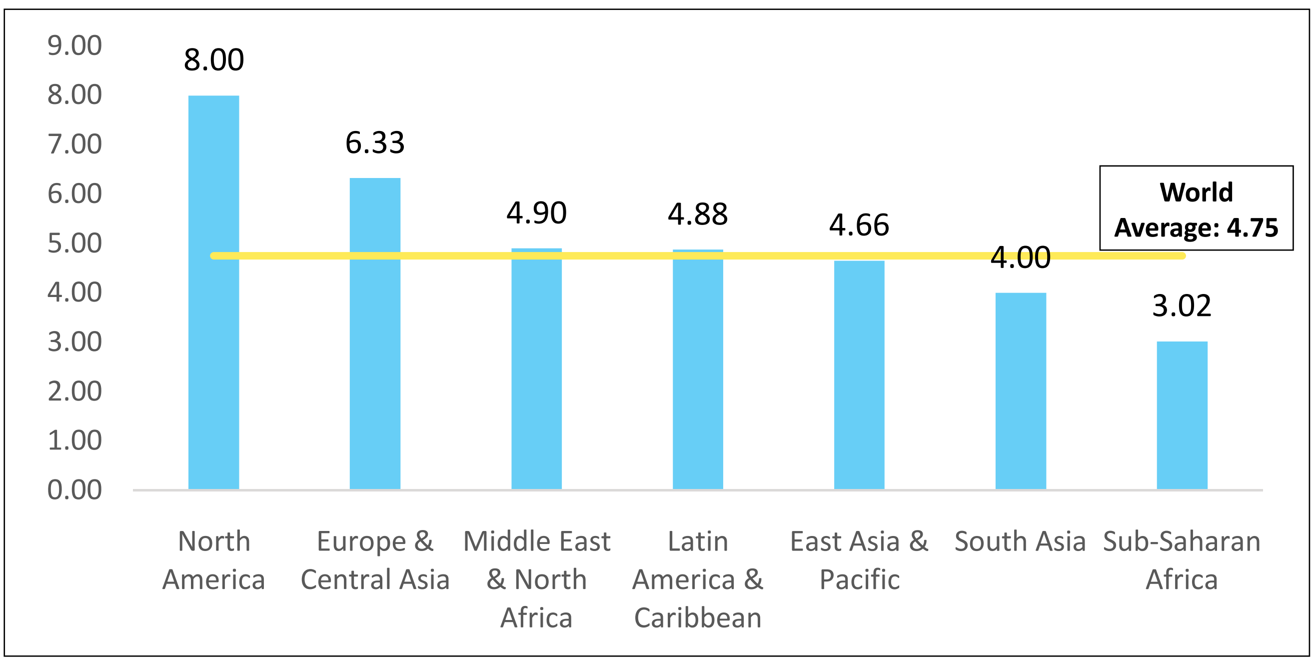
Capacity building will be essential at the level of regulators as well. To begin with, greater dialogues among the financial institutions and regulators will be required to help ensure that trade and development considerations are prioritized and adequately reflected in the regulatory changes in the countries. Greater interactions among regulators is also needed to build a resilient trade finance architecture. To reap the full benefits from regional mechanisms for trade financing, a topic discussed later in the current Chapter, harmonization of regulatory frameworks will be an essential first step.

Remedying the knowledge and technology gaps, while simultaneously addressing the regulatory aspects related to cross-border financial services can significantly reduce the risk of marginalization of developing countries in trade transactions. While North-South knowledge sharing has been the norm, the growth of South-South sharing of knowledge has exponentially grown over the past several years. South-South cooperation can play an important role in equipping local banks with basic to complex trade finance solutions and adopting international best practices, establishing self-sustainable ECAs, and regional regulatory cooperation, thereby making the trade finance architecture more resilient.

MARKET INFORMATION

Collection and sharing of credit information is a critical component for enabling accurate risk assessment of trade finance providers. Correct and reliable information on creditworthiness of importers and exporters can improve the risk assessment process and allow the banks and the financial institutions to offer affordable products. The scope, accessibility and quality of credit information available through public or private credit registries is especially restricted in the regions of East Asia and Pacific, South Asia, and Sub-Saharan Africa. The depth of credit information index, which measures rules and practices affecting the coverage, scope and accessibility of credit information available through either a credit bureau or a credit registry, stands at 4.0 for South Asia and 3.0 for Sub-Saharan Africa — significantly lower than the 4.75 global average. (Figure 23). There are several ways through which MDBs, ECAs and national DFIs can provide support to countries and institutions for creating a robust credit information system. A favourable environment can be created by advising and supporting government authorities, regulators, etc. Direct support can also be provided to countries for developing new credit bureaus and credit registries. Support can also be provided to enhance existing bureaus. IFC is already providing such assistance under its Global Credit Reporting Program.

Figure 23: Depth of Credit Information Index



Note: Range of Index is from 0 to 8, 8 being the highest and 0 being the lowest
Source: World Bank, Doing Business project

Information gaps also arise in cross-border financial services. Correspondent banking relationships have declined following the Global Financial Crisis. While re-evaluation of business models has contributed towards such decline, withdrawal of such relationships has also arisen where regulatory expectations are unclear, risks cannot be mitigated, or there are legal impediments to cross-border information sharing .

Collaborative partnerships can help mitigate the market information gaps. Partnerships among countries for developing and disseminating trade finance data can help in better understanding of the markets, and an accurate pricing of risks. This shall also help understand the disruptions in trade finance markets during periods of shock and crisis, and help devise responsive solutions.

While durable solutions may take time to be established, interim solutions can help improve information flows between correspondent and respondent banks. This includes use of "Know Your Customer" software utilities which store customer due-diligence information in a single repository and allows easy access to bank customer information. Legal and contractual issues can also be streamlined to facilitate information sharing across institutions and countries.

MDBs have also made an attempt to bridge the information gap from the end of exporters and importers. World Bank, for example, has engaged in trade finance clinics which provide capacity building for trade finance in Africa. The clinics provide information about innovative products and mechanisms for trade finance, as also the best practices of institutions.

ALTERNATIVE TRADE FINANCING

Bank-intermediated transactions represent more than a third of world trade, equal to trillions of dollars each year. However, non-bank capital is also emerging as an important source of trade finance. Since the time of the financial crisis, these players have played an increasingly crucial role in meeting unmet demand, and have experienced considerable growth.

Going forward, the role of fin-techs and alternative-finance providers will be crucial in bridging the trade-finance gaps. 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. Fin-tech companies also seek to supplement the existing pool of bank-intermediated trade finance. Hedge funds have also been active in trade financing. Partnerships among DFIs, banks and fin-techs can help drive efficiency and improve the capacity of financial systems to extend trade finance.

TRADE FINANCE FACILITY

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 since the global financial crisis, as they reduce the risk aversion of operations in developing countries by closing the gap between the actual level of risk and its perception. As discussed in the previous chapter, several MDBs provide such facilities which ensure that the bank accepting to confirm an L/C will be paid even if the issuer defaults. Trade finance programs of major MDBs (EBRD, IFC, ADB, IDB, AfDB, ITFC) supported close to US$ 109.8 billion of transactions in 2016, facilitating a host of trade transactions which otherwise may not have been supported. 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.

Several 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 in key regions such as Asia-Pacific, Africa, and Latin America and Caribbean, such dedicated trade finance facilities can be formed through mutual cooperation amongst the countries. The facility will be especially beneficial in case of regions such as the Caribbean and the small island states of the Pacific, which, as discussed in earlier sections, have seen a precipitous decline in correspondent banking relationships.

TRADE ENHANCEMENT FACILITY FOR SMALL STATES

A special Trade Enhancement Facility can also be set up for Small States, which have been disproportionately impacted in the post-crisis period. These countries cannot get L/C, opened by them on behalf of their importer customers, confirmed by exporters' banks at reasonable prices as the perceived risks of the L/C opening banks is considered high by the exporters' banks. This denies importers in these countries access to trade finance through L/C and other instruments, which form the backbone of current international trade architecture. This in turn impacts the competitiveness of businesses in these countries.

In such a scenario, a Trade Enhancement Facility for such small countries can be set up. The proposed facility for Small States could comprise a credit enhancement mechanism which enables confirmation of L/C opened on behalf of importers by banks in the countries participating in the Facility. The confirmations would be enabled by guaranteeing the credit risk of L/C opening banks in these countries. The guarantee may be backed by pool of cash collateral contributed by member states into a Fund, which can be managed by an independent Facility Manager, who, inter alia, can identify banks in the member countries who would be interested in participating in the program, and assign credit limits to these banks depending on parameters such as credit profile, potential usage, etc.

The Fund can receive revolving grant contributions from member states which can form the core capital of the Fund. These contributions may be invested in high quality liquid assets which can be drawn in the event of defaults to honour the claims. Support from bilateral and multilateral development finance agencies, and private sources of capital may also be considered for contributions to the Fund.

REGIONAL FINANCING MECHANISM FOR ASIA

In value terms, global merchandise imports registered second consecutive year of decline in 2016. However, Asian exports have witnessed a remarkable rebound since the second quarter of 2016. While the overall exports have increased during this period, intra-regional trade in Asia has continued to decline. Intra-regional exports registered third consecutive year of decline in 2016, accounting for only 59.6 percent of Asia's total trade (Figure 24).

Intra-regional trade in Asia can serve as an important avenue for shielding against decline in exports to developed country. Asian economies, especially in East and Southeast Asia, are already fairly dependent on each other and have strong product value chains. Adequate availability of trade finance will be critical to maintain the existing value chain linkages and extend them further to other geographies within the region.

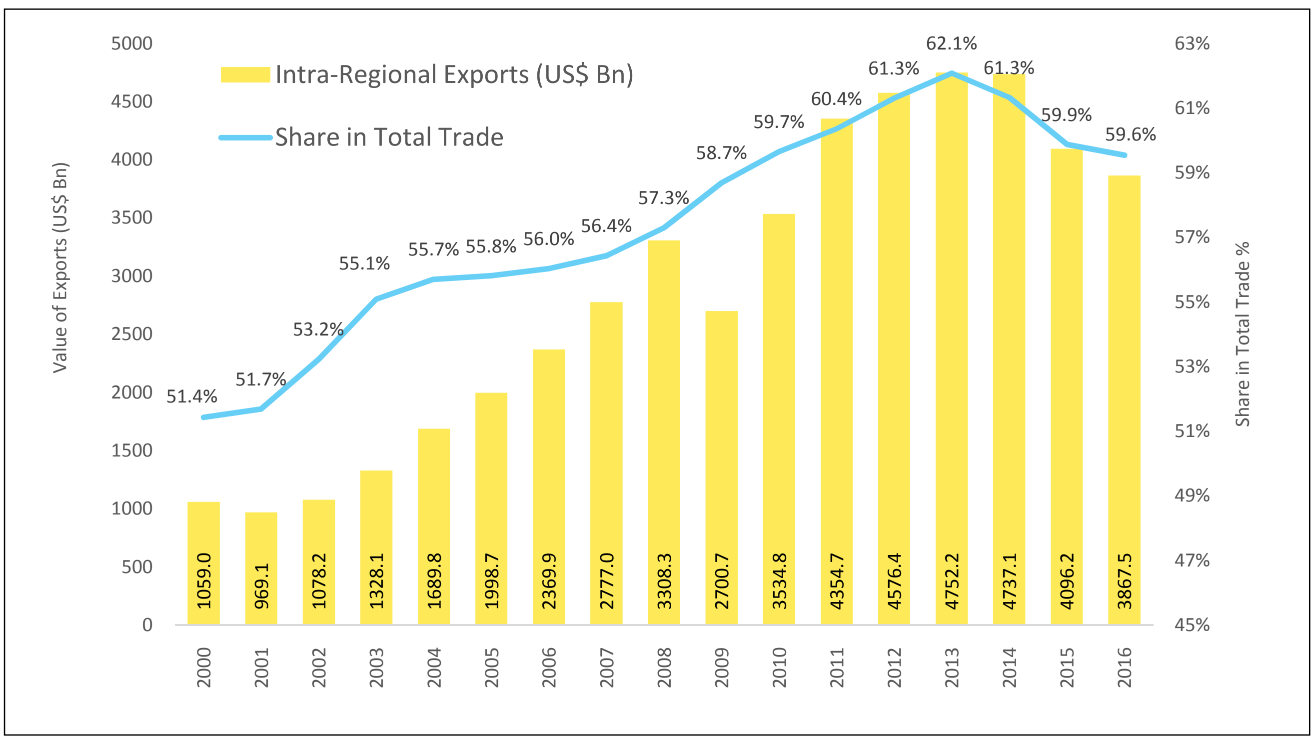
In much of the developing Asia, the financing mechanisms, which are taken for granted in industrial nations, are rudimentary and sub-optimal. Information networks and policy environments required for banks to carry out international transactions with a fair deal of confidence are also yet to stabilise. A regional mechanism which pools funds and risks across countries can benefit the intra-regional trade in Asia. In this context, an Asian Exim Bank can be set up, as a key agency for refinancing trade and investment in the region, with a focus on enhancing intra-regional trade. It can contribute towards recovery of short-term trade finance, and also enable importers to access medium and long term finance for capital goods and project imports from other Asian countries.

Asian Exim Bank

<u>Objectives</u>

The proposed Asian Exim Bank will be the principal agency in Asia for re-financing trade and investment and may operate on business principles. The basic objective of the Asian Exim Bank would be to improve

Figure 24: Intra-Regional Trade in Asia



Source: UNCTAD, Exim Bank Research

the access to trade finance for Asian economies through credit enhancement and risk mitigation measures and thereby, contribute to enhance intra-regional trade and investment.

With a view to achieve this purpose, the Asian Exim Bank may provide refinance/ rediscounting / reinsurance facilities to ECAs / commercial banks in the region to enable them to extend financial assistance to the exporters and importers of the region, at both pre and post-shipment stages as also to enable banks in the region to extend short and medium / long term credit through a variety of instruments / programmes to promote intra-regional and industrial development.

Expected Benefits from the Asian Exim Bank

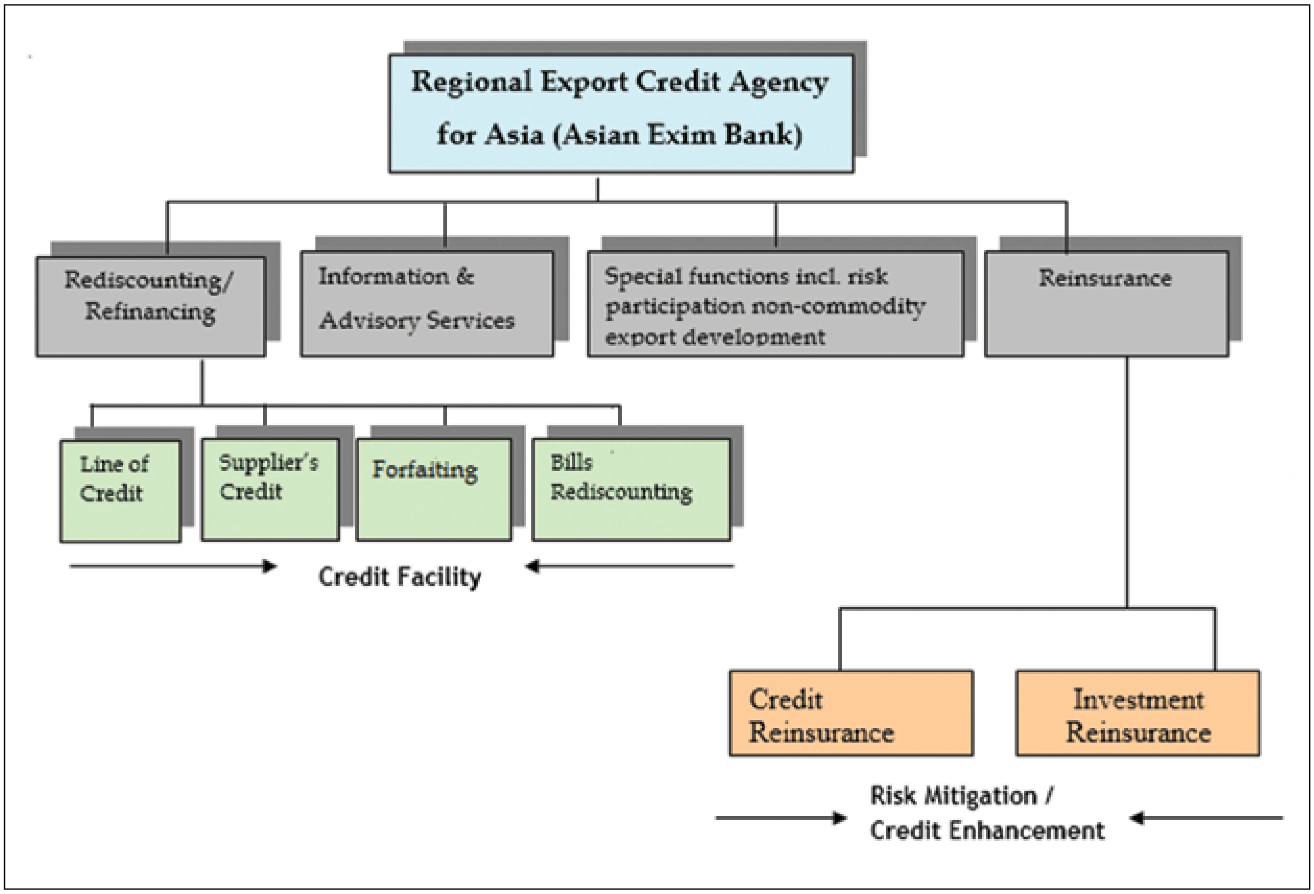
The establishment of the Asian Exim Bank to facilitate trade and investment flows in the Asian region and address financial and institutional gaps in trade finance and insurance may be expected to confer several advantages for the member countries.

- The Asian Exim Bank would serve to facilitate intra-regional trade through credit enhancement and risk mitigation measures;
- The Asian Exim Bank, by virtue of being a quasi-multilateral body would be able to access international finance at lower cost and provide refinance / reinsurance to ensure availability of trade finance at acceptable cost to developing member countries;
- For developing member countries, access to international trade finance at reasonable cost would ensure adequate finance for exports and export diversification into new markets and new products;
- For developed and emerging member economies, expansion of markets for export of capital goods, technology, manufactures and assurance of payment with a view to promoting trade and developing infrastructure in frontier countries;
- The Asian Exim Bank would also provide support to ECAs / commercial banks in the region with a view to developing the small and medium exporters, who contribute significantly to the development of a country;
- The Asian Exim Bank would complement rather than duplicate or supplant existing multilateral, regional, sub-regional and national institutions, which would increase the level of intra and extra Asian trade and investment;
- The Asian Exim Bank would also seek to provide information and advisory services, generally on pay-as-you-use basis in collaboration with existing institutions, national and international;
- The Asian Exim Bank would provide a common forum for its members, the Asian shareholder governments, for coordinating their trade financing and trade promotion activities in a more efficient manner;
- The Asian Exim Bank would encourage a local currency programme that will foster greater use of local currencies, thereby further reducing the foreign exchange cost of intra-Asian trade transactions.

Financing Programmes & Range of Activities

The Asian Exim Bank would develop various rediscounting/ refinancing and reinsurance facilities for ensuring adequate liquidity for ECAs and commercial banks and thereby addressing the funding gap. It shall also provide credit enhancement in order to contribute to mitigation of credit risk. Apart from these, the Asian Exim Bank would work closely with the several regional blocs and ECAs towards facilitating exchange of information and sharing of experiences (Figure 25).

Figure 25: Proposed Programs of Asian Exim Bank



Capital Structure

The Asian Exim Bank can draw its resources from equity capital subscription from member countries, supplemented by borrowings in international capital markets, and lines of credit from multilateral financial agencies. Equity contribution can be decided in proportion to economic indicators such as weighted average GDP, per capita GDP, trade indices, etc.

CONCLUSION

Trade finance gaps in developing countries have been exacerbated in the aftermath of the Global Financial Crisis. This has emerged not just from the dearth of liquidity in the system, but also from the stringent regulations and compliances during this period. 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 current Study, has been pivotal in restoring balance, and financing transactions which would otherwise not have been financed.

Going forward, the role of MDBs, ECAs and national DFIs will be crucial in bridging the trade finance gap, as also in catalysing private finance. These institutions can expand the scope of existing collaborations in areas such as co-financing, insuring of loan exposures, and reinsurance of guarantee exposure, and also deliberate upon the prospects for cooperation by way of new initiatives such as establishment of regional trade finance facilities, and regional financing mechanisms like the Asian Exim Bank, while suitably leveraging emerging technology platforms such as blockchain to augment the availability and reduce the cost of trade finance.

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