CREATING A RESILIENT TRADE FINANCE ARCHITECTURE

A COMPENDIUM OF ARTICLES

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CREATING A RESILIENT TRADE FINANCE ARCHITECTURE: A COMPENDIUM OF ARTICLES

The Compendium is an attempt to systematically present the impediments to trade finance and draw out innovative, inclusive and integrated strategies for scaling up trade finance and catalyzing global trade. The various perspectives can interest development agencies, policy makers, exporters/ importers, export promotion agencies as well as researchers. The views and opinions expressed in the articles are those of the authors and do not necessarily reflect those of EXIM Bank. EXIM Bank accepts no responsibility for authenticity, accuracy or completeness of the information and data.

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01

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SUMMARY

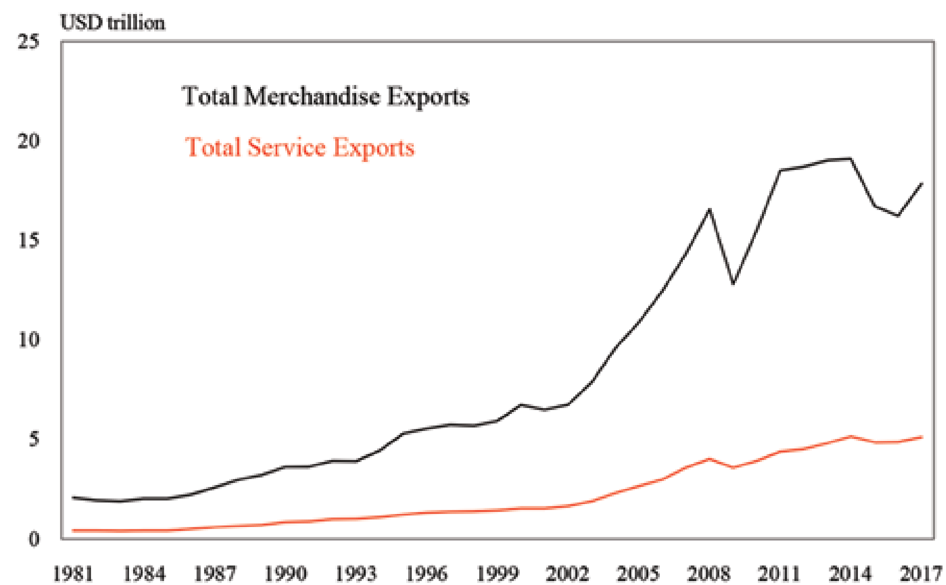
Trade finance, which is vital for a healthy world economy, came under pressure in the wake of the global financial crisis from the unintended impact of tightened banking regulations as well as heightened risk aversion. While having to navigate challenging times, the recent finalization of the Basel III Accord setting international capital, leverage and liquidity standards aimed at achieving a safer financial system helps bring a modicum of certainty. It largely completes decade-long regulatory reforms while preserving the relief given to trade finance at the urging of the G20 and other concerned stakeholders. Moreover, although capital requirements will rise for European banks, the revised agreement preserves the use of banks' risk-weighted internal models, and was not as onerous as previously feared. Meanwhile, non-traditional sources of trade finance are growing, from open account transactions, supply change financing and the promise of fintech, to be positive for supporting the revival in global trade underway since late 2016.

GLOBAL TRADE IS REVIVING AFTER A DIFFICULT PERIOD BUT FACES CHALLENGES

The strong expansion in trade, which has been vital for global growth and development, took a hit in the wake of the financial crisis, whose epicenter was in the US, UK and Europe. While trade has revived from late 2016, it is nevertheless passing through challenging times. Political changes have resulted in a pushback against globalization in some countries, brought on by feelings of marginalization amongst the working class amid rapid technological change, rising income and wealth inequalities, and delayed recovery from the financial crisis. Another set of challenges stems from the unintended consequences of strengthening of international bank regulatory standards aimed at preventing a repeat of the financial crisis and curbing use of financial services for illegal and terrorist activities. This has arguably had a dampening impact on trade finance and will be the focus of the paper.

Over the past several decades, global trade in merchandise goods has grown exponentially, with total exports rising from US$ 3.6 trillion in 1990 to US$ 16.6 trillion in 2008, before plunging in 2009, a temporary upturn over 2010-2014, renewed weakness in 2015-16 and then another nascent revival to US$ 18 trillion in 2017 (Figure 1). Trade had been lifted by declining tariffs along with the dismantling of quantitative barriers, albeit with some slippage in the aftermath of the financial crisis in 2008. The leading economies of Emerging Asia in particular have benefitted immensely from global supply chains shifting production to the region, attracted by lower wages, productivity gains, scale economies, manufacturing prowess and declining logistics costs. However, they are also under risk of protectionism in mature economies.

Figure 1: World Trade

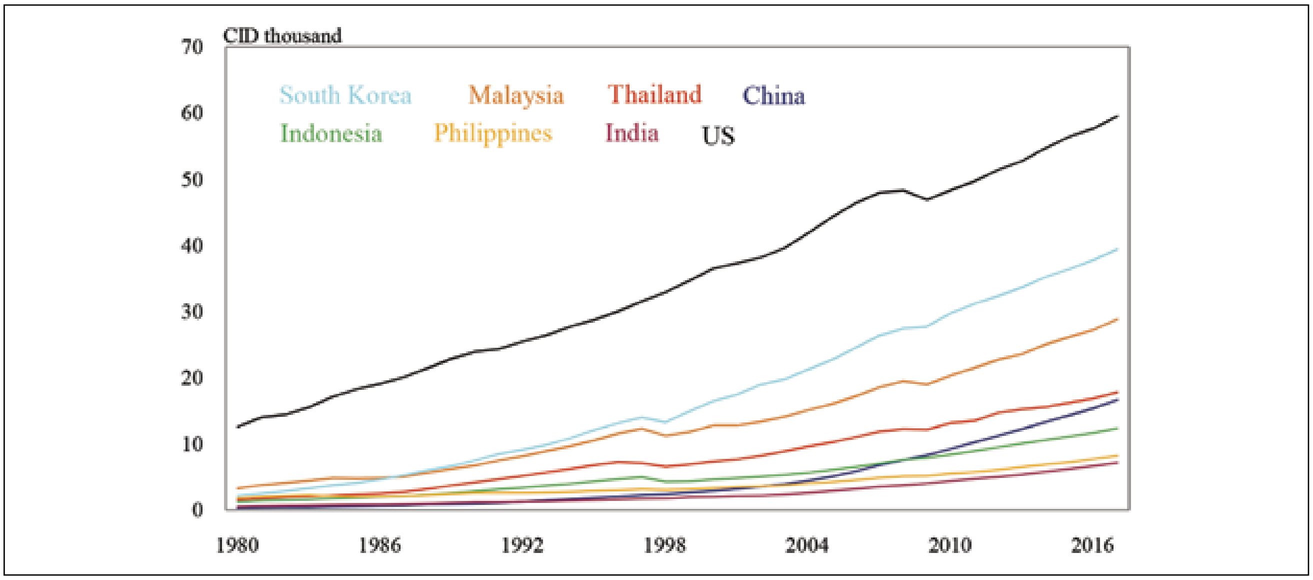


Source: WTO

While the expansion of trade in services has lagged in large part due to still substantial restrictions around the world relative to goods, services exports have nevertheless risen from US$ 0.8 trillion in 1990 to US$ 4 trillion in 2008, before following similar trends of a plunge, temporary upturn, renewed weakness and resumed expansion to US$ 5.2 trillion in 2017. It should be noted that services exports and imports comprise a heterogenous mix of activities, ranging IT-enabled services receipts, tourism, transportation services receipts, such as in shipping, entertainment and financial services, and fintech.

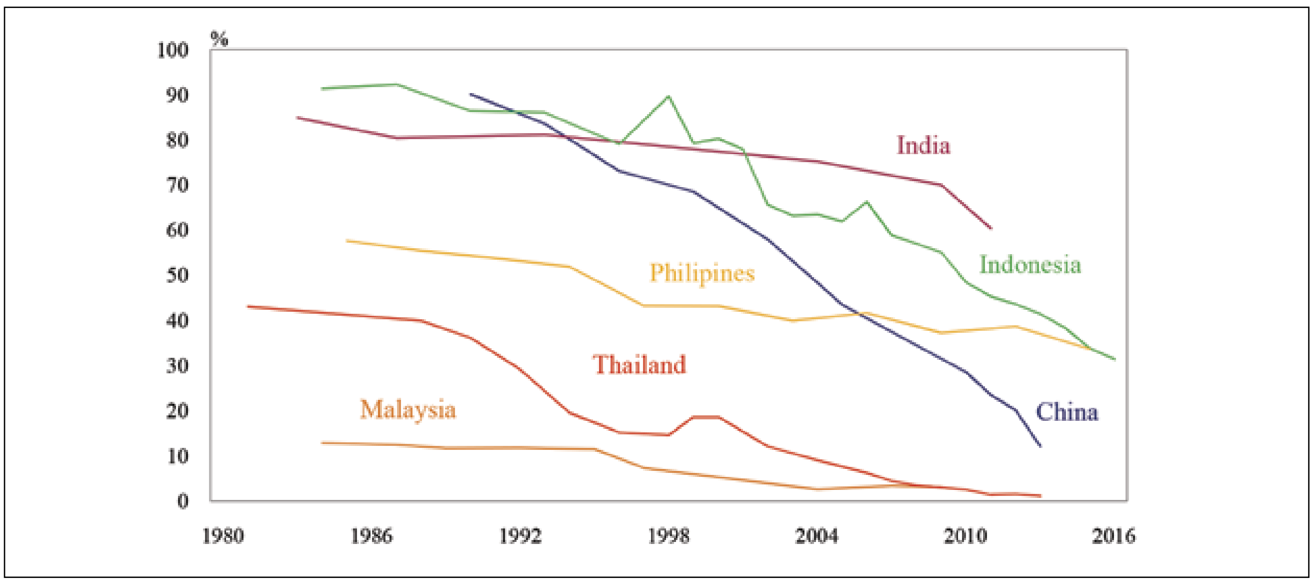
The leading countries of Emerging Asia have benefitted significantly from their external openness, as evident from sizeable income, wage and employment gains since the 1980s to help bridge the gap with the US somewhat (Figure 2). Further gains are needed in the next several decades, as the catch-up still has a way to go. The embrace of globalization also helped trigger a massive reduction in poverty across developing countries, especially in Asia (Figure 3). Overall, using the World Bank

Figure 2: GDP based on PPP per capita



Source: Haver

Figure 3: Poverty Headcount Ratio at $3.10 a Day



Source: Haver, WDI

measure, poverty in East Asia and Pacific declined by a billion people between 1980 and 2013, with the drop alone for China around 850 million. For South Asia, poverty fell by around 650 million during the same period, of which India accounted for around half.

After several weak years following the financial crisis, trade has rebounded from late 2016, lifted by the synchronized global expansion as the recovery brought on by policy stimulus and reforms set in, and commodity prices revived, but challenges abound. While trade has brought large positive spillovers for the global economy, inadequate efforts to help those left behind by globalization and technology changes along with the financial crisis in the US and Europe could trigger inward-looking policies. There is also a strong sentiment that China, which has made huge gains from integrating with the world economy in the past several decades and is the second largest economy, does not quite play by the rules of a free and a fair global trading system. As such, China needs to open up its own market to ward off the threat of global trade tensions. Policy makers in emerging markets also need to learn from the recent political upheavals in mature economies that both trade liberalization and inclusive growth are important. Meanwhile, the challenge remains as to how to expand the availability of trade finance, which is important for both developing countries and small-and-medium sized enterprises (SMEs) across the world.

TRADE FINANCE FROM BANKS UNDER PRESSURE

Banks play a vital role in facilitating world trade through financing, but this has come under pressure in recent years as evident from the trends in trade finance credits of several leading international banks (Table 1). These peaked in 2011, except for Industrial and Commercial Bank of China (ICBC), which peaked in 2013 and could also possibly been adversely impacted in part by capital controls to combat yuan weakness. Bank provide assurances of payment and delivery to parties who would otherwise be unable to establish the certainty needed for international contractual arrangements through letters of credit, guarantees and insurance, and they provide trade-related working capital. According to the World Trade Organization (WTO) as much as 80% of global merchandise trade relies on some form of trade finance. Using a narrower definition of trade finance, the Bank of International Settlements (BIS) estimates that trade finance directly supports roughly a third of trade, with letters of credit, used for a sixth of trade, playing the most important role.

Trade finance is of particular importance in emerging markets for a number of reasons. Exporters and importers are more likely to seek bank intermediation when trading with new partners. Bank intermediation is more attractive when trading with countries that are far away, have a weak record of contract enforcement, limited legal protection for foreign parties, or high political risks. Smaller companies are more likely to rely on working capital loans to complete orders, as they often do not have access to funds for production internally. The Asia/Pacific region, for which the tradeable sector is especially important, accounts for over half of trade finance and letter of credit exposures.

The decline in traditional trade finance evident in the wake of the global financial crisis is therefore particularly concerning for emerging markets, and in particular the Asia/Pacific region. Although reliable trade finance data is hard to get, another proxy could be trade-related credits and insurance by Berne Union members, in support of lending primarily from international banks, which shows

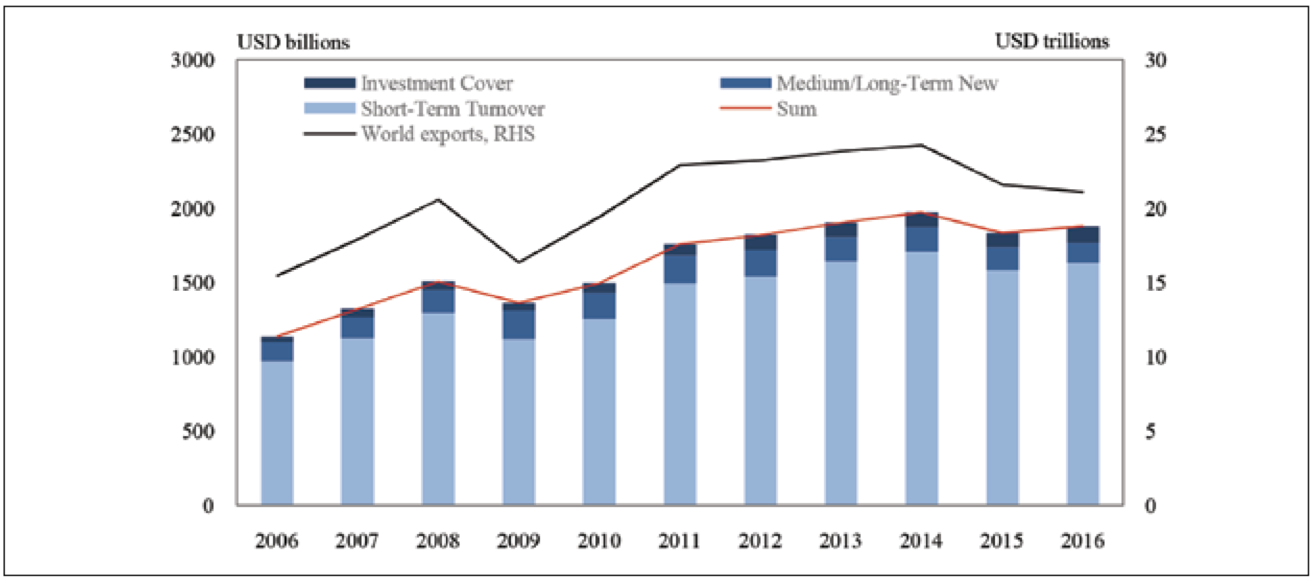
Table 1: Trade Finance Credits

USD millions	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
HSBC			9789	9066	12051	13498	13359	12154	120820	10168	9190
Standard Chartered	5209	6504	5270	6695	7505	8612	7610	7409	7911	4852	4120
JPMorgan				10227	21156	36696	35783	30752	25713	19255	15923
ICBC		11910	17873	45598	73796	141109	14109	182096	160546	103229	86713
UniCredit								16753	13891	12192	12570

Source: Documentary credits and short-term trade-related transactions HSBC Annual Reports, Documentary credits and short-term trade-related transactions Standard Chartered Annual Reports, Trade finance loans (period-end) JPMorgan Annual Reports, Trade finance loans (within working capital loans) ICBC Annual Reports, Advances to customers for import/export UniCredit Annual Reports

stagnation since 2014 (Figure 4). Moreover, the ADB estimates a trade finance gap of around US$ 1.5 trillion globally in 2016, with much of it in developing countries.

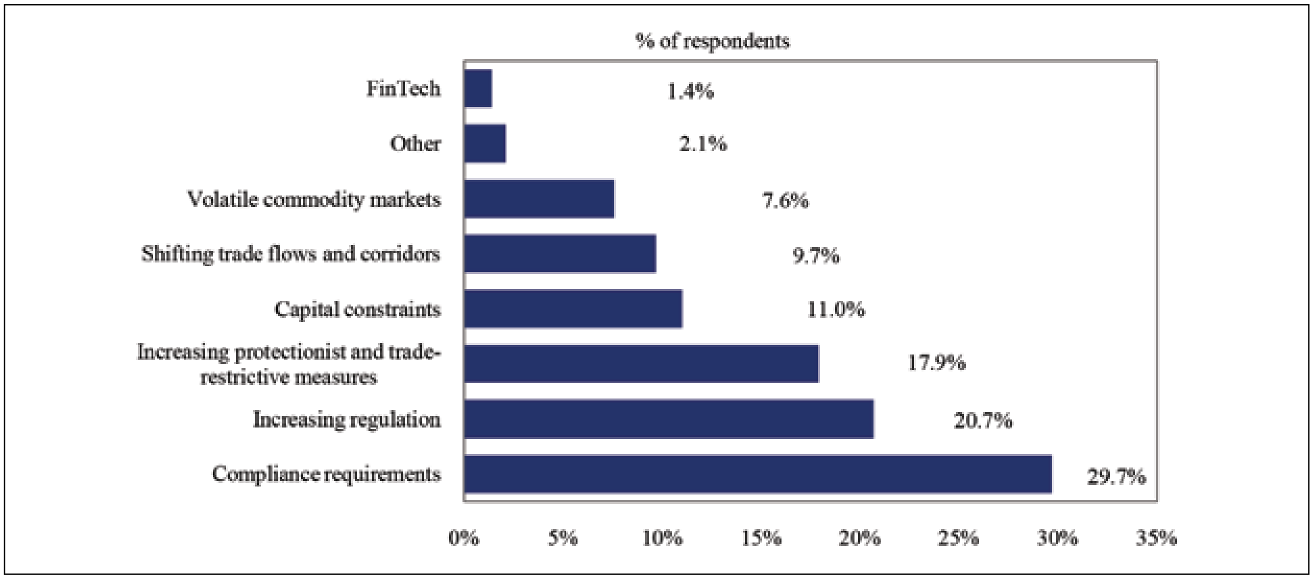
Figure 4: New Business and Total World Exports



Source: Berne Union

A likely explanation for the decline in traditional trade finance centers around recent regulatory changes in the global economy. Know-your-client (KYC) requirements and anti-money laundering (AML) measures have made it more difficult to provide trade finance to new clients and small businesses, and are cited by 90% of respondents to an ADB survey as a hindrance. In addition, 77% of respondents viewed Basel III, which introduced more stringent capital, leverage and liquidity requirements, as an obstacle. The International Chamber of Commerce (ICC) 2017 survey provides similar results, with over 60% of respondents indicating that compliance requirements, increased regulation, and capital constraints constituting key contributory factors towards reduced trade finance revenues (Figure 5).

Figure 5: Aspect Most Likely to Adversly Impact Business in the Short Term



Source: ICC Global Survey on Trade Finance 2017

BROUGHT ON IN PART BY THE OVERHAUL OF THE REGULATORY REGIME

In the aftermath of the financial crisis, the Basel Committee on Banking Supervision, which brings together regulators from 28 countries and is housed in the BIS, moved to overhaul the regulatory framework for banks related to capital adequacy, leverage and liquidity, known as Basel III. The first set of Basel regulations had introduced minimum capital requirements for banks in 1998 using standardized weights provided by supervisors. This was followed by the Basel II framework in 2004, putting in place the 'three pillars' of minimum capital requirements using both standardized approach with risk weights from external ratings and internal ratings-based models, supervisory review, and information transparency. However, clearly the system failed to prevent the financial crisis, which hit the US, UK and Europe with global spillovers. In tandem, global regulators moved since 2002 to strengthen AML and KYC regulations related to customer acceptance, identification, monitoring and risk management in order to prevent access to bank financing for illegal and terrorist activities.

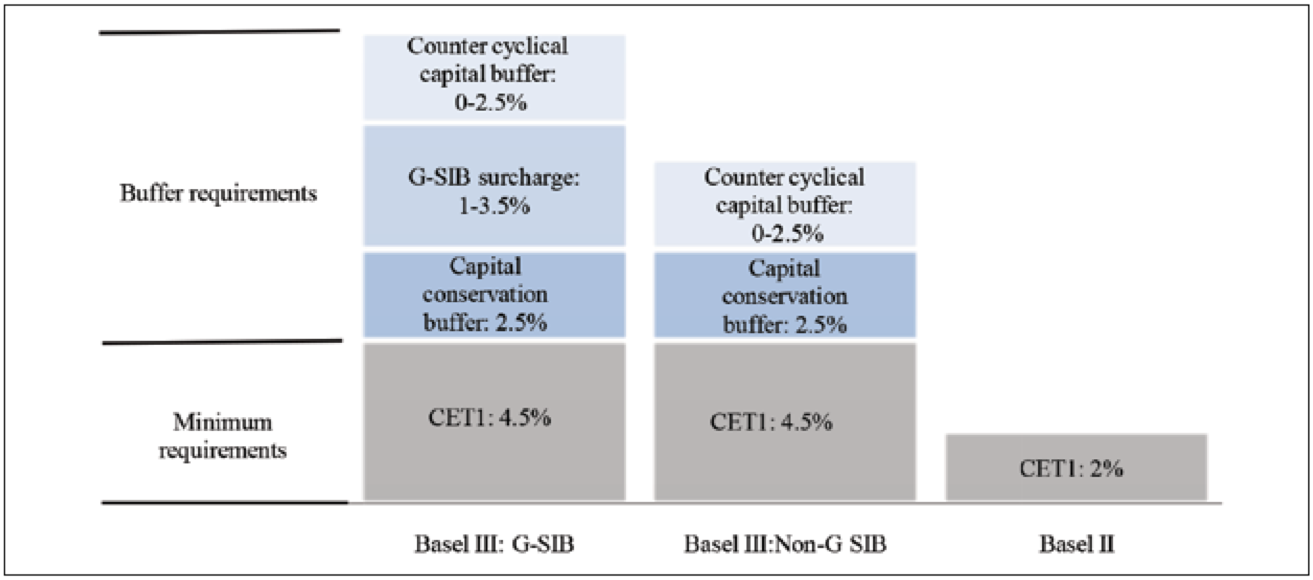
The Basel III accord drawn up by the Basel Committee was directed at addressing shortcomings in the pre-crisis regulatory framework and provide a foundation for a resilient banking system that would help avoid the build-up of systemic vulnerabilities. Basel III sought to:

- Improve the quality of bank regulatory capital by placing greater focus on going-concern loss-absorbing capital through bolstered Common Equity Tier 1 (CET1) capital;
- Increase the level of capital requirements to ensure that banks were sufficiently resilient to withstand losses during financial stress;
- Revise the risk-weighted capital framework, including setting global standards for market risk, counterparty credit risk and securitization;
- Add macroprudential elements by introducing capital buffers to limit procyclicality, mitigate systemic stress arising from large exposures and interlinkages across financial institutions, and externalities created by systemically important banks;
- Specify a minimum leverage ratio requirement of 3% for total assets and off-balance sheet positions to constrain excess leverage in the banking system;
- Introduce an international framework for mitigating excessive liquidity risk and maturity transformation, through the Liquidity Coverage Ratio and Net Stable Funding Ratio;
- To calculate Risk-Weighted Assets (RWA) for determining capital requirements for banks, which could use the Standardized Approach utilizing externally-given risk weights or, if banks portfolios were more complex and diversified and they had more advanced risk measurement and management capabilities, the Internal Ratings-Based (IRB) approach.
- Capital requirements jumped gradually to 7-9.5% for common equity, 8.5-11% for Tier 1 capital, and 10.5-13% for total capital including Tier 2, with many countries setting norms higher than the minimum while globally systemically important institutions attract surcharges of 1-3.5% (Figure 6).
- Banks were given a transition period to implement the accord gradually from 2013 through 2019, but faced market pressure to move quickly to the new norms.

While Base III is an important and needed effort to mitigate the risk of future financial crises, concerns have been raised related to potential macroeconomic costs, especially in crisis-hit economies in Europe, the UK and to a lesser extent in the US, besides bringing adverse spillovers for emerging markets. Banks, under pressure from constrained balance sheets and facing difficulties in raising capital, could seek to widen spreads between lending and deposit rates to boost net interest margins, or reduce overall risk exposure, especially related to cross-border transactions in countries or in businesses perceived to be risky.

In this regard, many large multinational banks in Europe, the UK and the US have sought to scale back their activities in emerging markets. Moreover, trade finance, despite being an activity with

Figure 6: Summary of CET1 Capital Requirements under Basel III



Source:BIS

low credit risk, default and loss rates, as well as short average maturities of well below a year and ample collateral, has been negatively impacted as the regulatory changes eroded tight profit margins. Correspondent banking relationships, which facilitate global trade and economic activity, have also been under pressure in some countries, brought by changes in the regulatory regime and AML/KYC norms.

PROMPTING G20 TO PUSH FOR RELIEF TO TREATMENT OF TRADE FINANCE UNDER BASEL III

In response to the concerns raised for trade finance, prompted by the November 2010 G20 Summit and many other stakeholders, the Basel Committee in October 2011 made several changes to the Basel III framework to mitigate the unintended impact. Relief was provided to financing for trade finance by:

- Waiving the one-year maturity floor for trade finance instruments under the advanced internal-ratings approach for credit risk;
- Waiving the sovereign-floor for trade-finance related claims on banks using the standardized approach for credit risk;
- Reducing the credit conversion factor (CCF) for trade finance for calculating the leverage ratio;
- Reducing the CCF for exposure at default calculation for performance guarantees;
- Changing inflow assumptions for trade finance activities from assuming that 50% of drawdown in any given month to zero drawdown when calculating the liquidity coverage ratio for trade finance facilities.

The changes lower capital requirements for trade finance in several ways. Waiving the one-year maturity floor for issued and confirmed self-liquidating letters of credit, instruments particularly relevant for low-income country importers, would reduce capital requirements for banks engaged in trade finance to a fifth of those initially envisaged. This was subsequently extended by regulators in the EU and the US, among others, to cover all trade finance instruments. The second waiver would also lower capital requirements as it reduces the risk weighting applied to bank exposure for unrated borrowing country banks from 100%, which is the floor for the relevant sovereign, to 50% or even 20% for short-term claims. With regard to the reduced CCF for the leverage ratio, this lowers it from 100% of nominal exposure for all off-balance sheet items to 20% and 50% respectively for LCs and Guarantees so as not to disadvantage banks specialized in trade finance. With regard to the CCF for performance guarantees, it effectively lowers it from 100% to 20%, which was the pre-crisis status quo.

While relief was given, a number of worries remained, the most pressing of which related to the revision of Basel III to address risk-weight variability across banks using internal models, which were producing very different capital requirements despite similar portfolios, raising the possibility that some banks were underestimating risks. Accordingly, over several years, the Basel Committee sought to reform Basel III. Banks grew increasingly concerned by the planned final revision, with the fear that it would impose restrictions on the ability of banks to use the internal risk-based model for calculating regulatory capital in favor of the standardized approach. An important downside in this regard was that the standardized approach did not allow receivables or physical collateral to be counted as a credit risk mitigatory, unlike internal models. As a result, the proposed recalibration of Basel III could result in a further significant increase in capital requirements, negatively impact profitability and prompt banks to reassess capital management, portfolio composition, product structures and risk, to the detriment of trade finance.

FINAL DECEMBER 2017 RE-CALIBRATION OF BASEL III NOT AS ONEROUS AS PREVIOUSLY FEARED

After some delay, the Basel Committee in December 2017 released the finalized Basel III reforms to the global regulatory framework (Figure 7). The Committee stated that the revisions were intended to restore credibility in the calculation of the RWA framework and improve the comparability of banks' capital ratios by:

- Enhancing the robustness and risk sensitivity of the standardized approaches for credit risk, credit valuation adjustment (CVA) and operation risk;
- Constraining the use of the internal model approaches, by placing limits on certain inputs used to calculate capital requirements under the IRB approach for credit risk and by removing the use of the internal model for CVA risk and for operational risk;

Figure 7: Key Revisions to the Basel III Bank Capital Framework

Revised standardized approach to credit risk

- Flat risk weights replaced by a more detailed risk weighting approach (e.g. risk weights for residential real estate to vary based on loan-to-value ratio of the mortgage, a look-up table with specific risk weights for exposures to small and medium-sized enterprises, more granular and differentiated treatment for retail exposures).
- Reduced reliance on external credit ratings (e.g. sufficient due diligence when using external ratings, detailed non-ratings-based approach for jurisdictions that cannot or do not wish to rely on external credit ratings).

Revised IRB framework for credit risk

- No IRB approach allowed for equity exposures.
- Removal of the option to use the advanced IRB approach for exposures to financial institutions and large corporates.
- Where the IRB approach is retained, minimum levels are applied on the probability of default and for other inputs.

Revised credit valuation adjustment

- Firms can only use the standardized approach, basic approach, or, if have an aggregate notional amount of non-centrally cleared derivatives of less than or equal to €100bn, a simple multiplier of counterparty credit risk charge.

Revised operational risk framework

- Removal of option to use internal models.
- A single standardized approach replaces four current approaches.
- Single standardized approach to be based on a measure of a bank's gross income and internal loss history over 10 years.

Revised market risk framework

- Specification of instruments to be assigned to the trading book (e.g. short-term resale, locking in arbitrage profits) and to the banking book (e.g. unlisted equities, real estate holdings).
- Supervisors able to remove internal model approval at desk level and based on passing an ongoing profit and loss attribution test.
- Capital add on for risk factors that cannot be properly modelled because of insufficient data.
- Revised standardized approach to incorporate risk sensitivities across asset classes and to align with front office pricing and models.
- A move from value-at-risk to an expected shortfall measure of risk under stress, and incorporation of varying liquidity horizons.

New Globally Systemically Important Bank (G-SIBs)

- Each G-SIB to have a leverage ratio buffer of 50% of its existing risk-weighted G-SIB buffer.

New output floor

- Calculations of RWAs generated by internal models cannot, in aggregate, fall below 72.5% of the RWAs computed using the standardized approaches.

Source: Deloitte

- Introducing a leverage buffer ratio to further limit the leverage of globally systemically important banks;
- Replacing the existing Basel II output floor of 80% with a more robust risk-sensitive output floor of 72.5% based on the Committee's revised Basel III standardized approaches.

The final recalibration of Basel III as set out in the reformed regulations was not as onerous as initially feared, although there could be some dampening impact. The limiting of the deviation on capital requirements calculated from internal models to 27.5% from that calculated from the standard model will result in increased capital requirements, especially for European banks. These banks tend to make greater use of internal models than US banks, which are constrained by the leverage ratio. Moreover, European banks tend to hold mortgages on their balance sheets while the US banks tend to securitize them. To the extent that large European banks limit their trade finance activities as a result, there could be some negative impact.

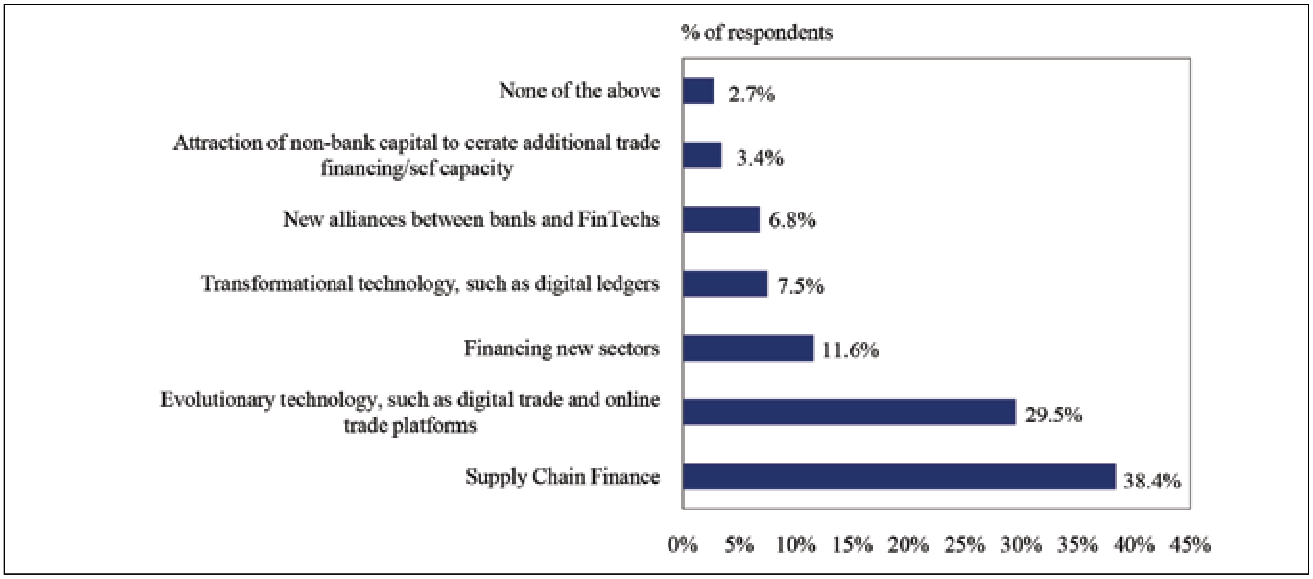
However, the overall shape of the final Basel III standards is positive and largely ends the policy uncertainty. The revised agreement continues to allow banks to use internal models to calculate capital requirements and the earlier relief given to trade finance was preserved. Moreover, there is a longer phase-in of the regulations from 2022 through 2027. In addition, the implementation of the fundamental review of the trading book, which will determine how banks treat the risk of stocks and bonds they hold over the short term, was delayed from the planned initial implementation in 2019. Finally, individual jurisdictions could adjust the regulations somewhat to reflect local priorities.

NON-TRADITIONAL SOURCES OF TRADE FINANCE TAKING OFF

Even prior to the global financial crisis, non-traditional sources of trade finance through open account terms and supply chain finance had gained in popularity because of cost and competitive reasons. These have grown in importance since then, in response to the regulatory changes as well as trust-building between purchasers and suppliers over time. Similarly, recent digital technological advancements are allowing fintech companies to enter trade finance as competitors to commercial banks. Banks are also partnering with them as they present an opportunity to reduce costs related to trade finance, and thus improve profitability.

Overall, digitization presents a potential transformative solution to bridging the trade finance gap, by lowering costs, increasing the efficiency and range of products, and better meeting the financing need of services trade. As such, these non-traditional sources have been identified as the area of greatest potential for growth and evolution in the financing of international trade in the 2017 ICC Survey (Figure 8).

Figure 8: Area of Greatest Potential for Growth and Evolution in the Financing of International Trade



Source: ICC Global Survey on Trade Finance 2017

CONCLUDING OBSERVATIONS

In conclusion, the recalibrated Basel III brings some relief and reduces the uncertainty for the availability of trade finance from international banks. Moreover, new non-bank players are emerging in this arena. Both of these factors are positive going forward for bolstering the provision of trade finance and, by extension, global trade. In short, although there are challenges to overcome, the worst of the disruptions in trade finance in the wake of the global financial crisis are behind us and the prognosis for a new equilibrium being achieved is positive

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The Role of the WTO in Supporting Trade Finance

02

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Trade finance is an indispensable "oil" to make trade happen. Only a fraction of international trade is paid cash-in-advance. For this reason, the trading system needs a well-functioning financial system providing trade loans and guarantees to traders. While such support has been taken for granted for decades, notably during the strong expansion of global trade in the 1990's and early 2000's, the chronic occurrence of international financial crises and the emergence of developing countries into the international trading system have created challenges for supplying adequate amounts of trade finance flows at any point in time.

The World Trade Organization (WTO) acknowledges these challenges. For years, it has teamed up with multilateral development banks to expand a global network of trade finance facilitation programs, which is providing trade finance support in the developing world. It has participated in a multi-country and agency plan to provide additional capacity to markets during the 2008 financial crisis and its aftermath. It has conducted a mutually beneficial dialogue with the Basel Committee on Banking Supervision to ensure that the prudential treatment of some trade finance products remained. At the present moment, it has developed a plan to address, with partner institutions, more protracted trade finance gaps in the least developed countries, arising, inter alia, from the withdrawal of international banks from some trade finance markets since the 2009 crisis. This article is elaborating on each of these initiatives and some of their results. Section 1 looks at the characteristics of trade finance markets. Section 2 considers the implications of financial crises on trade finance and subsequent policy interventions. Section 3 discusses the content and outcome of the policy dialogue held by the WTO, and partners, with the Basel Committee on Banking Supervision. Section 4 looks at the difficult recovery of trade finance markets after the 2008-9 financial crisis, and the adverse consequences on the availability of trade finance in developing countries. Section 5 examines the ways in which the WTO currently leads an initiative to improve such availability in developing countries, especially for small and medium-size enterprises (SMEs).

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WHAT IS TRADE FINANCE AND HOW BIG IS THE MARKET?

What is Trade Finance?

Only a small part of international trade is paid cash in advance, as importers generally wish to pay, at the earliest, upon receipt of the merchandise in order to verify its physical integrity on arrival. Exporters, however, wish to be paid upon shipment. In order to bridge the gap between the time at which exporters wish to be paid and the time at which importers will pay, a credit or a guarantee of payment is required. Trade finance provides the credit, payment guarantees and insurance needed to facilitate the payment for the merchandise or service on terms that will satisfy both the exporter and the importer. As such, trade finance is often described as a lubricant of trade. Most trade credit, payment guarantees and insurance are short-term, with a standard maturity of 90 to 120 days. In certain cases, trade credit can be extended for longer periods of time (so-called "export credit"), particularly for categories of goods subject to longer production and delivery cycles, such as aircraft and capital equipment.

A key aspect of trade finance is that it helps mitigate the risk of cashless trade transactions.

There are two main forms of trade finance:

- Inter-company credit: The credit is directly accorded by the buyer to the seller ("buyer's credit"), or inversely by the seller to the buyer ("seller's credit"), depending on the ability of one or the other to extend credit, and the moment at which the two parties agree that the final payment is due. In such supply chains, the ability of firms (i.e. large suppliers) to extend credit to their trading counterparties (buyers) is enhanced by opportunities to discount their receivables (receiving cash immediately against documentation such as the export contract, a process called "factoring"), or to mitigate payment risk by purchasing trade credit insurance. Long-standing relationships between buyers and sellers may lead the two parties to choose to settle transactions on "open account", meaning that the credit for delayed payment is automatically granted by one or the other party. As indicated above, factoring companies (discounting receivables) and export credit agencies, play a very important role in trade finance. They help mitigate the credit risk taken by companies. Export credit agencies are also playing an important role in transactions described below (bank-intermediated finance), as they also insure bank trade finance exposures, either short term or long term.
- Bank-intermediated finance: Letters of credit are widely used in international trade. They are written commitments to pay typically issued by the bank of the buyer (importer, company A) on its behalf to the seller (exporter, company B) or its bank. The letter of credit provides the

seller with a guarantee that the purchase will be paid, and carries a number of obligations for the seller (delivery conditions, submission of documentation) and the buyer (notably the guarantee that if the buyer is unable to pay, the bank will cover the outstanding amount). Letters of credit and other forms of document-based guarantees are well-know and ancient instruments of trade finance. However, they are not the only form of bank-intermediated trade finance. Banks may lend to their customers, in the form of pre-shipment finance, working capital or imports. Banks can also provide liquidity and lending to traders in the context of supply chain finance. In this case, supply chain finance would not consist only of buyers and sellers' credit provided by companies, but the bank would, for example, finance the receivables and payables from its clients, which may hold a central position into the supply chain.

How Big is the Global Trade Finance Market?

The Bank of International Settlements (BIS, 2014) has noted that there is no single, comprehensive source of statistics allowing for an evaluation of the exact composition and size of trade finance markets (BIS, 2014b). Still, BIS estimated that global short term trade finance, in its widest definition (bank and non-bank intermediated), had supported up to US$ 11-12 trillion in trade transactions in 2011 – representing two-thirds of total global trade in merchandise and services (US$ 18 trillion) that year. Bank-intermediated finance accounted for an estimated US$ 6.5 to 8 billion of flows, while non-bank intermediated accounted for the rest. As estimated by the Asian Development Bank since 2013, the global trade finance gap (a measure of the mismatch between demand and supply) is estimated to be about US$ 1.5 trillion annually, somewhere between 10% and 15% of the estimated global trade finance market.

How Risky is Trade Finance?

While the commercial risks involved in an international trade transaction seem in principle to be larger than in a domestic trade transaction - non-payment, loss or alteration of the merchandise during shipment, fluctuating exchange rates - trade finance is considered to be a particularly safe form of finance since it is underwritten by strong collateral and documented credit operations. The low risk nature of short-term trade finance is supported by data collated in the International Chamber of Commerce's (ICC) Trade Finance Loss Register, established in 2011. According to the ICC's Global Trade Register reports for 2016, the average transaction default rate on short-term international trade credit was no more than 0.2%, of which a third or more was recovered though the sale of the underlying asset, the merchandise.

Figure 1: Risk characeristics of short-term trade finance products, 2008-2015

CATEGORY	Defult Rate by Exposures	Loss at Default	Expected Loss Rate
Import letters of credit	0.08%	27%	0.02%
Export letters of credit	0.04%	40%	0.02%
Loans for import/export	0.21%	35%	0.07%
performance guarantees	0.19%	5.5%	0.01%

Source: 2016 International Chamber of Commerce (ICC) Trade Register Report, p.22

TRADE FINANCE: MARKET BEHAVIOUR AND POLICY INTERVENTIONS

The Asian Financial Crisis of 1998-99 and Policy Considerations

For decades, the financial sector has efficiently supported the expansion of world trade by delivering mostly short-term trade credit in the forms of letters of credit or the like, open account liquidity and other instruments described in the previous section. This low-risk, low-default segment of credit also generated relatively low fees per transaction, as a recognition of its relatively routine character. Long-term trade finance involving larger, possibly multi-year contracts involved more complex services, including trade credit insurance, and hence brought higher fees to those willing to finance and insure transactions. Trade finance markets have been broadly resistant to financial crises between the 1960s and the late 1990's, in part because of a relatively well-established methodology and preferred treatment in handling officially guaranteed trade credit in the case of sovereign default. In these cases, commercial claims of private nature were in parallel "handled" by the London Club - generally in the form of restructuring, the interest of both governments and private sector banks being that the flow of trade should not be interrupted by efforts to restructure (or reschedule) old debt. This is necessary to keep trade flowing and the balance of payments turning around. While officially guaranteed credit represented an important part of trade between developed and developing countries in the 1970's and 1980's, private markets have expanded more rapidly and took over the short-term trade finance segment as the expansion of local banking sectors allowed for the establishment of global inter-bank links helping to connect traders from the "North" and the "South".

These links have been temporarily disturbed, in a massive way, during the Asian and Latin American financial crisis of the late 1990s, when foreign "correspondent" banks reconsidered existing exposures to local banks, in the context of a solvency crisis affecting local financial institutions. In the most extreme cases, credit lines for available financing have been interrupted and outstanding debt left pending. In crisis stricken countries, the temporary stoppage of trade finance disturbed trade flows significantly, delaying the recovery of the trade-reliant economies.

Both the Inter-American Development Banks and the Asian Development Bank extended guarantee facilities to international banks confirming local banks' letters of credit. Some export credit agencies from developed countries provided short-term insurance for credit extended during the crisis period on bilateral trade. Urgency trade finance schemes, which were largely inspired by the trade finance facilitation program of the European Bank for Reconstruction and Development (EBRD), have become more standardized after the Asian crisis.

The common element of all these ad-hoc mechanisms was to offer risk mitigation to induce endorsing entities to accept commitments to pay. Although some local financial systems in East Asia had collapsed, in many cases the underlying trade links had not been broken - and contracts illustrated the existence of a solvable demand. Risk mitigation devices such as guarantees of payment in case of default proved to be an effective tool for the implementation of contracts. The fact that a credit crunch could affect both exports and imports to the point of stoppage induced the international financial and trading communities to organize a "debriefing" exercise, involving the IMF, World Bank, WTO, regional development banks and private sector actors. This exercise aimed in particular at identifying and analysing any market failure, best practice and cooperative policy action during a crisis period (IMF, 2003; WTO, 2004).

In its 2003 paper, the Fund had suggested a "framework for trade finance in crisis resolution" with recommendations that multilateral development banks extend risk-sharing agreements such as the ones developed by the Asian and Latin American Development Banks during the crisis period.

The WTO's 2004 paper also recognized the case for public intervention and indicated that "ad-hoc" solutions developed by regional development banks had been regarded as successful, in terms of having "suffered no default or losses while keeping minimum cross-border trade alive". It also recommended that trade finance facilitation schemes by multilateral development banks become more standardized. The WTO paper also identified regulatory issues to be dealt with, as a way to secure a greater availability of trade finance in the long-term. The paper looked at factors which may have contributed to interruptions in the supply of trade finance: herd behaviour, increased gap between the level of risk and perception of risk, fragility of the market due to a relatively limited number of leading banks, confusion between country and counterparty risk, lack of visibility on the market situation due to the lack of statistics on short-term movements. Besides, trade finance markets are mostly short term in nature. They finance transactions with a maturity cycle of mostly

90 to 120 days. Hence, trade finance facilities depend on the good or less good conditions of inter-bank markets for instruments of similar maturities. In other words, tensions in international inter-bank markets are immediately reflected on the whole spectrum of short-term securities.

Some of these causes have re-emerged in the "cocktail" of factors which characterized the global tensions in trade finance markets in 2008-2009.

The 2008-09 Crisis and the G-20 led Plan for Trade Finance

Post-Asian crisis achievements include, as mentioned above, the expansion of trade finance facilitation programs of multilateral development banks. It also includes the realization that any crisis would need to be managed cooperatively, with public and private sector actors. In this vein, the IMF and WTO created an "Expert Group on Trade Finance", which first met in the IMF in 2003 and thereafter moved to the WTO in 2004 to examine on a regular basis the market conditions for trade finance market and its problems. The Expert Group comprises high-level representatives of multilateral agencies, export credit institutions, private banks and representatives of professional associations involved in trade finance.

After monitoring closely the situation in 2007, it became clear in the following year that the overall liquidity squeeze on money markets had started to hit trade credit supply, as the refinancing of such credit had become more difficult. Trade-related lending had also been affected by the general reassessment of risk linked to the worsening of global economic activities. Beginning in the fall of 2008 and continuing into 2009, indications of shortages in the trade credit market came from exchanges with key banks and multilateral development banks in the context of the Expert Group. After the Lehman failure, the secondary market for trade bills (mainly letters of credit) had dried up and inter-bank liquidity had become too tight for trade orders to be financed.

Given the state of statistics on trade finance, one of the achievements of the "Expert Group on Trade Finance" during the period 2004-07 had been to develop relatively comprehensive market surveys on trade finance relying on bank information. Contrary to the Asian crisis period, policy-making could rely on aggregate information coming from the "field". Surveys emanated from the ICC Banking Commission and the Bankers Association for Trade and Finance (BAFT). By the time of the London G-20 Summit, in April 2009, the surveys had confirmed the deterioration of trade finance markets. Calculated on a year-on-year basis, by the end of the third quarter of 2008, the flows of trade finance to some developing countries' regions had fallen more than the flows of trade for the same period. The fees on letters of credit in these regions had increased sharply under the combined effects of scarce liquidity and re-assessment of customer and country risks. Spreads on 90-days letters of credit had increased from 20 to 30 basis points above LIBOR prior to the crisis to levels of 250 to 500 basis points. The closure of the secondary market for letters of credit, directly linked to the freeze in inter-bank transactions on short term refinancing instruments, had left a capacity gap estimated at US$ 20 billion per month. Market specialists had noted that, while demand for trade was falling as well, some of such demand remained unfinanced. Using the surveys as well as capacity reduction linked to the closure of some market, it was estimated in the Expert Group that the "supply" gap at the period of the market crisis had reached between US$ 200 and US$ 300 billion – mainly felt in developing regions.

The process which led the G-20 Summit in London, in response to these concerns, to step in and commit to the availability of extra-capacity of US$ 250 billion for trade finance, has been well explained and documented (Auboin, 2009; Chauffour and Malouche, 2011). The commitment to support the provision of short-term trade finance was one element in a wider set of fiscal, monetary, and financial actions undertaken by the international community to support the continued functioning of international trade and financial markets during a period of acute stress. The G20 agreed to provide temporary and extraordinary crisis-related trade finance support that would be delivered on a basis that respected the need to avoid protectionism and would not result in the long run displacement of private market activity. It relied on public guarantees and risk co-sharing agreements between banks and national and international public institutions. It consisted of three main "products":

- An increase in credit insurance and risk mitigation capacity by export credit agencies (ECAs). Some ECAs also provided working capital and credit guarantees aimed mainly at small and medium enterprises. Several large ECAs extended these facilities to imports as well.
- Regional development banks (RDBs) and the International Financial Corporation (IFC) of the World Bank Group increased guarantees for letters of credit under their trade facilitation programmes, before the G20 Meeting, and after. The increase was manifest in credit guarantee products and risk participation agreements.
- Some RDBs also provided liquidity windows as part of their trade finance facilitation programs. In a period of liquidity squeeze, the demand by banks for such access had increased significantly, particularly for transactions involving the poorest markets. To this aim, the IFC reinforced its global trade finance facility through the introduction of Global Trade Liquidity Pool (GTLP), allowing for a 40-60 % co-lending agreement between the IFC and commercial banks.

Above and beyond the G-20 trade finance package, central banks have also provided support, notably by extending foreign exchange resources to traders which needed it, as the peak crisis period was marked by a US dollar shortage that reflected the tensions in the US money market. Central banks with large foreign exchange reserves also supplied foreign currency to local banks and importers generally through repurchase agreements (Korea). Other central banks opened temporarily "discount windows" for local traders willing to discount foreign trade receivables and other bills (Japan). The US Federal Reserve Board helped central banks that did not have sufficient reserves in US dollars with the conclusion of 14 swap agreements, aimed at facilitating the payment of trade transactions. Most of these mechanisms were time-bound and waived when market conditions returned to normal. It considerably helped banks and importers in developing countries acquire scarce foreign exchange resources to conduct trade operation at one of the most difficult times of recent history.

The G-20 established a "follow-up" working group aimed at monitoring the implementation of the London trade finance initiative. The package being demand-driven, the idea was to monitor commitments and utilization rates, partly to make sure that it did not last longer than necessary. The working group indicated that most of the support initially promised for a period of two years had been front-loaded, and hence used during the first year of the initiative. Overall, some US$ 140-150 billion have been used out of the total commitment of US$ 250 billion (Auboin, 2015). Given these developments, G-20 Members began to scale back their support after the G-20 Summit in Toronto in 2010. While perhaps the trade finance-related G-20 programme was only a minor part of the overall effort to increase liquidity in financial markets at a time of illiquidity, the capacity put in place allowed exporters with existing orders to count on lending and trade credit insurance to be able to ship their goods. While the counterfactual may be difficult to establish, the non-delivery of orders could have had a chilling effect on trade for a longer period when the economic cycle rebounded.

AVOIDING THE UNINTENDED CONSEQUENCES OF BASEL III ON TRADE FINANCE, PARTICULARLY FOR DEVELOPING COUNTRIES: A WTO- WORLD BANK DIALOGUE WITH PRUDENTIAL REGULATORS

In a joint letter sent to the G-20 Leaders in Seoul (2011), the Heads of the World Bank Group and the WTO raised the issue of the potential unintended consequences of the Basel II and III frameworks on the availability of trade finance in low-income countries. While trade finance received preferential regulatory treatment under the Basel I framework, in recognition of its safe, mostly short-term character, the implementation of some provision of Basel II proved difficult for trade. The application of risk weights and the confusion between country and counterparty risks have not been particularly advantageous for banks willing to finance trade transactions with developing countries partners. Basel III added to these requirements a 100% leverage ratio on off-balance-sheet letters of credit, which are primarily used by developing countries. At a time when more risk-adverse suppliers of trade credit revised their general exposure, the application of more stringent regulatory requirements raised doubts about profitability and incentives to engage into trade finance relative to other categories of assets.

Besides, the feeling increased that the preferential prudential status granted under Basel I to trade finance in relation to such other categories of assets was being significantly reduced; in other words, the comparative advantage of supplying trade finance, a relatively low profitability business, was being diminished.

As a result, and in the overall framework of paragraph 41 of the Seoul Summit Declaration, these issues have been discussed by the Basel Committee on Banking Supervision's Policy Development Group and the institutions concerned with trade finance, notably the WTO, the World Bank and the ICC.

In the context of the WTO Expert Group on Trade Finance, the Director-General of the WTO encouraged the ICC's banking commission to collect the necessary data, and for the dialogue with banking regulators on trade finance to be fact-based. Since 2010, the ICC has been able to collect data on loss default for trade finance operations, with the world's main banks contributing. This "trade finance loss register" indicates that the average default rate on international trade credit operations is no higher than 0.2% globally, including during the recent period of financial crisis. This is lower than most domestic lending activities. Aggregate data were passed on to the Basel Committee on Bank Supervision to feed the discussion with its partners. According to the ICC, World Bank, and WTO, the data indicate that cross-border trade finance is a safe financial activity, including in low-income countries. While it was fully justified to re-regulate the financial sector in view of recent difficulties, trade finance ought not to become an unintended casualty.

The Basel Committee on Banking Supervision discussed which measures of the prudential regulation affecting trade finance was most detrimental to trade and trade finance availability, with a particular focus on the beneficial effects for low income countries. Proposals were made by the WTO and the World Bank to the Committee with a view to waive the obligation to capitalize short-term letters of credit for one full year, when its average maturity was according to the registry between 90 and 115 days (consistent with the maturity of the vast majority of international trade transactions). This measure was "blocking" hundreds of millions of dollars of unnecessary capital that could be used to finance more trade transactions. During the G-20 Meeting in London, at the initiative of the Director-General and of the President of the World Bank, the G-20 had already asked for a temporary relief from this regulatory measure to support trade in developing countries. The temporary relief will now be made permanent. Hence, 90 to 115-days trade letters of credit will be capitalized for that appropriate maturity.

Traditionally, trade finance – mainly letters of credit and other self-liquidating instruments of payments for trade – received preferential treatment from national and international regulators on grounds that it was one of the safest, most collateralized and self-liquidating forms of finance. This was reflected in the low credit conversion factor (CCF) determined under the Basel I framework for the capitalization of these instruments, which was set at 20 per cent, i.e., five times lower than any on-balance sheet loan. However, as the banking and regulatory communities moved towards internal ratings-based and risk-weighted assets systems under the successor Basel II framework, issues regarding maturity structure and country risk emerged.

After the 2008-09 financial crisis, in the context of prudential re-regulation of the financial system under Basel III, some requested that trade finance, which had suffered casualties by contagion from other segments of the financial industry, not be penalized. The unintended consequences of increased prudential requirements were to be avoided, notably in respect of the ability of developing countries to access affordable trade finance. At the end of 2011, the G20 asked that the WTO and World Bank on the one hand, and the Basel Committee on Banking Supervision (BCBS) on the other, engage in discussions aimed at improving a common understanding of trade finance and identifying any unintended consequences of prudential regulation.

This dialogue proved extremely useful. The data collected by the ICC under the pilot trade finance register allowed prudential regulators to improve their understanding of trade finance and verify the low-risk character and absence of leverage in the industry. The aggregate data delivered covered more than 20 major international banks, over five million transactions and revealed less than 1,150 defaults. Since 2011, the WTO and the World Bank have continued to hold discussions with the Basel Committee.

Since then, the BCBS has made three revisions reflecting the low risk of trade finance and improving its regulatory treatment:

- On 25 October 2011, the BCBS agreed to reduce the excessive risk-weighting requirements on low-income countries, and to waive the one-year maturity floors for letters of credit and related instruments. Both measures are of great importance in removing obstacles to trade finance in developing countries (BIS, 2011a).
- On 6 January 2013, the new Basel III guidelines on liquidity (concerning the liquidity coverage ratio) proved to be favourable to short-term self-liquidating trade finance instruments. In its Decision, the Committee allowed national regulators to set very low outflow rates - between 0 and 5%, significantly below previous levels - for contingent funding obligations from trade

finance instruments. Banks are allowed to hold fewer liquid assets against contingent trade liabilities, thereby increasing the availability of trade finance (BIS, 2013).

- On 12 January 2014, the BCBS reduced the leverage ratio on trade letters of credit and other self-liquidating trade-related instruments from a 100% CCF to a 20% CCF for capital purposes and 50% CCF for trade guarantees (BIS, 2014a). The 2014 modification was hailed by the WTO Director-General: "[this is] of particular significance for the availability of trade finance in the developing world, where letters of credit are a key instrument of payment. This is good news for developing countries, for the expansion of their trade and for the continued growth of South-South trade flows" (WTO, 2014a).

The situation on the prudential front looks better than it did a few years ago, thanks to the institutional dialogues opened by the WTO and the Basel Committee, and the data support provided by the ICC. There is no doubt that such initiatives have contributed to improving the policy coherence between the prudential and central bank community on the one hand, and the trading community on the other.

Other non-prudential regulatory issues described as "know-your-customer" (KYC) requirements have been subject to discussion within the WTO's trade finance community. The debate does not focus on regulatory requirements, which legitimately aim at increasing transparency in financial relations but rather on the various ways that they are being structured, defined and implemented by and in different countries and regions. It was argued that the accumulation of these requirements (very detailed information varying across jurisdictions about a customer's identity and the end use of money lent) led banks to terminate banking relations, including trade finance, with developing countries. More clarity is still needed to determine whether a lack of harmonized regulatory requirements discourages trade, particularly in developing countries. Some have suggested that the trade finance industry needs more fact-based evidence of trade foregone, lost correspondent banking relations and other criteria before it can assess the impact of lack of regulatory harmonization in this area (WTO, 2014c). Dialogue on this issue should of course take place within the appropriate governance structures, such as the OECD's Financial Action Task Force.

AN UNEVEN RECOVERY OF TRADE FINANCE MARKETS AFTER THE FINANCIAL CRISIS OF 2009

A Recovery Complicated by the "De-risking" of International Banks

According to ICC Global surveys on trade finance, the recovery of market materialized from 2011 onwards, in the main "routes" of trade, in line with the recovery of trade demand and improved financial market conditions within North America, Europe, Asia, and between Asia and the rest of the World. In these areas, prices for trade finance facilities had fallen. However, markets had become more selective. While quantitative easing made liquidity relatively abundant for the "higher end" of the market, allowing large corporates to benefit from easy financing at low rates, ICC Global Surveys insisted that the "appetite" of international banks to operate in developing countries, in particular the poorest, had fallen. Worse, the Surveys confirmed the trends of international banks in closing correspondent banking relationships with banks in developing countries in particular. By 2014, nearly 46% of the 500 banks surveyed by the ICC had terminated correspondent relationships, while 70% of respondent banks reported declining trade transactions. One major culprit, according to the surveyed banks, was the increase in regulatory requirements, such as "KYC" and anti-money laundering obligations. The need to adjust balance sheets downwards (process of "deleveraging"), in the light of new and more stringent capital adequacy requirements, also contributed to the retreat of global banks.

Hence, the trade finance markets during the period 2011-2017 can be characterized as "dual". On the one hand, the situation could be described as too many banks chasing too few international clients, in a very selective markets. Fees for letters of credit and similar instruments were being driven down by such intense competition. By contrast, traders in low-income countries were subject to the greatest difficulties in accessing trade finance at affordable cost, particularly regarding import finance. The same applied to small and medium sized enterprises in developed countries, which relied on small or medium-sized banks.

Challenges Stemming from the Concentration of Global Trade Finance Markets

A study by Bank of International Settlements (BIS, 2014b) also revealed that a large share of international trade is supplied by a relatively small group of globally-active international banks. This group of about 40 banks accounts for some 30% of international trade finance, with local and regional banks supplying the remainder. The market for trade finance, considered in its widest definition, is very large – certainly well above US$ 10 trillion annually. For bank-intermediated short-term trade finance only, the BIS (2014b) considered that the flow was between US$ 6.5-8 trillion was provided during 2011, of which around US$ 2.8 trillion was letters of credit. The main trade finance banks are also dominant in other segments of financial services. Since the financial crisis of 2009, some global banks have recalibrated their balance sheets, in part as a result of additional compliance requirements, albeit not only. Trade finance is particularly vulnerable to a reduction in correspondent banking network, despite the near-zero loss history and high recovery rates. Trade finance instruments, intermediated by commercial banks, are premised on an existing credit relationship between counterparty banks. International banks, which are, for example, required to "confirm" the payment to the exporter, take on the reimbursement risk related to local emerging market banks. Thus, in order for goods to be shipped, a confirming bank must be willing to take the payment risk of the local bank, and this may not be possible if exposure constraints exist for the client or the country or the potential return on this exposure does not merit the risk taken. In the process of deleveraging, some business models may have been more affected than others.

Of course, the withdrawal of global banks from one country or one region may leave opportunities for other banks and financial institutions to expand. The gap may only be temporary. This may in theory be true. However, in finance, size matters to make the heavy investment to establish a larger footprint. One important factor is the ability to offer traders global issuance and confirmation of letters of credit at an affordable rate. Another one is the ability to supply clients with US dollars, the most widespread currency in international trade. Finally, large banks are able to offer alternative services, such as factoring and other supply-chain financing solutions that smaller banks are not necessarily able to provide locally.

Current Global Trade Finance Gaps and the Particular Vulnerability of Small and Medium sized Enterprises in Accessing Trade Finance

<u>Vulnerability of SMEs</u>

Small and medium-sized enterprises (companies defined as employing 250 or fewer workers) constitute the vast majority of companies registered in both developed and developing countries. Their role in economic activity, generating growth and innovation cannot be overstated. According to the World Bank, SMEs contribute to over 60% of total employment in developed countries and 80% in developing ones, including the estimated informal sector (World Bank, 2013). Also, according to Organisation for Economic Co-operation and Development (OECD) figures, SMEs account for 40% of exports of OECD countries, and a somewhat smaller share in developing countries, where concentration of exports is highest among the largest firms (World Bank, 2013).

Recent research suggests that an absence of, or weak access to, finance can strongly inhibit formal SME development, regardless of the level of per capita income of countries. Market failures, notably in financial markets (be they financial crises or "information asymmetries"), fall disproportionally on SMEs, resulting in more credit rationing, higher costs of "screening" and higher interest rates from banks than larger enterprises (Stiglitz and Weiss, 1981; Beck and Demirgüç-Kunt, 2006). SMEs tend to be associated with smaller banks, to the extent they are banked at all.

Credit constraints are particularly reflected in access to trade finance, even in developed countries. For example, in a study covering 50,000 French exporters during the financial crisis of 2008-09, credit constraints on smaller exporters were found to be much higher than those placed on larger firms, to the point of reducing the range of destinations for business or leading the SME to stop exporting altogether (Bricongne et al, 2009). In Japan, SMEs were more likely to be associated with troubled banks, hence exporting SMEs were more vulnerable in periods of financial crisis (Amiti and Weinstein, 2011). In general, credit-constrained firms - mostly likely to be found among SMEs - were also less likely to export (Bellone et al, 2010; Manova, 2013).

In less capital intensive or less-developed economies, or economies with lower savings rates, local banks are even more conservative about supporting developing countries' exporters and importers. In developing countries, local banks may lack the capacity, knowledge, regulatory environment, international network and/or foreign currency to supply import- and export-related finance. Equally, traders may not be aware of the available products, or of how to use them efficiently. Other obstacles in developing countries include banking or country risk, particularly in the context of regional and global financial crises (WTO, 2014b).

<u>The Global Trade Finance Gap</u>

The Asian Development Bank (ADB) estimated that globally trade finance gap was US$1.5 trillion in 2016, against an estimated gap of US$ 1.6 trillion in 2015 and US$ 1.4 trillion in 2014. The survey is the outcome of a major cooperative effort by several institutions, including the WTO, multilateral development banks, private banks participating in the Banking Commission of the ICC, factoring companies, export credit agencies, and firms belonging to several networks (SME forum, UN ITC, the Netherland's Centre for the Promotion of Imports). Over 500 banks and 1,300 firms in over 100 countries (mostly developing countries) have been surveyed for the 2017 ADB trade finance gap survey.

While the 2016 global trade finance gap looks stable relative to the 2015 and 2014 ones, one could have expected a fall, given that trade in US dollar value has fallen by 16% in the previous two years. Geographically, 40% of the gap comes from Asia, 23% from Latin America, 15% from Africa and the Middle East. Banks had reported in the survey that 74% of their total rejections of trade finance requests came from micro and small and medium sized enterprises, and midcap firms.

One impact of such high rejection rates is foregone trade. Firms were asked what happened to the trade transaction after rejection of trade finance requested. About 60% of responding firms reported that they failed to execute the trade transaction. The remaining 40% of firms were able to complete the sale without bank-intermediated trade finance. Taking a different approach to the question of what happens after a transaction is rejected, more than half (53%) of surveyed firms did not look for alternative sources of financing when a transaction was rejected. Only half of the "rejected" firms found an alternative source of finance (either formal or informal solutions), and in this case 25% of such firms used it – others found the alternative to be too expensive. Respondent banks in Africa and in Latin America resorted to informal financial providers more than firms from other regions.

Almost a third of transactions are rejected by the banks due to their reluctance to undertake due diligence requirements for transactions which are regarded as either of insufficient profitability or too small in value. The lack of collateral against lending is also one of the main reasons for the rejection of requests for trade finance by banks. KYC, low profitability, and lack of collateral explain three-quarters of rejections. The Asian Development Bank concludes that a lot of requests for trade finance could be accepted/financed if firm identity solutions were implemented to address challenges in KYC due diligence. The ADB pleads for the adoption of the Legal Entity Identifier (LEI), a harmonized global identification system which is also promoted by institutions such as the Bank of International Settlements and the IMF; more trade finance transaction could be accepted if multilateral development banks were further supporting supply chain finance arrangements. Unlike traditional methods of financing that focus on financials and collateral, where SMEs tend to be weak, supply chain financing assess risk performance based on payment history and the "stickiness" of the supply chain relation – the buyer having an interest in encouraging banks to support its supplier.

THE WTO IMPLEMENTS A NEW ACTION PLAN FOR TRADE FINANCE AND SME

Based on the above facts, figures, and analyses, discussions took place in the WTO about how to address the challenges faced by developing countries, in particular their SMEs, in accessing trade finance after the financial crisis. On 26-27 March 2015, WTO Members held a seminar to discuss this topic with Government officials, bankers, multilateral development institutions. During the seminar, participants highlighted a number of key points, inter alia: trade financing gaps were due to a mix of structural and developmental factors (lack of know-how and capacity of the financial sectors in many developing countries) as well as the falling appetite of global banks to invest in developing countries after the financial crisis; developing local and regional trade finance industries took time, as it required knowledge dissemination, build-up of institutions, and specific support by multilateral development agencies; the WTO and its Director-General should pay greater attention to these gaps – notably gaps in the poorest countries in which the need was the largest while the potential growth of trade was also the strongest.

In his introductory address to the seminar, the WTO Director-General Robert Azevêdo promised to highlight the issue at the third United Nations Conference for Financing for Development, which he did in Addis Ababa in July 2015, and to revert to WTO Members with concrete proposals. Subsequently, the objective of improving the availability of trade finance in developing countries was included in the final text on Financing for Development.

In the first half of 2016, the Director-General issued a report ("Trade Finance and SMEs: Bridging the Gaps in Provision", 2016, available at www.wto.org), looking at these issues in detail and proposing a number of further step that could be taken, including:

- enhancing existing trade finance facilitation programmes to reduce the financing gaps. While trade finance facilitation programmes were not designed to eliminate all market gaps, they allowed SMEs and their banks locally to engage into international trade, thereby building capacity and experience. Currently, trade finance facilitation programmes of multilateral development banks supported trade transactions of a total value between US$ 20 and 30 billion annually, mostly from SMEs. The objective would be to increase this level of support, over time, in view of current increasing demand by SMEs to multilateral development banks and capacity of such banks to fulfil that demand;

- reducing the knowledge gap in local banking sectors for handling trade finance instruments by training at least 5,000 professionals over the next five years; professional organizations from the private sector would cooperate with multilateral development banks, in helping to pool the many training initiatives, where this is useful and when it generates economies of scales. The creation of the ICC Academy would be a useful tool in this regard.

- maintaining an open dialogue with trade finance regulators to ensure that development considerations are reflected in the implementation, and eventually design, or regulations.

- Improving monitoring of trade finance in provision. The mapping of global trade finance gaps needs to be improved to better target policy action and respond such gaps, particularly relating to any future crises.

A new effort to support SMEs access to trade finance, along the lines set out above, could have a positive impact. WTO Members expressed the wish for the institution to remain engaged on trade finance work, to monitor progress of the Director-General's initiative, and generally to support SMEs in their internationalisation when possible.

With this in mind, the Director-General has started to discuss some of his proposals with senior officials from multilateral development banks in the course of 2017, for example on the margins of WTO events such as the Public Forum and the recent 6th Global Aid for Trade Review. During this discussion, multilateral development banks indicated a willingness to do more in favour of trade finance, within existing resources. They generally confirmed that the outcome of the ADB survey was consistent with what they saw in the field. For example, the EBRD witnessed rejection rates affecting SMEs, on their requests for trade finance, in the order of 50%. Of course, there were also structural and legitimate reasons for such rejections: lack of know-how by local traders and local banks in managing the risks of trade and trade finance, lack of collateral for lending and lack of credit history, etc. However, the impact of some regulations and the greater selectivity of banks seemed to have played an important role as well.

The IFC, the private sector arm of the World Bank Group, had run a survey of 306 banks in 92 developing countries, which indicated that the smaller banks faced major challenges in complying with new international regulations on anti-money laundering and other sanction requirements. These challenges have reduced their ability to serve their customers, in particular, the traders. In some countries, local banks were being cut off from the international financial system. Specific cases were mentioned. MDBs were interested in increasing their capacity to serve markets, but the overall message was there was "only so much" they could do. The solution was hence to bring the private sector back into the most challenging markets. One way was to develop co-financing and co-risk sharing operational among MDBs where geographical coverage overlapped, and between MDBs and commercial banks. For example, the IFC and the Islamic Trade Finance Corporation signed a Memorandum of Understanding to conduct joint trade finance operations in Western Africa.

MDBs also agreed to boost capacity building on trade finance in countries in which trade was growing rapidly. They asked for a regulatory dialogue with the Financial Stability Board. Two arguments were put forward: first, multilateral development banks, in their support to local banks, could do a lot to get these banks to comply with international norms. At the same time, it had become obvious that the international bar had been placed quite high for these smaller banks, in small countries. MDBs were doing a lot to promote the pooling of information for compliance purposes. A dialogue extended to private sector representatives and regulators will continue in the months to come, with a view to making progress on resolving some of these policy issues.

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What Next For International Trade: ICC Banking Commission's Trade Finance Priorities

03

Mr. Daniel Schmand, Chairman of ICC Banking Commission

INTRODUCTION

Trade finance is an industry that is fast evolving, but it is also one that faces significant and complex challenges. Fundamental hurdles stand in the way of global GDP and trade growth – impacting the growth and prosperity of all businesses. Among the hardest hit are small and medium-sized enterprises (SMEs) – with straitened access to finance proven to impact their daily operations and limit their growth prospects. The entry of new financing and technology players, combined with burgeoning compliance and regulatory requirements – and, of course, the need to keep the wheels of trade turning – have given those in the industry much to consider.

Yet there is reason for optimism. The best years for trade finance may be yet to come – so long as the industry takes the right steps in innovating and evolving. We have reached an inflection point where collaboration, innovation and a focus on sustainability are essential. As a starting point, shared principles – particularly concerning regulation and compliance – will help to level the playing field and bring more players into the trade finance arena. Fortunately, trade – and its diverse and resilient community – has always been willing and able to "adapt and survive". The International Chamber of Commerce (ICC) Banking Commission aims to help prepare the industry for the change underway and the challenges that lie ahead.

A TRANSFORMATIONAL PERIOD

It is an exciting – albeit disruptive – time for trade finance. Firstly, the introduction of a host of technologies such as blockchain, big data, and artificial intelligence (AI) is redefining the way in which trade finance business is conducted. Trade finance has traditionally been largely paper-based, but the oncoming digital upheaval stands to benefit the industry at large, opening the way for new participants.

Digitalising trade finance is no doubt a transformative process – one that will facilitate the convergence of physical, financial and documentary chains. Cost reduction is one obvious benefit of this – through automating processes and reducing operational costs. This, in turn, leads to improvements in balance-sheet health and also contributes to working capital management. Digital processes improve the ability to access, review and approve online documents ("eDocs") remotely and separately from other parties – providing significant operational improvements at banks, ports and terminals. In particular, in the context of heightened focus on risk, distributed ledger technology and smart contracts ensure that all documents and participant actions are secure, listed on the shared chain, and visible to all required parties, with confidence that the data is authentic, verifiable and protected against fraud.

Meanwhile, we have also witnessed the growing popularity of supply chain finance (SCF) – the use of financing and risk mitigation practices to optimise working capital management and liquidity in supply chain processes and transactions. There has been an increased focus, among large corporates in particular, on optimising working capital – especially as CFOs, treasurers and finance teams react to difficult trading conditions, including international economic uncertainty and growing supply chain complexity.

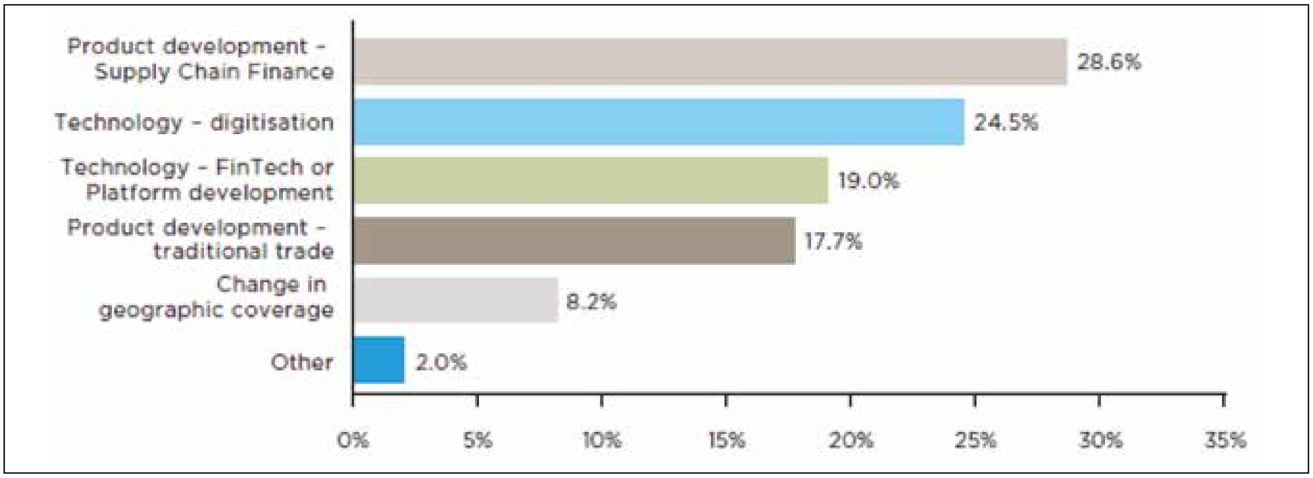
At the same time, technological upheaval and regulatory and compliance requirements are driving companies to seek new ways to access liquidity. Consequently, we are seeing the rise of technology platforms that enable trade finance providers to offer visibility of underlying trade flows. Indeed, digitalisation of trade finance is also being driven by the ongoing move to open account and the increasing demand for SCF, considering that SCF needs to be digitised in order to make business viable at any scale.

Almost 30% of banks surveyed for the ICC Banking Commission's 2017 *Rethinking Trade and Finance*[1] report identify SCF as the most important area for development and strategic focus in the following year (see figure 1). The growth of open account means that new trade finance techniques are evolving, involving new trade flows and corridors. This is an area of huge potential growth for trade finance, especially as SCF aligns with an increasingly holistic view of trade – considering the structure, global reach and functioning of global supply chains, and their commercial ties.

Adding to this picture, trade finance has, over the last decade, seen the entry of a host of new players into the industry, from FinTechs, challenger banks, pension funds, hedge funds, to insurers. In particular, partnerships between banks and FinTechs have become commonplace in the industry, particularly as banks seek to improve traditional practices in trade and SCF. While fostering innovation, FinTechs are clearly also providing valuable, additional sources of liquidity in the industry.

Of course, collaboration between banks and new players will be crucial to the future success of the industry. According to the Boston Consulting Group's contribution to Rethinking trade and finance, trade finance practitioners report that margin pressures and customer demand are directing them to focus on efficiency and new digital technologies – and innovation could bring industry-wide

Figure 1: Most Important Area of Strategic Focus for the Trade Finance Industry over the Following 12 Months (May 2017- May 2018)



Source : ICC Global Survey on Trade Finance 2017

cost reductions of US$2.5 - US$6 billion over three to five years[2]. But this requires investment in collaborative solutions that digitise information exchange and transactions. In trade finance, FinTechs have therefore become partners to banks, rather than competitors, as some envisioned – with the sheer amount of money in play, the complex regulatory framework, and the expertise required to minimise risks combining to form a compelling argument for enlisting bank support. Consequently, consensus now holds that many FinTechs require some form of collaboration in order to translate their ideas into tangible, sustainable businesses.

Clearly, with significant opportunities available, it would be wise for banks to participate in collaborative trade finance solutions by investing in innovation and taking part in pilots. Engaging with collaborative initiatives or partner communities such as we.trade, the R3 consortium and ICC Working Groups will help drive and accelerate the uptake of new technologies. This is certainly in banks' interests as these technologies can also enhance their ability to make informed credit decisions and forecasts, and to monitor risks.

Yet the industry needs to take steps to ensure new industry players fit seamlessly into the ecosystem, particularly as far as regulation and compliance are concerned. Law firm Sullivan & Worcester notes that non-bank financial institutions are subject to regulation, including national regulations as well as those related to sanctions[3]. Yet they do not face the same level of regulatory measures as banks in the areas of risk asset regulation and capital adequacy, and have greater flexibility when it comes to client onboarding and structuring facilities. Still, many in the industry hope that non-bank financial institutions will be well positioned to help bridge the global trade finance gap through their additional liquidity.

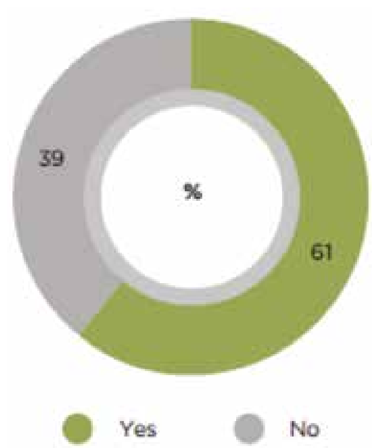
[2]ICC Banking Commission's *rethinking trade and finance* 2017 report, page 60.
[3]ICC Banking Commission's rethinking trade and finance 2017 report, page 214.

TWO MAJOR CHALLENGES FOR TRADE FINANCE

The Trade Finance Gap

Change almost always comes with challenges. The industry is navigating ever-changing regulatory procedures, technological disruption, and, as mentioned, the entrance of new sources of liquidity. But the biggest challenge of all remains that of bridging the global Trade Finance gap – a US$1.5 trillion shortfall in the supply of Trade Finance, as estimated by the Asian Development Bank (ADB)[4]. This is reinforced by the findings of the 2017 Rethinking trade and finance report, which revealed that 61% of survey respondents perceive there to be more demand than supply for trade finance (see figure 2).

Figure 2: Is There a Shortage in Servicing The Trade Finance Needs of the Global Market?



Source : ICC Global Survey on Trade Finance 2017

The lack of trade finance provision impacts emerging markets the most, particularly SME exporters. And while companies in Western Europe, China, and Advanced Asia experience low rates of rejection (7.6%, 8.2%, and 8.3% respectively), much higher rejection rates are reported in the Commonwealth of Independent States (CIS) (24.3%), followed closely by the Russian Federation (23.8%), the Middle East and North Africa (23.4%), and sub-Saharan Africa (21.6%).

This is a significant hindrance to the necessary – and beneficial – growth of global trade. And adding to the growing disquiet among industry players is the fact that it is becoming increasingly clear that banks alone will be unable to close this gap.

[4]Asian Development Bank, 2017 Trade Finance Gaps, Growth, and Jobs Survey: https://www.adb.org/publications/2017-trade-finance-gaps-jobs-survey

There is also clearly a discrepancy between where the most funds are available and where there is the highest demand. While pre-crisis levels of liquidity have largely been recovered by the global economic system, it is disproportionately available to multinational corporations and large corporates, compared to the micro- SME (MSME) segment. This therefore denies trade finance and suppresses trade growth among the businesses most in need. In fact, ICC Banking Commission's 2016 Rethinking Trade and Finance report found that despite submitting 44% of all trade finance proposals, 60% of SME applications for trade finance were rejected – in contrast to 33% of rejections among large corporates (40% of applications) and 9% of rejections among multinational corporations (16% of applications).

In order to address the gap we must be aware of the key forces behind it. Many in the industry would argue that one of the biggest contributors towards the gap is the increase in post-crisis regulation. Basel III – in addition to compliance requirements such as anti-money laundering (AML), know your customer (KYC), and even know your customer's customer (KYCC) – are cited as key reasons for a restricted trade finance offering. For example, over 68% of report respondents pointed to compliance and regulatory requirements as having the highest adverse impact on trade finance in the short-term.

In turn, compliance pressures have contributed to the phenomenon of "de-risking", where banks have selectively withdrawn from correspondent banking relationships – or the business entirely – after assessing the profitability and risk of their relationships[5]. This is particularly evident in emerging markets where financing is often deemed higher risk. However these are the very regions most reliant on the ability to access the global financial system.

Without a doubt, the trade finance gap represents significant untapped potential in trade and a host of lost opportunities in terms of economic development and inclusiveness – all impacting businesses and prosperity across the world.

Protectionism

There are also other less immediately apparent challenges threatening the long-term wellbeing of trade and the global economy. In particular, the rise of protectionist voices since the 2008 global financial crisis has driven an upsurge of trade-restrictive measures, threatening the global economic recovery.

The spread of this negative, populist rhetoric is in fact driven by a number of misconceptions around trade – whether it be that trade leads to job losses, that trade only benefits big corporations, or

[5]Recent trends in correspondent banking relationships—further considerations, IMF, 2017

that financing trade is high risk. These misconceptions, driven by political motivations, often lead to widespread anti-protectionist movements. Indeed, politicians regularly enshrine nationalist policies and calls for protection of national industries. For example, last year US President Donald Trump withdrew the US from the Trans-Pacific Partnership, which he dubbed a "great thing for the American worker"[6].

The truth is that trade is not behind uneven wealth distribution. Rather, domestic policies and trade integration are often the cause of job losses or low pay. This is addressed in great depth in a recent joint IMF-World Bank-WTO report, *Making Trade an Engine of Growth for All*[7]. So, while there are sometimes justifiable reasons to temporarily protect certain national industries in their early phases, in general, protectionist measures eventually lead to a decline in productivity and economic problems. A further rise in restrictive measures could lead to substantial welfare losses and a slower recovery than current projections suggest.

There is significant evidence that open economies grow faster. After going through processes of liberalisation, countries such as Chile and India saw their GDP increase by 1.5% a year on average in the last 50 years[8]. But this growth is threatened by the potential for reactive trade restrictions and even the reversal of existing trade agreements. Fortunately, for now, the larger trend towards deeper regional and bilateral trade agreements looks set to continue.

Given the growing size of the services sector and its potential contribution to growth, trade restrictions in this area are particularly concerning. According to the OECD Services Trade Restrictiveness Index[9], restrictions are particularly high in air transport, legal services and accounting services, while distribution, sound recording and logistics tend to be the most liberalised sectors.

ACCOMMODATING THE INDUSTRY: ICC EFFORTS

Fortunately, efforts are under way to tackle address the various concerns and evolving requirements of practitioners and wider industry stakeholders. Broaching issues from protectionism and the trade finance gap to the increasing complexity of navigating the trade finance industry, ICC is managing a number of initiatives aimed at clearing the path for frictionless trade and global economic prosperity.

Tackling Protectionism

Limiting any negative consequences of protectionism is top priority. This is precisely why ICC is working with the World Trade Organisation (WTO) to establish new trade recommendations for

[6]http://www.euronews.com/2017/01/23/donald-trump-signs-order-to-start-withdrawal-from-trade-deal-between-12-pacific-countries
[7]https://www.imf.org/en/Publications/Policy-Papers/Issues/2017/04/08/making-trade-an-engine-of-growth-for-all
[8]https://www.weforum.org/agenda/2015/02/how-to-lift-160-million-people-out-of-poverty/
[9]http://www.oecd.org/tad/services-trade/services-trade-restrictiveness-index.htm

all nations. Both organisations strongly advocate a level playing field as a means of reducing any negative perceptions surrounding trade. Clear rules concerning international trade procedures, documentation and terminology will help create that playing field.

Another effort aimed at combatting protectionist forces is provided by ICC's annual Open Markets Index (OMI)[10], which highlights the levels of trade openness in different economies (and covers 90% of trade and investment). ICC hopes that the OMI can serve as a guide for governments in implementing reforms to enable trade as a driver of sustainable growth and job creation.

The OMI index comprises four parameters measuring observed openness to trade, trade policy settings, foreign direct investment openness, and trade-enabling infrastructure. It is concerning to see that G20 nations are failing to deliver on their trade-enabling pledges, with only Canada placed among the world's top 20 open markets in last year's OMI report.

Fortunately, trade-related adjustment policies at the national level – easing worker mobility across companies, skills and reemployment programmes, and wage insurance programmes, for instance – will ensure that the benefits of trade reach the most vulnerable in society. Likewise, social safety-net programmes can provide workers with the necessary support between jobs.

Fostering Financial Inclusion

Meanwhile, perhaps the most immediately pressing priority for the trade finance industry is that of supporting financial inclusion. This is crucial in fostering trade growth in both developed and emerging markets.

Since the global financial crisis, numerous initiatives have been set in motion to measure and assess the shortage of trade finance and the subsequent effects. For instance, the ADB has conducted research on the trade finance gap since 2013, while the ICC Banking Commission has produced its annual trade finance report, including contributions from the International Finance Corporation (IFC) and other leading industry bodies. These research initiatives have played a significant role in influencing policymakers and raising awareness about the impact of the global trade finance gap and how this can be best managed. Of course, measuring trade finance gaps is no easy task, and the ADB, ICC and other partners strive to improve their methodologies year on year in order to stay relevant.

[10]https://iccwbo.org/publication/icc-open-markets-index-2017/

Furthermore, increased awareness of the low-risk nature of trade finance would help encourage more risk-aligned regulation as well as new sources of liquidity in the industry. The ICC Banking Commission fundamentally supports the need to ensure a stable and secure global financial system and works closely with regulatory authorities such as the Basel Committee on Banking Supervision, as well as regional and national regulatory bodies.

In particular, since 2009, the ICC Banking Commission's Trade Register has provided a transparent view of the credit-related risks and characteristics of trade finance – in turn supporting engagement with global, regional and national regulators in a fact-based dialogue and advocacy process.

The detailed findings and commentary in the annual report therefore provide an objective tool for discussions about global trade and trade finance policy – supporting informed and effective regulation, and appropriate industry measures. Year on year, the findings show that trade finance products present banks with short average maturities and little credit risk, with low default and loss rates. They also reflect a favourable risk profile when judged against comparable asset classes, such as corporate and SME lending.

Covering US$9.1 trillion of exposures and 17 million transactions – across major products and regions – the 2016 Trade Register highlights that short-term products are particularly low risk, citing the default rate (weighted by exposure) at 0.08% for Import Letters of Credit (L/Cs), 0.04% for Export L/Cs, 0.21% for Loans for Import/Export and 0.19% for Performance Guarantees.

In addition, medium - and long-term products also prove low risk, primarily due to the fact that in-scope transactions are covered by OECD-backed Export Credit Agencies (ECAs), at up to 95% of their value. The average default rate of medium- and long-term trade finance is therefore 0.44%, with a loss given default of 5.3% – driving an expected loss of 0.024%.

In recent years, the Banking Commission has refined the project's methodology to reflect the requirements of the Basel accords, with the aim of facilitating discussions with the Basel Committee. The 2017 edition – due to be released in early 2018 – has been refined to further enhance data quality and methodology, and going forwards aims to extend the scope as defined by product coverage and by risk category. This will also make the data more practical for internal risk-modelling purposes and bring it further in line with regulatory practice and definitions.

What is more, the Register has helped encourage new investors to view trade finance as an asset class in its own right, encouraging more players – from insurance providers, pension funds, hedge funds, mutual funds and private wealth managers – to provide finance for transactions. While there remains work to be done on promoting the asset class, it is clear that the high yield and low volatility on offer provide a compelling proposition.

Encouraging Standardisation

While the current influx of new participants into the trade finance arena certainly brings a welcome supply of new funding sources, ideas and offerings, it also renders the market more complex than ever before.

This is particularly acute in the case of SCF. As a result of the market's fast-paced development and the rapid growth of the business, industry participants were using inconsistent language to describe SCF products and programmes. In fact, SCF propositions evolved at different rates and in varying patterns depending on the region and the individual provider.

It became clear that the development and dissemination of standard definitions and terminology would bring clear benefits to the financial industry, regulatory authorities, clients and other stakeholders. This led to the creation of "The Global Supply Chain Finance Forum" in 2014, comprising the ICC Banking Commission, the Bankers Association for Finance and Trade (BAFT), the International Trade and Forfaiting Association (ITFA), Factors Chain International (FCI), and the European Banking Association. In a collaborative effort, these industry associations set out to create a set of "Standard Definitions" for SCF terminologies: *The Standard Definitions for Techniques of Supply Chain Finance*[11]. First released in 2014, this builds upon several initiatives aiming to develop terminology related to this fast-growing, but still emerging, form of financing.

As the Standard Definitions highlights, the use of inconsistent terminology has hampered advocacy efforts and even affected the value proposition of SCF programmes – in turn affecting the regulatory treatment of SCF. In fact, KYC and AML measures are not always well aligned with the actual risk profiles of SCF structures, a situation that can lead to unfavourable applications.

This is especially the case for Payables Finance, where the onboarding of SMEs often faces significant challenges, including the perception that it is a costly and risky process. The use of the definitions should help combat these issues – facilitating a common understanding of the characteristics of SCF programmes and techniques, supporting dialogue around the development of appropriate KYC, AML and financial crime compliance requirements, and allowing corporates to carry out SCF with confidence and without disruption.

As an example, Payables Finance is a technique used through a buyer-led programme, providing a seller of goods or services with the option of receiving the discounted value of receivables (represented by outstanding invoices) prior to their actual due date, and typically at a financing

[11]ICC Banking Commission, Standard Definitions for Techniques of Supply Chain Finance:
https://iccwbo.org/publication/standard-definitions-techniques-supply-chain-finance/

cost aligned with the credit risk of the buyer. The payable continues to be due by the buyer until its due date.

Yet the Standard Definitions for Techniques of Supply Chain Finance highlights that "Payables Finance" has been used interchangeably with an array of other terms such as "Approved Payables Finance", "Reverse Factoring", "Confirming", "Confirmed Payables" and "Supplier Payments" – among others. The Forum decided that the term "Payables Finance" best captures the essence of the technique.

Overall, the terminologies were created to facilitate a consistent and common understanding about SCF, followed by a strong advocacy effort to encourage the global adoption of these definitions. Of course, more variations of SCF techniques will evolve, so this initiative is therefore designed to incorporate regular updates.

INDUSTRY COLLABORATION UNDERWAY

In a rapidly evolving and diversifying industry, it is clear that collaborative efforts will be key to ensuring smooth transitions and effective initiatives. This applies to an extensive range of priority areas in trade finance, from the trade finance gap, compliance and regulatory requirements, and the involvement of non-bank players in the industry, to the growing focus on sustainable initiatives and the process of digitalisation.

The ICC Banking Commission – alongside a range of industry players – believes in promoting trade finance as a low-risk instrument for investors and an invaluable financing tool for SMEs. This is not only the aim of the Trade Register project, but also of industry efforts and wider ICC efforts. For example, in 2017, ICC was granted UN Observer Status and has since been actively involved in UN discussions around the importance of trade finance in economic value creation.

Following ICC engagement with the UN and national governments during the UN's annual Financial for Development review in May 2017, the UN underscored the importance of adequate trade finance provision for SMEs and entrepreneurs – noting the severe shortfalls in provision reported by the ADB and the ICC. This will form part of the UN's annual assessment of progress in mobilising finance to support sustainable development, with findings and recommendations to be issued in April 2018.

Of course, continued advocacy, dialogue and wider industry efforts will go a long way in helping to raise awareness of the importance of addressing the trade finance gap at governmental and intergovernmental levels – and hopefully help bridge the gap in turn.

Navigating Regulatory and Compliance Requirements

With continued concerns about the decline in correspondent banking relationships, multiple institutions have expressed support for clearer guidance on compliance, in addition to its application by regulators and the implications for participants. Stakeholders involved in trade finance rely on the rules governing the industry today – used by 90% of the banking industry – remaining up to date. The Banking Commission regularly updates rules and standards surrounding various areas of trade finance – including documentary credits, forfaiting, demand guarantees, and bank payment obligation, among others.

In April 2014, a Drafting Group was formed in order to update the Wolfsberg Trade Finance Principles paper[12]. As a collaborative effort involving Wolfsberg Group banks (a non-governmental association of global banks), ICC members, and BAFT, the Drafting Group aimed to standardise the practice of financial crimes compliance for trade transactions within the trade finance industry. Furthermore, the Trade Finance Principles sets a base for compliance requirements globally.

The Trade Finance Principles provides guidance on a comprehensive range of compliance areas – from control mechanisms (e.g. customer due diligence) to various transaction scenarios, and even on open account. These were expanded and updated and the paper and appendices were released at the beginning of 2017 to reflect changing regulatory expectations.

This also provides an important tool for an industry that is inherently "global" in nature – with the Principles taking cultural differences into account, as well as the varying sizes of banks involved in trade finance. Additionally, it specifies the role of financial institutions in the management of processes around addressing financial crime risks associated with trade finance activities, as well as compliance with national and regional sanctions and embargoes.

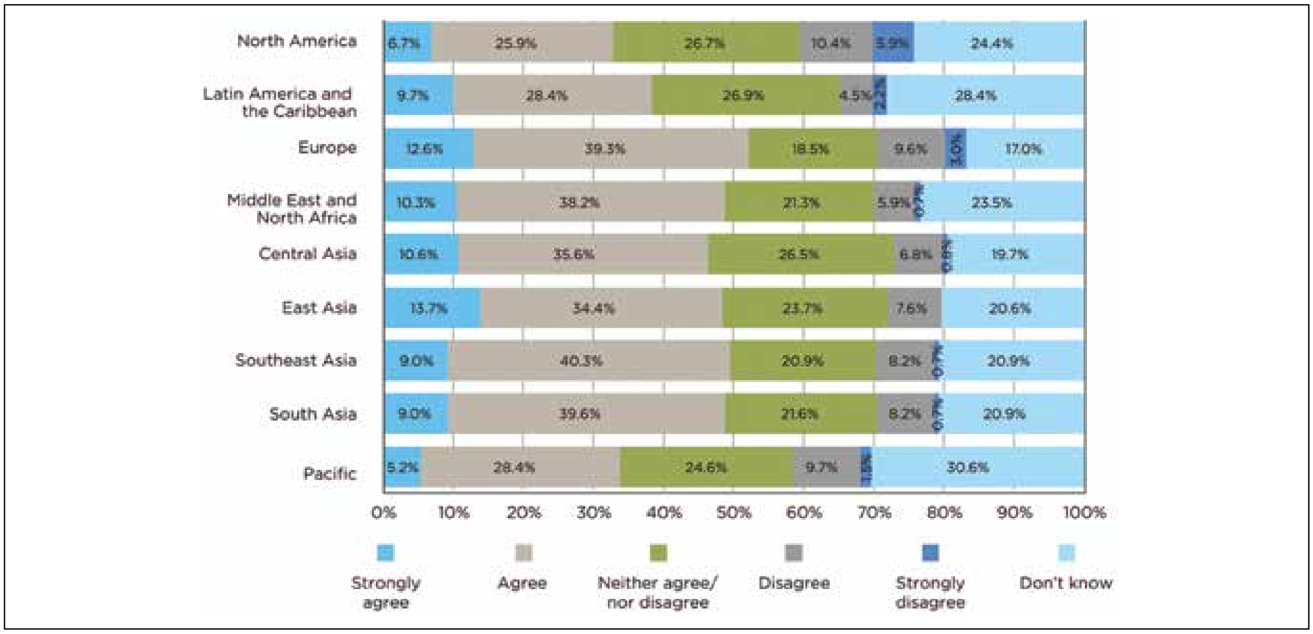
Those in the industry stand to benefit from adhering to and keeping up to date with any changes to the Trade Finance Principles, ensuring that they adopt measures appropriately in an ever-changing regulatory environment.

Involvement of Export Credit Agencies and Multilateral Development Banks

Since the 2009 global financial crisis, the trade finance industry has benefitted from the rebirth and increasing involvement of export credit agencies (ECAs) and multilateral development banks (MDBs) in facilitating transactions. In fact, about half of respondents in the 2017 Rethinking Trade and Finance report indicated that MDBs and ECAs were helpful in fulfilling demand for trade finance in both Asia and Europe (see figure 3).

[12]https://iccwbo.org/publication/wolfsberg-trade-finance-principles/

Figure 3: Extent to which MDBs and ECAs Help in Fulfilling Demand for Trade Finance in Different Regions



Source : ICC Global Survey on Trade Finance 2017

For example, ADB's Trade Finance Program (TFP) fills trade finance gaps by providing guarantees and loans through over 200 banks. In 2016, TFP supported US$3.09 billion in trade, a 24% increase from 2015 when it supported US$2.5 billion. In particular, the TFP focuses on markets where the private sector's capacity to provide trade finance is proportionally the smallest, leaving the largest market gap. ADB's TFP supported over 1,500 SMEs in 2016 – a significant contribution, since SMEs are known to have the most trade finance transactions rejected and experience the biggest shortfall in funding. In addition, the TFP will also continue providing support to SMEs through its growing Supply Chain Finance Program (SCFP). By offering guarantees to partner financial institutions on post-shipment post-acceptance transactions, the SCFP works with corporates and partner financial institutions to enhance SMEs access to working capital.

MDB programmes are also demonstrating their positive impact globally. For example, IFC's Global Trade Finance Program (GTFP) creates new opportunities for emerging market firms to participate in global value chains by linking emerging market institutions with international banks. Following the success of GTFP, IFC has since designed other initiatives, such as the Global Trade Liquidity Program (GTLP) and Critical Commodities Finance Program (CCFP), which aim to extend the availability of trade and commodity finance in emerging markets. While IFC supported US$300 million in trade annually in 2005, by 2014, it was enabling the same volume of trade every five days.

Similarly, ECAs help ensure access to trade and export finance in challenging markets, as well as in times of crisis. In particular, ECAs most often provide medium- to long-term financing – often perceived as higher risk than short-term financing – for projects in power/transmission (18%), infrastructure (14%), industrial production (10%), and shipping (9%), among other sectors.

However, the mandates and structure of ECAs vary significantly, as do the domestic and international political contexts in which they operate. For example, US Exim Bank has faced ongoing challenges on largely political and ideological grounds. In contrast, many other nations deem ECA support crucial to enabling trade flows and allowing businesses to expand internationally.

Undoubtedly, the involvement and increasing role of MDBs and ECAs will go a long way in helping to reduce the trade finance gap.

Going Green – a Focus on Sustainable Trade

Sustainable trade finance – especially in commodities – is becoming increasingly important for companies across the world, and is gaining growing recognition for its value to global development. Crucially, sustainable trade fosters economic growth while also raising living standards, fighting poverty, and safeguarding the environment.

Fortunately, banks are in a strong position to help their clients meet sustainability objectives. Certainly, banks possess the organisational infrastructure and know-how needed to mitigate risks and achieve alignment with environmental, social and governance (ESG) practices. In particular, banks can identify transactions and relationships where environmental risks could be present, and therefore need to be analysed before extending credit. The financial industry's influence in the adoption of sustainable practices in global trade should not to be underestimated.

In fact, it is in banks' own interests to help pave the way for sustainable economic development and financing, since their activities are increasingly being critically observed by their own customers and stakeholders, as well as by the media, advocacy organisations, and sustainability rating agencies. In the 2016 Rethinking Trade and Finance report, 75% of survey respondents revealed that their bank was actively tracking this debate, reflecting the growing traction in this area.

Furthermore, by working with development banks, lenders can even mitigate risks and facilitate transactions in countries and markets previously difficult to access. Here, trade finance provides a particularly effective way to integrate emerging economies into global trade systems.

Yet clear principles on sustainable practices will be important in allowing banks and corporates to seize opportunities in sustainable trade. This is precisely why the ICC Banking Commission formed a

Working Group on Sustainability in Trade Finance last year, with a clear mandate to leverage banks' role in financing sustainable trade and encouraging sustainable practices. The group aims to raise awareness of the adverse environmental and social impacts that have arisen in supply chains and the various tools that can help identify and better manage risks.

As a starting point, the group has provided a clear definition for sustainable trade finance, as "financial services that support trade transactions in goods and services produced or supplied in a manner that minimises adverse environmental or social impact or risk or that promote environmental protection or social benefits."

Furthermore, the group provides training and highlights available resources for Banking Commission members. It also benefits in particular from a strong relationship with the University of Cambridge Institute for Sustainability Leadership (CISL), which challenges, informs and supports leaders from business and policy to deliver change towards sustainability.

Overall, the industry is currently presented with a unique opportunity to help pave the way toward sustainable economic development for the future.

Accelerating Digitalisation

A phenomenon particularly influencing business models and strategies for banks is the move to "digital". Indeed, the digitalisation of trade finance has gained significant momentum due to its ability to simplify and reduce costs, while also allowing banks to meet the needs of SMEs and stimulate trade flows. Increased participation on digital platforms will certainly help accelerate industry-wide progress.

In fact, nearly 44% of respondents to the Rethinking Trade and Finance report identify priorities linked to digitisation and technology, including FinTechs and the development of fast-emerging platform propositions, as priority areas of strategic focus.

Digital transformation could revolutionise trade by enhancing efficiencies while also bringing transparency and reducing operational risk. Furthermore, digitalisation could potentially help trade banks meet their regulatory and compliance requirements – in turn helping to free up bank capacity, facilitating financial inclusion and even boosting GDP. Indeed, this will decrease the cost of processing a L/C and reduce the costs of transactions. Likewise, the simpler process also facilitates customs clearance procedures – allowing goods to move through supply chains more easily and reach consumers faster.

Yet despite significant progress and developments in the industry, trade finance has only just begun to truly reap the benefits of digitalisation – tapping into data extraction and analysis, for instance.

In particular, players often focus on digitising their own processes and operating in digital "islands", rather than linking up with the wider industry. Digitalisation has yet to reach a point of critical mass where there is a sufficient level of appetite in the industry for the benefits to be widely and consistently enjoyed. Here, industry-wide digitalisation will be accelerated if players communicate with each other and link up the islands.

There are also misconceptions surrounding what digitalisation truly means. For many, digitalisation is simply the process of converting paper into digital images and transferring these between institutions. But it is much more than this – positively impacting business processes through data extraction and analysis.

So, given this, what next for digitalisation? Clearly, industry-wide collaboration will be key in expediting progress. Digital platforms will enable parties involved in shipments to work in tandem, reducing errors and accelerating the process while allowing players to share their practices. The trade finance industry should also make use of existing demand for digitalisation and where digitalisation is already underway.

Finally, government involvement will also undoubtedly accelerate digitalisation processes. For example, government support in the Asia-Pacific region has made the region a global leader in digitalisation. Indeed, there are many examples of successful digitalisation on a national level – last year saw the 10th anniversary of M-Pesa, a mobile phone-based money transfer and financing service launched in 2007 by Vodafone for Safaricom and Vodacom, the largest mobile network operators in Kenya and Tanzania. M-Pesa has clearly reshaped Kenya's banking and telecommunications sectors, providing financing for nearly 20 million Kenyans and facilitating the creation of thousands of SMEs[13].

Certainly, minimum standards and clearly defined rules will help ensure a smoother connection to digital platforms, allowing service providers to operate on a level playing field. This also applies to service providers in legal, liability, information security and technology, since the discussion around liability of data between platforms presents potential issues.

ICC's Digitalisation of Trade Finance Working Group is developing a set of minimum standards for the digital connectivity of service providers with the aim of removing legal uncertainty – and also providing advice on practical solutions to digitalisation. The group also aims to evaluate the "e-compatibility" of ICC rules such as the electronic UCP and ensure these are "e-compliant".

[13]https://www.forbes.com/sites/danielrunde/2015/08/12/m-pesa-and-the-rise-of-the-global-mobile-money-market/#eb9e8bb5aecf

Ultimately, the more confidence the trade finance industry has in digitalisation, the faster progress will be made. The ICC Banking Commission sees collaboration between different players as a defining factor in the pace and success of the shift to paperless trade.

CONCLUSION: BRINGING THE TRADE FINANCE COMMUNITY TOGETHER

This is a watershed moment for the trade finance industry, with stakeholders navigating various regulatory changes, an influx of new players, and pervasive changes such as the shift towards digitalisation and the growing prominence of sustainability. In such an environment, the Banking Commission's role in facilitating change and fostering collaboration is more relevant than ever.

Firstly, if we are to support trade in the long run and overcome protectionist rhetoric, the public needs to see a level playing field – an equal distribution of the fruits of trade. Furthermore, its ability to generate jobs and growth needs to be clearly communicated. Here, ICC Banking Commission, and ICC at large, aims to be a voice for trade – demonstrating its importance to global prosperity at all levels, whether on the ground or at UN forums.

A level playing field is also needed within the trade finance industry itself. Clarity around compliance and regulatory requirements, in addition to further dissemination of standard definitions and terminology for the fast-growing area of SCF, will benefit all stakeholders, and will also prove increasingly important with the entry of new players into the complex industry.

The Banking Commission's ongoing dialogue and advocacy efforts in support of trade will continue to play a critical role in helping to reduce the trade finance gap. Dialogue with industry stakeholders – especially with regulators – is vital if we are to encourage trade-enabling regulation that encourages adequate levels of trade financing.

Central to this are the ICC Banking Commission's Annual Meeting, which gathers together over 500 banking executives and government officials from more than 65 countries, and its Technical Meeting, which provides an important opening for members to air disagreements and work towards solutions. Both forums serve as vital gatherings for the industry and foster collaboration in a number of areas.

Trade finance is on the brink of a digital revolution. Overcoming key barriers to digitalising trade finance – from a reliance on paper-based practices, a lack of recognition of the legal status of electronic documents, to uncertainty over standards and a general lack of clear legal and regulatory frameworks – will be key in determining the speed and success of the move to digital.

Finally, with sustainable trade now acknowledged as key to global development, the banking community has a unique opportunity to help pave the way forward in this area. Again, collaboration will foster industry progress. The Banking Commission has therefore secured Working Group membership from MDBs and partner banks – including the IFC, ADB, European Bank for Reconstruction and Development, African Development Bank and International Islamic Trade Finance Corporation, among others – while also benefitting from the involvement of the "Banking Environment Initiative" facilitated by the Cambridge Institute for Sustainability Leadership.

All of these efforts highlight that the ICC has capabilities, expertise and the mandate to take the lead on fostering necessary change. The time is ripe for all players to engage.

Trade Finance Gaps in a Post-GFC Regulatory Environment: The Role of Development Banks in Addressing Trade Finance Gaps

04

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INTRODUCTION: TRADE FINANCE AFTER THE GLOBAL FINANCIAL CRISIS

The 2008-09 global financial crisis (GFC) – unlike previous crises – began within the financial sector due to the unravelling of overvalued assets. It moved quickly to affect trade and investment: many banks' ability to finance trade dried up as they could no longer access capital or did not have available risk capacity. Now, a decade after the beginnings of the crisis, the global economic outlook is only slightly more positive. Global trade flows reached its lowest in 2016 and revenues in trade finance declined from US$41 billion (2014) to US$36 billion in 2016 (Ramachandran et al., 2017). By 2016 the ratio of trade growth to world GDP growth had reached a low of 0.6:1 (WTO, 2017). Indeed, global trade growth in 2016 was the weakest since the global financial crisis, with goods trade stagnant for most of the year (Engel and Reis, 2017). Global stagnation has been attributed to various factors: a cyclical inventory drawdown across advanced economies, shrinking import levels in China and major commodity exporters, an exacerbating low-inflation environment, etc. In addition, some of the decline in trade finance revenues might have been attributable to a shift to simpler and cheaper trade finance products. At the same time, at the policy level, trade restrictions reached a post-crisis high in 2016. During that year, G20 countries took more trade-restrictive measures than trade-facilitating ones. Since 2008, the WTO recorded 2,978 trade-restrictive measures on Members (WTO, 2016). Of those measures, only 240 had been removed by mid-October 2016 and the overall share of G20 imports affected by restrictions has continued to rise (WTO, 2016). Some restrictions can be necessary: they might serve short-term public policy objectives without being overly protectionist i.e. protect infant industries, avoid dumping, and prevent illicit flows of goods across borders. Excess restrictions and regulations, on the other hand, create cost and complexity, and they are a barrier to economies reaching their full potential.

In the last global financial crisis, both policy makers and regulators responded to the crisis quickly: governments backed financial systems and lending regulations tightened, and new supervisory structures, bodies and agreements were established to reduce the probability of any future systemic collapse. In line with the G20 global plan for recovery and reform, G20 governments also committed US$ 250 billion of support for trade finance (in the form of credit guarantees and trade insurance), US$130 billion of which was set aside for developing countries (WTO Secretariat, 2016). The GFC exposed many things. It showed that in the present globalized economy, localized instability in the financial sector can become quickly wide-spread; that the combination of an improbable and unforeseeable event ("black swan" phenomena) with a catastrophic impact needs to be increasingly understood by banks and factored into their potential future loss calculations. It also illustrated to world leaders, industry experts, executives and academics that trade invariably relies on some form of trade financing. If trade is a key engine to economic and social progress, then trade finance is its lubricant.

Global Trade Finance Gaps

The importance of trade finance has been well documented. It is crucial for trading partners in order to bridge the time lag between export order and payment for goods and services produced. However, latest survey results and analysis by the Asian Development Bank (ADB) point to a gap in global trade finance in the range of US$1.5 trillion annually – much of it in emerging markets, particularly developing Asia and the Pacific (Di Caprio et al., 2017). This is substantial, even though it suggests a US$100 million decrease from the previous year. According to the ADB's 2017 study, which gathered data from 515 banks from 100 countries and 1,336 firms from 103 countries, the Asia and Pacific region faces some of the greatest shortfalls in trade finance. It makes up 46% of trade finance proposals globally and yet it accounts for close to 40% of total rejections (Di Caprio et al., 2017). Meanwhile, the African Development Bank (AfDB) released a report in 2014 after investigating the market for bank-intermediated trade finance, and estimated that the value of unmet demand for trade finance in Africa was as much as US$120 billion (AfDB, 2014a).

Demand and Supply Side Challenges

Various organizations and groups have explored the barriers faced by potential clients in accessing trade finance and the key limiting factors among providers in fulfilling trade finance needs. On the demand side, the WTO found that technical capacity among borrowers, insufficient levels of collateral and numerous other issues, including incomplete financial literacy among SMEs combined to influence rejection rates, thus contributing to the trade financing gap (WTO Secretariat, 2016). Similarly, financial institutions in the ADB's 2017 Trade Finance survey indicated that the primary reasons applicants were rejected related to KYC concerns (29.3%), insufficient collateral or unclear financial requirements (21.4%), and low quality of applications (20%)(Di Caprio et al., 2017). It would seem that trade finance gaps appear to be exacerbated by a lack of awareness and familiarity among companies – particularly SMEs – about the many types of trade finance products and innovative alternatives such as supply-chain financing, bank payment obligations and forfaiting. The WTO's 2016 study on Trade Finance and SME's suggested that greater financial education would help overcome a major demand-side barrier contributing to trade finance gaps. Consistent with surveys that the ADB has undertaken in previous years, it finds that SMEs and mid-caps continue to represent the greatest market segments underserved by trade finance; these businesses face more challenges than large corporates in accessing every type of trade finance mechanism. Banks report that 74% of rejections are towards SMEs and mid-caps (Di Caprio et al., 2017). In addition, women — who are primarily owners of smaller businesses — are 2.5 times more likely to have 100% of their proposals rejected by banks than men (Di Caprio et al., 2017).

Meanwhile, in terms of supply-side barriers, surveys issued to financial institutions in 2016 showed that both Anti-Money Laundering / Know-Your Customer / Counter-Terrorism Financing (AML/KYC/CTF) regulations and Basel III regulatory requirements were viewed as major impediments to their ability to service trade finance gaps; 79.2% of respondents expressed agreement that AML/KYC/CTF is a barrier (nearly half stated they 'strongly agree') and 71% of respondents affirmed Basel III was a barrier (Kim et al., 2017). Low country credit ratings and low credit ratings of issuing banks (each over 70% of respondents) has also been cited as a key barrier among institutions in extending trade finance (Kim et al., 2017). Interestingly, a survey by TFX and ICC investigating export finance also suggested that a large proportion (30%) of export financiers (banks and corporates) felt that a lack of knowledge of new markets was holding them back from doing business there; regulatory requirements (52%) or sanctions (42%) being of primary concern (Zakai and Thompson, 2017). In a world where both the cost of due diligence on transactions in new markets, and the stakes for entering a new market and failing to properly address regulatory requirements are extremely high, it is likely that any lack of clarity or shortfall in information available will generate a more pronounced risk aversion.

Box 1: Trade Finance in Africa

The global balance of trade shifted after the 2009 Global Financial Crisis – Europe and the US declined while emerging economies relatively expanded. Africa's traditional industrialized export partners faced decline, while trade volumes between Asia and Africa, and Asian investment in Africa rose rapidly - the value of Sino-African trade growing by an average rate of 14% a year 2000-2012 (AfDB, 2014b). As the global economy rebounded and liquidity levels improved since the GFC, shifting dynamics within Africa—urbanisation, population growth, and improving political stability – has enabled many countries within the continent to become drivers of global economic growth.

However, Africa still lags behind. It has the world's highest proportion of low income countries and accounts for a small proportion of global trade. Lacking affordable trade finance, the region has not been able to take full advantage of the opportunities that the changing global economic landscape has offered. It also is yet to fully exploit trade opportunities with neighboring emerging economies, and importantly, intra-African trade remains a relatively small proportion of total African trade.

Even though a report by the African Development Bank in December 2014 revealed that 72% of responding African banks expect to increase their trade finance activities in the immediate future (AfDB, 2014a), SWIFT data revealed that Africa experienced the highest decrease (12.99%) in trade finance traffic of all regions in 2016 compared to the previous year (Garg, 2017). As such, there are still many obstacles to overcome. Low economic growth combined with weaknesses in the African banking sector—such as low US dollar liquidity, regulation compliance, limited capital, and the inability of local banks to assess the credit-worthiness of potential borrowers—create a bottleneck to increased access to trade finance, particularly for SMEs (WTO Secretariat, 2016).

In addition, trade finance default rates have remained higher in Africa than in the rest of the world—estimated at 5% in comparison with a global average of less than 1%, while the average default rate of SMEs in Central Africa is as high as 31% (Drammeh, 2017). Given this, it is unsurprising that the most frequently cited reason why banks reject the trade finance requests of clients is weak client creditworthiness (36%) and insufficient client collateral (30%) (Drammeh, 2017). These findings corroborate earlier studies by the AfDB and others.

Going forward, as long as these market gaps persist, economic development in Africa will be stymied. Innovative solutions are needed, as traditional approaches will not suffice.

REGULATION: ITS INFLUENCE ON TRADE FINANCE GAPS

Like other financial sector mechanisms, Trade Finance benefits from policies that promote financial stability. However, two forms of financial regulation that have been widely adopted since the global financial crisis have proven to be costly and complex for banks, and can have negative effects on the provision of Trade Finance. These are: i) capital, leverage and liquidity parameters as stipulated in the Basel Accords; and ii) AML and CTF measures. A third form of regulation, sustainability regulation, has also emerged in recent years, and it presents new regulatory demands on banks.

Basel III

Since the global financial crisis in 2007, banking regulation has expanded and intensified around the world. The Basel Committee on Banking Supervision has been at the centre of these developments, with the set of reforms it released under the third Basel Accord (Basel III) in response to the deficiencies in financial regulation revealed by the financial crisis. Basel III has ushered in significant regulatory changes to international banking rules; tougher capital, leverage, and liquidity requirements are the key pillars of the new standards ("Basel III," 2017). Since their publication in 2010, certain elements of the Basel III reforms have been highlighted by actors in the trade finance industry as having, potentially, adverse effects on the ability of banks to provide trade finance in a cost-effective fashion (Basel Committee on Banking Supervision, 2017)(Tavan, 2013)(Brandi et al., 2014). Initially, concern was raised that Basel III was not sufficiently nuanced to reflect the nature of trade finance products. Specifically, it is very unlikely that trade finance assets, which tend to be low-risk and highly-collateralized, will contribute to financial system instability; yet, Basel III requires banks to take them into account in capital and leverage calculations (Thieffry, 2016). The ICC's Trade register indicates that default and loss rates for traditional trade finance products are very low. For example, the default rate on short-term trade finance products range from 0.04% to 0.21% depending on the product, and the expected loss of medium-term products is only 0.024% (ICC, 2016a).When first developed, Basel III treated the risk weighting of trade finance assets the same as other riskier assets. By this design, there are incentives for banks to favour riskier transactions because a bank could use its resources to gain a higher rate of return for the same level of regulatory capital given that the same risk-weights apply to different risk-level transactions. As such, the Basel architecture has evolved with time to accommodate the nuances of trade finance and mitigate these unintended consequences (Nixon et al., 2016). Nevertheless, some concerns remain. Notably, a 2016 ICC study revealed that roughly two thirds of respondent banks said that the implementation of Basel III regulations has affected their cost of funds and liquidity for trade finance (ICC, 2016b).

Anti-Money Laundering and Counter Terrorism Financing Regulation

The second area that regulators have become increasingly focused on in recent years is the mitigation of financial crimes such as money-laundering or terrorism financing. Recommendations and standards set by The Financial Action Task Force (FATF) — an inter-governmental body that aims to promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats (FATF, 2017) — have been adopted to different degrees by regulators around the world. To wit, pressures to mitigate illicit financial flows has intensified, and Anti-money laundering ('AML') and Counter Terrorism Financing (CTF) procedures, laws or regulations have placed banks under intense scrutiny and compliance obligations

(Kaminski and Robu, 2016). Financial institutions providing credit, or allowing customers to open accounts are required to complete comprehensive due-diligence assessments of their customers and counterparty banks to stop the practice of generating income through illegal actions. These anti-money-laundering rules have therefore led to a significant focus on KYC, "know your customer," KYCC, "know your customers' customer," KYCS, "know your customers' supplier," and KYT, "know the transaction." However, with the onus to perform extensive customer due diligence, compliance costs in the financial sector have swelled and led banks to look for means to minimize their expenses. A LexisNexis survey of banks across the six Asian markets estimated that AML compliance budgets reached US$1.5 billion annually (LexisNexis, 2016). Moreover, 82% of the survey respondents saw overall AML compliance costs increasing in 2016, and one-third projected that costs will continue to rise by 20% or more (LexisNexis, 2016). Connected with this, since 2009 the role of compliance within banks has evolved: compliance activities were primarily of an advisory capacity; now the role of compliance is expansive. All this is invariably matched by increased resources devoted to compliance and higher KYC costs. Indeed, among financial institutions in Asia, personnel costs are attributed as by far the largest portion (81%) of AML compliance spending (LexisNexis, 2016).

At the same time, the penalties for non-compliance have risen considerably in recent years and there have been a number of high profile enforcement actions. A 2017 Boston Consulting Group report values the amount paid by banks in fines since 2008 at US$ 321 billion (Grasshoff et al., 2017). Less quantifiable is the reputational damage they incurred. Hence, not desiring to be subject to such fines, banks have accordingly deepened their investment in customer due-diligence. They have also, however, adjusted their risk tolerance for certain clients and markets, and terminated certain correspondent banking relationships which were deemed too risky.

Sustainability Regulation

Thirdly, a movement is afoot to institutionalize the concept of sustainable banking into regulatory regimes. Just as Basel III is designed to protect financial system stability and AML/CTF requirements are in place to protect financial institution's integrity, sustainable banking regulations are intended to protect (and enhance) the environmental and social (E&S) dynamics in which a financial institution operates (IFC, 2017a). Indeed, recognition that the financial sector's business relationships are exposed to E&S risks, and a view sustainability practices should be integrated into the financial sector's internal processes, has led national governments to establish country-level sustainability frameworks (IFC, 2017b). Often this are based on the Equator Principles, a voluntary set of principles/ risk management framework for determining, assessing and managing environmental and social risk in projects (IFC, 2017b). First adopted by ten international banks in 2003, the Equator Principles are now applied by forty-three financial institutions, covering 80% of global project finance

(IFC, 2007). The IFC's Sustainable Banking Network (SBN) – a voluntary community developed in 2012 of financial regulators, banking associations and environmental regulators — is at the of centre of sustainable banking progress by supporting green/sustainable policy formation and implementation in member countries. Sustainability regulation is becoming of increasing concern to local policy makers and bank regulators and, as such, the requirement to undertake environment and social evaluations and impact assessments is becoming a component of pre-screening for credit transactions. While the Basel Accords and regulation regarding AML and CTF represent demands on compliance to move financial institutions to process conformance with pre-determined acceptable risk thresholds, the intention behind regulation around sustainable banking is process performance to create long term value (IFC, 2007). In this sense, though all three have been discussed in this section, the former two, without devaluing their importance, present obstacles to successful trade finance, while the later (even though it adds cost and additional complexity to due-diligence) creates opportunity, and is increasingly championed by multi-lateral and national development banks. The scope of responsibility among financial institutions (particularly in emerging markets) is widened via the introduction of sustainability regulations. Broadly, their adoption requires a blend of adjusted risk management perspectives, and a focus on 'green' loan origination (IFC, 2017b). The former relates to managing social and environmental risks at both a strategic and transaction level; the latter is proactive, it involves identifying opportunities for innovative (green/sustainable) product development (IFC, 2017b).

DE-RISKING: THE UNINTENDED IMPACT OF REGULATION

The broadening reach of banking regulations is a critical development for the global financial sector to become immunized against the contagion seen in the GFC. However, arguably there are and will continue to be consequences of these regulations on the economy.

De-risking

Banks are becoming better at managing more risks. This is a good thing. The surge of regulatory activity in recent years has built resiliency to the global financial system. Nevertheless, it comes at a cost. Banks face increases in capital reserve requirements and in compliance costs. The outcome: "de- risking". De-risking refers to banks terminating or restricting their relationships with clients or categories of clients to avoid risk (World Bank, 2015). Its impact falls on both direct customers and correspondent banks. International banks, increasingly concerned about AML and CTF risk, are de-risking at times from entire countries where there is a lack of transparency over local banks' activities and compliance strategies (Starnes et al., 2016). In a joint 2016 survey by ACAMS and LexisNexis, 40% of surveyed banks said they intended to leave specific geographic areas (Taylor and Martinez, 2017). The two main reasons why were: i) that the segment was no longer within the firm's risk appetite (50%); and ii) that the cost of compliance made the segment unprofitable (51%) (Taylor and Martinez, 2017).

Impact on Banks in Emerging Economies

The effects of increased regulation on correspondent banking relationships (CBR) post-financial crisis have been well documented in recent years. The IFC's 2017 Survey on Correspondent Banking, issued to over 300 banking clients in 92 countries, revealed that over one-quarter of participants in Europe, Central Asia, Latin America and the Caribbean experienced decreases in their correspondent banking relationships (Starnes et al., 2017). At over one-third, the impact in Sub-Sahara Africa recorded by survey participants is even more pronounced (Starnes et al., 2017). The compounded challenges of local regulators and cross-border correspondent banks imposing further (and often dissimilar) compliance requirements; reductions in the number of active CBRs; reductions of line limits; and limited alternatives are regularly cited as the main barriers in local banks' ability to serve customers (IMF, 2017). A 2016 IFC survey of 210 emerging market banks illustrates the levels of pessimism among emerging market banks regarding the availability of correspondent lines. Indeed, of those surveyed, the percentage that indicated they had a negative outlook on CBR availability had increased from zero to 27% (Starnes et al., 2016). Meanwhile, a 2015 World Bank survey on regulatory bodies and local banks, revealed three-quarters of large correspondents had reduced their correspondent relationships and that 95% stated concerns about AML/CTF risks for terminating and/or restricting foreign CBRs (World Bank, 2015). The Society for Worldwide Interbank Financial Telecommunication (SWIFT) examined messaging data relevant to correspondent banking between 2011 and 2015. Looking at 204 jurisdictions, it confirmed a decrease in the number of active correspondents in over 120 of them and over 40 of those experienced a decline exceeding 10% (Garg, 2017). Additionally, where relationships have remained, many banks have set new minimum activity thresholds, passing on higher costs to respondents, or pressured respondents to limit their exposure to certain "high-risk" categories of customers (World Bank, 2015). Often these "high-risk" customers have been small and medium sized companies.

Box 2: Belize, a Case Study in CBR withdrawal

In the last two years, the Central Bank of Belize has lost three of its five CBRs. At one stage, a mere two of ten domestic and international banks in Belize had full banking services with their CBRs (IMF, 2017). Some were unable to process USD wire transfers. Four banks lost credit card settlement accounts in New York, and were forced to process credit card transactions through brokerage accounts or through a large credit card company (CaPRI, 2016).

The flight of CBRs in Belize has had a considerable impact on its trade relations. CBRs enable cross-border payment services, which are vital to international trade. As trade is a high portion of its GDP (2000-2015, 7.5% per cent of average FDI net inflows) relative to other countries, de-risking that limits CBRs is thus particularly liable to affect Belize on metrics such as poverty levels, unemployment and economic growth (CaPRI, 2016).

Cumulatively, the impact of the loss of CBRs on Belize's international trade volumes remained difficult to detect based on the data available at the time. Most CBRs actually remained in place until late 2015 or early 2016 (IMF, 2017). Its adverse effects can be seen in the hikes in wire transfer fees and in processing time; and decreases in the rate of deposits in Belize's banking system during this time period. At worse, a scenario analysis undertaken by the IMF found that a loss of 70% of CBRs would generate a drop in real GDP of up to 6 percentage points in the next 5 years (Starnes et al., 2017).

Solutions entertained by the authorities have included (i) increasing fees for CBR services; (ii) channelling more business volume to a more concentrated number of correspondent banks through collective action; (iii) processing cross-border payments through a U.S.-licensed special purpose vehicle; and (iv) providing CBR insurance policies (CaPRI, 2016).

Impact on SMEs

Today, market gaps in trade finance are particularly visible in asymmetries between demand side needs of SME clients, as well as banks themselves (particularly in emerging markets) who do not have available trade lines to service their clients —big and small. However, the lower end of the market faces the greatest problems to obtain affordable finance, affecting smaller companies in developing economies the most. Without the provision of trade finance, smaller firms are not able to gain access to global value chains that are critical for private sector employment and growth. Where the cost of due diligence is equally high or comparable for SME clients as it is to larger corporates, there is less incentive for a bank to maintain low return SME relationships. Banks report that 74% of rejections come from SMEs and mid-caps (Di Caprio et al., 2017). In addition, women — who are primarily owners of smaller businesses — are 2.5 times more likely to have 100% of their proposals rejected by banks than men (Di Caprio et al., 2017). Following rejection, they are also less likely to find alternatives (ADB, 2016). It is estimated that over 70% of women-led SMEs are either unserved or underserved financially (Women's World Banking, 2014). Close to 70% of MSMEs in emerging markets lack access to credit (Peer Stein et al., 2013) and the IFC and McKinsey has estimated their global financing gap to be in the range of US$ 2.6 trillion (Starnes et al., 2017). In a world where more than 90% of companies are SMEs, the impact of this is tangible. In emerging markets, where SMEs contribute greatly to exports, almost 40% of GDP, and as much as four out of every five new jobs, the consequences are immense (WTO Secretariat, 2016). Entrepreneurs are faced with even greater challenges in their efforts to progress in commercialization; their growth is stunted without adequate access to finance. In theory, successful national development strategies around improving SME access to trade finance should generate a positive develop impact. In particular, they should increase employment. Firstly, SMEs employ the majority of the global workforce (the median employment share of SMEs across countries is 67%) (Auboin and Di Caprio, 2017). In addition, exporting firms grow and hire new employees at a faster rate than non-exporters (Auboin and Di Caprio, 2017). Therefore, enabling SMEs to export more will increase employment. In addition, woman-owned SMEs tend to hire more women—yet, as already discussed, they are the most credit constrained (Stupnytska et al., 2014). Therefore, one can also conclude that improving trade finance to this particular group can also expand employment among women.

Least Connected Countries

Of further concern, and linked to what has already been discussed, is the possibility of new forms of financial exclusion arising as an unintended consequence of regulators and international banks managing financial crime-related risks. As highlighted by the IMF, though it may be rational by cost-benefit analysis for an individual bank to cease some of its CBRs, the aggregate withdrawal by many banks from CBRs could have a systemic impact and result in some countries being disconnected from the global financial system (IMF, 2017b). The concept of 'least connected countries (LCCs)' is used in discussion around internet connectivity. Yet, with confronting data on the decline of CBRs, it might be suitable to talk about the least connected countries in the context of global trade. A 2015 World Bank survey showed financial exclusion resulting from global de-risking has been particularly felt by smaller developing economies in Africa, the Caribbean, Central Asia, Europe and the Pacific (World Bank, 2015). Small Island Developing States (SIDS), such as in the Caribbean, appear to be the most affected by declines in CBRs.

Trade is well recognised as a fundamental driver of development and economic growth, but for some Caribbean small states, trade is equivalent to almost 100 % of GDP (CaPRI, 2016). At least sixteen banks across five countries in the Caribbean region have lost all or some of their correspondent relationships (Boyce et al., 2016). Banks' de-risking in Caribbean and terminating CBRs puts the region at disproportionate vulnerability. In addition, Small Islands Developing States (SIDS) often rely on imports for critical goods such as food, medical supplies, oil, primary resources etc. Hence, the reduction of CBRs not only limits export potential but inhibits some economies access to fundamental production inputs and other goods for living (Starnes et al., 2016). In addition, while regulators dictate AML and CTF requirements in order to ensure financial institutions in their jurisdiction are not involved in illegal financial flows, if CBR flight is the impact of these regulations, then—perhaps ironically— there might be an increase in the risk of money laundering and terrorist financing. Specially, as the availability of CBRs decline, the risk increases that businesses or clients, who have become excluded from the financial system, will seek less regulated and less transparent channels to conduct transactions.

Banking regulations have naturally changed the way banks operate. This is to be expected. What has not been sufficiently anticipated is the impact on trade because of restricted access to finance, particularly access to trade finance, for small firms, small banks and small countries. Without access to trade finance, the ability to execute on trade opportunities evaporates, trade flows shrink and economic growth stalls. Hence, access to trade finance becomes a development problem. Avoiding the widening of regulatory market gaps and the risks of financial exclusion among emerging markets requires coordinated efforts between the public and private sector. Multilateral and National development banks are well positioned to tackle these market gaps and convene various actors on local and international levels and between the public and private sector.

THE ROLE OF DEVELOPMENT BANKS

Multilateral Development Banks and TFP Programs

Multilateral Development Banks (MDBs) and international development finance institutions are actively pursuing methods to reduce the adverse impacts of de-risking. In regions particularly impacted by the withdrawal of CBRs, multilateral development banks have engaged industry associations and other regional bodies in advocacy efforts and sought to find solutions or propose policy-based courses of action to ensure access to trade, cross border payments and other critical services. For example, the Caribbean Development Bank (CDB) has worked alongside regional bodies such as CARICOM, and local groups such as the Jamaica National Building Society (JNBS) to address the decline in CBRs (IMF, 2017). Moreover, as pressures mount on major commercial banks to add regulatory capital, the integral role that MDBs play of keeping supply chains financed through of trade facilitation programs (TFPs) is increasingly apparent. TFPs not only facilitate short-term guarantees to Confirming Banks covering both the commercial and political risks of international trade credit transactions emanating from Issuing Banks, some MDBS also provide revolving credit facilities directly to specified companies and banks. They also aim at increasing the capacity of local banks and traders to handle themselves in trade finance operations on a routine basis. Gaps specifically persist for smaller transactions in countries with little access to international markets and/or no or low international ratings. In such countries, even where the banking system might be sound, local financial institutions do not find partners to share the relatively limited risk of financing or guaranteeing short-term trade transactions. Therefore, by providing short-term guarantees to banks covering commercial and political risks of international trade credit transactions emanating from local banks, MDBs play a crucial role in financing trade. Over 75% of bank respondents indicated that the trade finance programs of multilateral development banks—such as the European Bank of Reconstruction and Development (EBRD), Asian Development Bank (ADB) and Inter-American Development Bank (IDB), among others— were narrowing trade finance gaps, according to an ADB 2016 survey (ADB, 2016). More generally, these programs have proven effective for addressing market gaps— be they, cyclical gaps which emerge during crises; structural gaps relating to transaction size; or structural gaps relating to country or bank size/creditworthiness.

National Development Banks

Like Multilaterals, National Development Banks (NDBs) play a potentially crucial role in bridging market gaps and supporting segments of the market in local economies that have been shut out by commercial banks. Some of the main features that allow NDBs to make valuable contributions to addressing trade finance gaps, and mitigating the effects of de-risking includes their: 1) development mandate; 2) ability to mobilize; 3) risk appetite level; and 4) understanding of financial rules.

<u>Development Mandate:</u> NDBs exist to meet a public policy need. They are mandated to deliver to their shareholder (usually a public sector governing authority) a return on investment in both financial and socio-economic development terms. In other words, they must seek to generate a financial return as well as a "development dividend". Therefore, they operate in market gaps and meet the needs of areas of the economy that are underserved by private sources of finance. Where gaps exist in trade finance, NDBs may be well positioned to provide various forms of trade credit or risk-sharing activities with the private sector.

<u>Ability to Mobilize:</u> Typically, NDBs have strong relationships with the development finance community, bilateral and multilateral DFIs, as well as borrowers. As such, they are well positioned to

mobilize resources in order to serve a development financing need. In a number of countries, NDBs are the main financial player with access to hard currency borrowings as well as grants and non-reimbursable technical assistance resources. It is not in the nature of NDBs to compete. They seek to "crowd in" private financial intermediaries and be "additional" (i.e. support transactions that would not be financed otherwise). Similarly, they look to generate "demonstration effects". This means that NDB's look to lead other market participants to change their behaviour. MDBs, bilateral development finance institutions and foreign export credit agencies use NDBs as financial intermediaries and in turn NDBs usually look to increase their capital via credit lines from these actors.

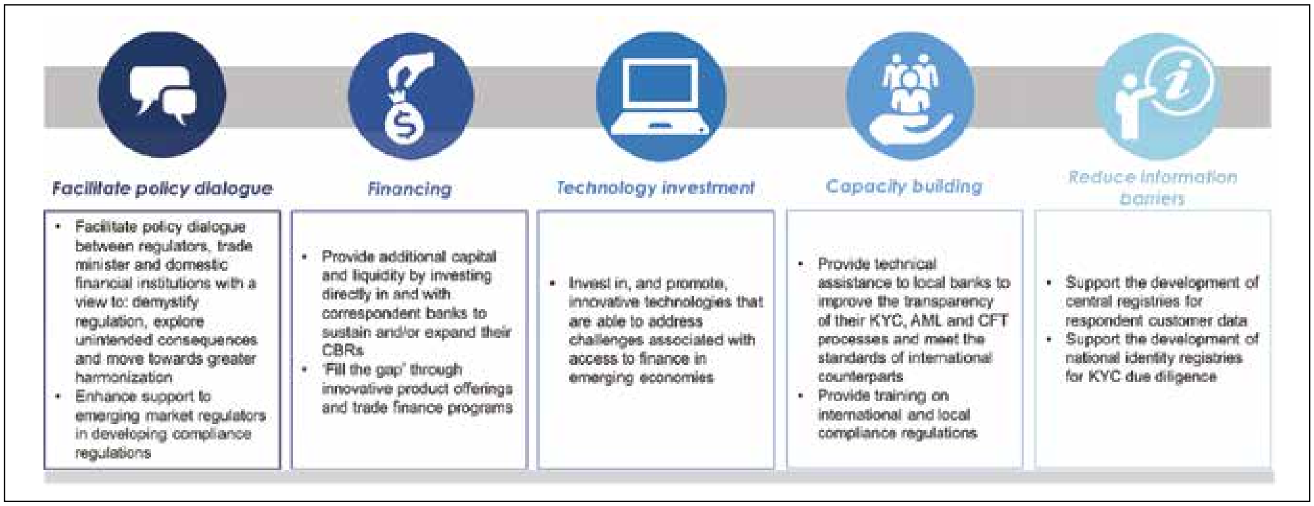
<u>Risk Taker:</u> NDBs tend to have strong relationships with local private sector financial institutions, and are well attuned to the myriad of factors influencing domestic markets. Therefore, they understand the risks and barriers that local financial institutions encounter in providing trade finance. Moreover, as a financial institution, NDB are risk takers. Their development mandate usually gives them a higher risk appetite than commercial bank and thus leads them to accept certain risks, tenors or costs that private sector entities cannot or will not take. Hence, they are able to go down-market to smaller transactions and be a trade finance player for untapped market segments (such as the women-led SMEs). They are also able to step in and assume the role of 'collateral provider' by providing a guarantee.

<u>Understanding of the Financial System:</u> NDBs are first and foremost financial institutions and therefore in the business of financing and risk taking. Moreover, they are designed to work with the grain of their local financial system. Some are required to operate under the same bank supervision rules as their respective domestic commercial banks; others—overseen instead by a specific governing body— are not. Nevertheless, by virtue of being an agent for executing national development strategies, NDB have a unique relationship with bank supervisors, occupying a seat at the same table when it comes to public policy.

Ways Development Banks can Address Trade Finance Gaps

There are a number of ways development banks can play an important role in addressing regulatory driven market gaps in trade finance. Primarily, as summarized in Figure 1, development banks can: 1) facilitate policy dialogue among national and international stakeholders to ensure local regulations are in-line with international standards; 2) provide trade financing to 'fill the gap' or provide additional capital and liquidity to local banks; 3) invest in, and promote, technologies and forms of digitalization that reduce the cost for banks to complete AML/KYC due diligence or address other challenges; 4) provide technical assistance to build the capacity of local banks to carry out due diligence in line with international standards and educate local banks and businesses on the compliance standards they need to meet; 5) help reduce information barriers by supporting the development of central registries that share customer data and therefore reduces due diligence costs for banks.

Figure 1: Areas and examples of ways MDBs and NDBs can address trade finance gaps



CONCLUSION

Various stakeholders at national and international levels have an interest in seeing trade finance gaps minimized and international and intra-regional trade flourish. Moreover, trade finance prospers in a well-regulated global financial system. Policy makers need to find the right balance between policies that encourage risk-taking and boost output and investment, while also avoiding financial stability risks and exacerbating domestic and global imbalance. At the same time, multilateral and national development banks are well positioned to work alongside policy makers and regulators to address trade finance gaps. They can offer a range of instruments to fill trade finance gaps and further support banks and underserved markets (SMEs) in emerging economies to overcome challenges associated with de-risking.

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Trade Finance and Credit Insurance

05

ECGC Ltd.

INTRODUCTION

Trade finance signifies financing for trade, and it concerns both domestic and international trade transactions. This article deals with role of credit insurance in trade finance in the context of international trade. A trade transaction between a seller and a buyer requires services from various intermediaries like bank and agencies like transporters etc. Banks and financial institutions facilitate trade transactions by financing and/ or providing settlement mechanism for the trade. Trade finance refers to the financing of individual transactions or a series of revolving transactions, often self-liquidating i.e., the realised sales proceeds are applied to clear the existing loan, if any. Trade finance concept basically revolves around products and services which are used for ensuring that the seller is paid his dues and the buyer gets the delivery either on immediate payment or future payment schedule. The importance of trade finance is assuming larger proportion in today's more connected world, with a great amount of financial uncertainty and it is imperative that the provider protect itself against any kind of commercial and political risks. The reliability of the buyer and their creditworthiness are key to the overseas transaction, as it takes longer to get paid. Trade financing is a huge driver of economic development and helps maintain the flow of credit in supply chains. Most businesses require financing at some stage, particularly those in the international export or global supply chain trade where capital costs are high and profitability is greater when order volumes are high. Apart from economic benefits like job and wealth creation, individual companies benefit from export finance as it generally increases productivity, profitability and growth.

TYPES OF TRADE FINANCE

1. Trade Credit

Ideally the seller requires payment for goods in advance or immediately upon shipment while the buyer would like credit period of 30-60 days or more, after the shipment. Trade credit, which is probably the easiest and cheapest arrangement, is based mainly on trust directly between the buyer and the seller. In the absence of such trust or information on the creditworthiness of the buyer, a bank backed bill of exchange guaranteed by the buyer's bank, facilitating payment in a secure and timely manner (e.g. SWIFT), mitigating possible risks through insurance, tracking the shipment of goods in transit and seeking credit insurance support to cover the risks of non-payment by the buyer and political risks, makes the transaction relatively safe from credit risk point of view.

2. Working Capital Loans or Cash Advances - Pre-shipment Finance and Post-shipment Finance:

The main purpose of pre-shipment finance is to enable exporter to procure raw materials, carry out the manufacturing process, packing and forwarding the finished goods. Pre-shipment credits are granted in the form of packing credit, advances against receivables from government, like duty drawback etc, advance against cheques /drafts etc which represents advance payment. Pre-shipment credit, which is granted in local currency and in foreign currency, are decided based on the nature of the order, commodity and the capability of the borrower to bring in his contribution and it is extended for a maximum of 360 days.

Post-shipment finance means any loan or advance granted or any other credit provided by a bank/ financial institution to an exporter of goods / services from India from the date of extending credit after shipment of goods / rendering of services to the realisation of export proceeds. The facility is meant for financing export sales receivables which is self-liquidating in nature, granted up to 100% of the invoice amount and with recourse against the exporter.

3. Buyer's Credit:

Buyer's credit is a financial arrangement whereby a financial institution in the exporting country, or another country, extends a loan to a foreign buyer to finance the purchase of goods and services from the exporting country. This arrangement enables the buyer to make payments due to the supplier through credit arrangement from financial institution in the supplier's country. Credit risk in realising the payment falls on the financial institution which may seek cover from Insuring Exporting Credit Agency (ECA).

4. Supplier's Credit:

Supplier's credit is a financing arrangement under which an exporter extends credit to the buyer in the overseas country to finance the purchases of the buyer. Credit risk is to be borne by the supplier who may de-risk by availing cover from ECA.

5. Receivables Discounting

The finance houses and market allow and facilitate sales of receivables in the form of invoices, post-dated-cheques or bills of exchange at a discounted price in return for immediate payment. The discount rate, which is relatively high and can be costly for SMEs, is calculated based on the risk of default, creditworthiness of the seller, and whether the transaction is international or domestic.

6. Factoring and Forfaiting:

Factoring and forfaiting are similar services that serve to provide better cash flows and risk mitigation to the seller. While Factoring is for short-term receivables and is more related to receivables linked to sales of manufactured goods, forfaiting is for receivables arising out of export of capital goods against which payments are due over a longer term, up to 5 years.

Factoring is a continuing arrangement between a financial institution (the Factor) and a business concern (the client) selling goods or services to trade customers wherein the former purchases the client's book debts either with or without recourse to the client. The buyer is informed in writing that all payment of receivables should be made to the Factor. The benefits of factoring include (1) conversion of credit sales to cash sales for improved liquidity (2) credit protection, (3) pre-assessment of the buyers (4) no need to provide collateral security and (5) outsourcing of MIS reports. A Factor performs at least any two of the services namely (1) financing (2) maintenance of accounts receivables ledger, (3) collection of the account receivables and (4) credit protection against the buyer.

Forfaiting is a similar service where the exporter surrenders his rights to claim for payment on goods delivered to an importer, in return for immediate cash payment from a forfaiting agency. Thus, forfaiting is a mechanism of financing exports by discounting of export receivables carrying medium to long-term maturities, evidenced by bills of exchange or promissory notes, without recourse to the seller (exporter).

7. Term Loans

Longer term debt (including loans, commercial mortgages and overdraft facilities) can be more sustainable sources of funding. They are often security or guarantee backed. Often in the world of international trade and finance, securing against assets owned by business owners in other countries is considered more risky, especially due to different ownership regulations in other jurisdictions.

8. Documentary Credit

Letters of credit (LCs), also known as documentary credits are financial, legally binding instruments, issued by banks or specialist trade finance institutions, which pay the exporter on behalf of the buyer, if the terms specified in the LC are fulfilled.

An LC requires an importer and an exporter, with an issuing bank and a confirming (or advising) bank, respectively. The financiers and their creditworthiness are crucial for this type of trade finance; it is called credit enhancement – the issuing and confirming bank replace the guarantee of payment from the importer and exporter.

Buyer applies to his bank for a letter of credit in favour of the seller. Buyer's bank approves the credit risk of the buyer, issues and forwards the credit to its correspondent bank (advising or confirming). The seller of the goods verifies through his bank that the LC is valid and then ships the goods as per the order. The seller then takes the required documentation to the bank to collect on the LC. The seller's bank draws the money from the issuing bank and the issuing bank collects from the buyer. The correspondent bank is usually located in the same geographical location as the beneficiary (seller). The LC is universally governed by a set of guidelines known as the Uniform Customs and Practice (UCP 600), which was first produced in the 1930s.

9. Bank Guarantee (BG):

Guarantees are given by bank on behalf of its customer regarding specific performance / obligation by the customer to the other party. The guarantees ensure payment to the party with whom the bank's customer is doing business. A bank guarantee / surety bond may only be issued if the customer has been granted a line of credit and collaterals are insisted upon in certain cases. While LC ensures that the issuing bank guarantees payment, which is a 'positive action' instrument, BG is a non-performance instrument. Hence, payment is released under LC as and when all the terms of the underlying LC conditions are met. On the other hand, payment is released under BG when the terms of the underlying transactions are not complied with. BGs are not typical trade finance tools. They are risk mitigation tools for buyers or assure performance of the exporter client. BGs are issued at the bid stage called bid bond guarantee. Once the contract is awarded, advance payment guarantees are issued for protecting the buyer for the advance payment made for assuring the performance of the exporter-client. Similarly, performance guarantees are issued for due performance of the contract. In certain situation, BGs are issued to Government authorities for duty / tax exemption for import of goods with an export obligation, in the future.

CREDIT INSURANCE ENABLING TRADE FINANCE AND EXPANSION OF TRADE VOLUME

In international trade, while the importers wish to pay upon receipt of merchandise in good order, the exporters wish to be paid upon shipment. There is a time gap which is bridged by the trade finance provider with the support of credit insurance. Trade finance provides the credit; support of payment guarantees or insurance (usually by an ECA or insurer) facilitates the transaction for merchandise or service on terms that will satisfy the exporter, the lender and the importer. Hence, trade finance is often described as a lubricant of trade as it helps to mitigate the risk of cashless trade transactions, and credit insurance acts as a catalyst for trade finance. Credit insurance enables the availability of trade finance itself. Hence, a credit sale supported by trade finance and insurance / guarantee is considered to be a safe bet in expanding business.

Credit Risks in Trade Finance and its Mitigation

In all the types of trade finance described above, there is credit risk which is borne either by the trade finance provider (buyer credit) or the exporter (suppliers' credit etc), depending upon the type of facility chosen. This is the area where credit insurance provider steps in to provide the covers that mitigate the credit risks to a large extent. International trade finance, often involving complex transactions, longer tenors, strategically critical trade flows and risk profiles seek recourse to export credit insurance/ guarantees for support. The International Chamber of Commerce (ICC) and others in the market note the critical role of ECAs in assuring access to trade and export financing in some of the most challenging markets on the globe, and in times of crisis, as seen during the global meltdown. The mandates and operating models of ECAs vary significantly, as does the domestic and international political context in which they operate.

ECAs provide credit insurance covers to exporters protecting them against credit risks while the currency risk is usually managed through hedging. Such covers, issued to the exporters give the comfort and also act as a collateral security to the trade finance provider.

In addition to this, the trade finance provider can seek a working capital insurance cover from the ECAs for protecting them from the risk of non-payment of the advances granted to the exporter either due to insolvency and protracted default of the exporter, which provides the necessary comfort for the trade finance provided to deal with the client.

ROLE OF ECGC IN SUPPORTING TRADE FINANCE WITH CREDIT INSURANCE TO BANKS/ FINANCIAL INSTITUTIONS

ECGC began its operations with credit insurance policies to exporters but soon, the focus also turned towards products for banks, since 1960. The schemes to banks were evolved to enable exporters avail easy and hassle-free access to export finance which significantly enhances an exporter's ability to compete in the global market. While the banks do the due diligence and generally insist on mortgage of adequate collateral before sanctioning export finance, export credit insurance often acts as the collateral for the exporter's access to bank finance, and grant favourable terms of credit to exporters. Thus, in addition to funding exports, export finances also provides capacity to expand international business, and thereby limit the firm's risk in international transactions through diversification.

ECGC covers are available for working capital extended to exporters at pre-shipment and post-shipment stages, due to protracted default and insolvency of exporters, the indemnification at an agreed percentage. While Banks have the option of taking covers exporter-wise, bank-wise and bank branch-wise, the bank-wise covers, known as whole turnover covers (portfolio) are very popular. The cover provides for certain pre-agreed exclusions. Whole turnover covers also provide automatic cover up to certain specified value (discretionary limit), giving flexibility to banks to extend export credit to any new firms or MSMEs which carry higher risks in the early stages of venture. ECGC introduced the Export Performance Guarantee Scheme to the banks to protect the banks against losses on account of failure of exporters against the non-fund based facilities extended in the form of issue of guarantees like bid bonds, performance bonds, advance payment guarantee bonds and retention money guarantee bonds in the year 1969, and presently the scheme is in operation by in the name of Surety Covers, since 2013.

SUPPORT DURING GLOBAL FINANCIAL CRISIS

The 2008-09 global financial crisis will be remembered as one of historic milestone being the broadest, deepest and complex crisis since the Great Depression. The developed and the developing countries faced massive failures of financial institutions, commercial entities and a staggering collapse in asset values resulting in credit crunch and the banks became reluctant to lend to even the highest credit quality firms. The financial crisis and the ensuing trade collapse immediately prompted the policy makers and analysts to link the two events; trade dropped in part because of lack of supply of trade finance. The crisis affected both trade finance and other financial markets. Banks were increasingly cautious with real-sector customers and counterparty banks, and pricing margins often increased. The impact of the 2008 meltdown and the resultant slowdown in the international trade impacted India. The Indian banks faced major defaults from their exporter customers arising out of buyer failures. ECGC compensated banks to the tune of INR 6,000 crore in the last decade beginning from the meltdown. The support provided by ECGC enabled a stable export credit framework in the country during the tumultuous period. The support continues and even in the year 2016-17, INR 5,70,000 Crore worth disbursements were covered under the covers extended to banks, which represents approximately 62% of the total disbursements.

Credit Insurance to Exporters

Credit insurer facilitates international trade by allowing suppliers to sell goods and services, and promising to indemnify a seller if a buyer fails to pay for the goods or services purchased, known as commercial risks, and accepting premium in the form of charges from the supplier. In addition, international trade transactions are subject to political risks, where an overseas buyer willing and able to pay might be prevented by doing so, because of a political situation.

Export credit insurance allows exporters and trade banks to safely extend credit to buyers abroad, thus enabling trade transactions that would not happen otherwise. It is customary to define short-term export credit insurance (ST) as insurance for trade transactions with repayment terms of 1 year or less, while medium and long term export credit insurance (MLT) covers trade transactions of more than 1 year (typically 3-5 years, occasionally up to 15 years). ST business is usually insured on a whole turnover basis whereby the credit insurer insures the exporters' entire portfolio of trade receivables. MLT business is usually insured on a transactional basis, covering sales of capital goods, services, turnkey projects with repayment terms deferred over several years.

ECGC Ltd since 1957 has designed different export credit risk insurance products to suit the requirements of Indian exporters and commercial banks extending export credit. ECGC also provides direct financing to exporters by purchase of receivables under its factoring scheme. ECGC has also evolved schemes to support project exporters in the country by providing a range of products, and also provide cover to the banks for providing the necessary fund based and non-fund based facilities to them.

Short Term Covers Directly given to Exporters (Policy)

Credit risks borne by the exporters are mitigated by sharing the risks with credit insurers by way of Policies. Under the short term credit insurance policy issued to the exporters, ECGC protects them from losses arising out of non-payment by the overseas buyer either due to (1) insolvency and / or (2) protracted default which is classified as commercial risks. In addition, the protection is extended for non-payment due to political risks in the buyer's country namely (1) war, civil war, civil disturbances (2) import restrictions (3) transfer delay due to foreign exchange crunch (4) diversion of voyage. The short term credit insurance policy issued to the exporters is the oldest product of the Corporation, in force since its inception. Initially, there was only one product, namely shipment comprehensive policy (SCR). Later on various products were introduced to cater to the requirement of exporters including customised covers. These Policies obtained by exporters act as a collateral security to the banks / financial institutions who provide the trade finance to exporters. Any compensation / indemnification provided to exporters under these Policies are routed through the banks / financial institutions which improves their liquidity. ECGC also has evolved Export Factoring Scheme to Micro, Small & Medium Enterprises (MSME) exporters providing them a package of financial products consisting of working capital financing, credit risk protection, and maintenance of sales ledger and collection of export receivables from the buyer located in the overseas country. These facilities for the purchase of the export receivables are provided without recourse and ECGC assumes the risk on the overseas buyers. The volume of business covered by ECGC, under Short Term, was to the tune of INR 1.41 Lakh crore for the year 2016-17.

Medium and Long Terms (MLT) covers

Project export contracts which refers to export of capital goods on deferred payment terms, execution of turnkey projects, execution of construction works contract and rendering of services abroad are generally of high value and exporters undertaking them are required to offer competitive credit terms, spread over a long period time, to enable them to secure orders from foreign buyers. Similar to short-term, the covers issued under MLT can also be divided into two viz., (i) covers for exporters and (ii) covers for banks. Broadly, the credit insurance covers issued by ECGC can be classified as Policy covers, Covers for Banks and Special covers. Policy covers are the covers issued to exporters to cover the risk of non-payment by the buyers whereas the covers offered to banks are for covering the non-payment risks of the fund-based and non-fund based credit facilities extended by banks to project exporters for executing the project export contracts. The special covers refers to the Overseas Investment Insurance (OII) cover to provide protection for Indian investments abroad, in the form of equity capital or untied loan for the purpose of setting up or expansion of overseas projects. ECGC also supports banks / financial institution in India by way of credit insurance cover to protect from the risk for credits extended to the foreign buyers, where the exporters in India realise the export value in Indian rupees from the banks / financial institution straightway. The volume of business covered by ECGC under MLT was to the tune of INR 6,000 crore for the year 2016-17.

DEVELOPMENT OF PRODUCTS BY ECA AFTER GLOBAL FINANCIAL CRISIS

The challenges posed during the crisis by deteriorated economic environment and the resulting risks have highlighted the importance of risk management, which has become a priority for companies and financial institutions all over the world. As the global crisis moves on and signs of economic recovery are seen in some regions of the world, the indications for credit insurance industry are positive in terms of global recognition, increased demand for its products, and ECAs meeting its obligations and paying claims at unprecedented levels. The role of ECAs in unlocking of bank financing and providing liquidity for ST and MLT finance is laudable. The co-existence of public and private credit insurers is vital to the industry. With lessons from 2008-09 crisis, the credit insurance industry is well equipped to support international trade in the future. They will continue to offer risk capacity to facilitate trade transactions worldwide.

ECAs' initiatives included increased ceilings or capital, higher percentages of cover of the individual export transactions, enhanced support for working capital, and introduction of new products and joint efforts targeting most vulnerable groups of exporters (e.g., SMEs). Some ECAs launched consulting and advisory services, free credit assessments, and programs aimed at facilitation of regulatory environment, etc. Other ECAs enhanced their international cooperation by entering into bilateral agreements with ECAs of their major trading partners.

The growing role of ECAs in facilitating ST and MLT export transactions has been clear since the 2008-09 meltdown which almost toppled the world's financial systems. The subsequent period has hosted a massive boom in MLT transaction volumes underwritten or financed by ECAs with a particular focus on the project finance market. Commercial banks which were providing the liquidity in the earlier years, struggled to provide the same, particularly in emerging markets, after the crisis. ECAs, in order to encourage exports from their respective countries, introduced Working Capital Loan Guarantee Scheme to provide support to the banks for favourable lending, based on the ECGC model.

Basel III regulations and a consequent reduction in commercial lending capacity shrunk the role of commercial banks. In this context, the ECAs have stepped up to fill the gap and support their exporters by facilitating a far broader volume of official MLT financing. ECAs have also brought in a new approach to structuring deals wherein ECAs are joining together in sharing risks. The involvement of ECAs early in the project helps in identifying the risks in the projects. It is now accepted practice that ECAs and other international financial institutions are involved in term sheet negotiations from the beginning.

CONCLUSION

Unlike in India, in western countries, the partnership between banks and ECAs intensified post the global financial crisis, as banks started contracting their balance sheets in order to comply with prudential norms by holding back on credits, including export credits. The role played by ECAs since the 2008 global financial crisis in building stronger partnerships with banks in various ways is commendable. Credit insurers and banks complement each other in supporting international trade and in exports of large infrastructure projects. Any sharp decline in trade credit has an adverse consequence disrupting a country's trade and growth, exacerbating a crisis. Scarcity of trade credit may frustrate the potential stimulus to a country's exports. Trade finance industry remains a banking business and will continue to be so with ECA support as there is a natural fit between banks and ECAs in a symbiotic relationship.

Berne Union is the leading global association for the export credit and investment insurance industry. The members of the association include government-backed official export credit agencies, multilateral financial institutions, and private credit insurers, 84 in number from 73 countries around the world. In 2016, Berne Union members provided US$ 1.9 trillion of payment risk protection to banks, exporters and investors - equivalent to 11% of world cross border trade for goods and services. The International Credit Insurance & Surety Association (ICISA) brings together the world's leading companies that provide trade credit insurance and / or surety bonds. Their members have insured over Euro 2.3 trillion in 2016. The services of Berne Union and its members and ICISA and its members in promoting Trade are laudable.

The clients and financial institutions are in the process of streamlining their trade activities in order to reduce the costs and improve efficiency. The submission of large set of papers and involvement of middlemen entities is affecting the working capital and supply chain costs. The major driver of cost and the biggest roadblock in global trade is regulation, Know Your Customer requirements, Anti-Money Laundering and its compliance. The problems have been daunting the trade finance markets; but technology up gradation is expected to help the situation. These problems have led to digitally documented trade technologies like Block Chain, Artificial Intelligence, Internet of Things and Machine Learning which are likely to help resolve the problems of banks in trade finance. This will lead to paperless process, cost reduction, document verification and authentication through system, and easy transfer of ownership of assets. Digital identifiers, smart contracts with digital signatures will help in monitoring of the transactions and increasing the creditworthiness of the participants of the trade, while facilitating easier regulatory reporting. These technologies upon successful implementation are expected to transform the global export trade finance operations, supported by efficient credit insurance processes.

Economic Development and Protecting Trade: The Case for Credit Insurance

06

Mr. Vinco David, Secretary General, Berne Union

INTRODUCTION

Trade is an important contributor to development – economic development, at least. In many developing countries and emerging markets, growth is driven by exports. As the national economies are often too small to propel this growth on their own, this entails also imports of capital goods and the construction of infrastructure necessary to enable export. All these goods and services crossing international borders are thus testament to economic development. Too often, however, these transactions are not in fact realised, as the risks – payment risks of the exporter, in particular – are deemed too high. There are ways to overcome these (perceived) risks and one important tool in this regard is credit insurance.

This article is about the importance of cross-border trade, and the role credit insurance can play to support and stimulate this. First, we will try to quantify this importance in terms of income; subsequently we will explore the role of credit insurance in economic development. Following this, we will explore the examples of China and India, and lastly we will try to draw some conclusions about the relationship between economic development through export and credit insurance.

WHY TRADE?

World cross-border trade amounted to over 14 trillion dollars in 2016[1]. That is a 14 with 12 zeros – a staggering amount indeed, and a figure composed of added value along all trade chains. Without this, we could just have over 14 trillion less income across the globe. That amounts to about 2,000 dollars per head, every year. It also has a cross-over effect domestically, as foreign trade spurs domestic trade too through the supply chain to exporters.

The 85 members of the Berne Union – that is, the insurers of credit and investment risk worldwide – support and protect some 13% of all cross-border trade. Without their support, this trade would often not take place. As said, the exporters or their financing banks would deem the payment risk on the importer as too high. The transaction would then simply not go ahead. Without cash or credit there is no trade. Trade is only trade when paid.

[1]UN Comtrade, World Bank and ITC statistics

WHY CREDIT INSURANCE?

Not all trade requires protection against credit risk. Payment risk in inter-company trade, or for goods and services paid in advance, or trade on some spot markets, such as for oil, is negligibly low. But lots of goods and services are sold on credit to companies or governments, with tenors ranging from 1 day to over 20 years. These different credit terms go hand in hand with the economic life of the respective goods. Perishable goods, such as fresh meat, vegetables or flowers are typically sold on terms of a week or less. Large infrastructure projects or ships require a much longer repayment period. Fortunately, many of these buyers do pay (although not always within the agreed term). However, it happens too often indeed, that purchases are not being paid for. Hundreds of thousands of companies go bankrupt or are otherwise declared insolvent, every year. Or, depending on the jurisdiction, they simply can no longer afford to pay, without a formal insolvency procedure. In the US alone – the world's single largest export destination – the number of bankruptcies (not including other insolvencies such as Chapter 11 filings) was close to 100,000 in 2016. In some emerging markets the incidence of bankruptcy is also high. In Vietnam, for instance, more than 60,000 companies were declared bankrupt in 2016 alone[2]. Indeed, even governments and state owned enterprises sometimes fail, often due to lack of hard currency. Recent examples are Tanzania or Gabon: These countries were strapped of dollars, euros or other convertible currency, partly due to the decline in the price of the commodities they exported.

In addition to credit insurers, banks, factoring companies and forfaiters can also absorb payment risk for exporters. This all comes at a price, of course, and there is some – but not much – price competition between the various instruments. But factoring, forfaiting, letters of credit (L/C) or the discounting of bills of exchange do not eliminate every payment risk. What if you are manufacturing tailor made goods and your buyer goes bust before you can supply these? In such a case there will usually not be any receivable to sell, or any draw-down under a bank's L/C. If your goods are commodities, you can probably re-sell these to another buyer at a reasonable price, but what to do with customised goods? Or what if your financier has recourse against you in case the buyer does not pay? Furthermore, in transactions with more complex payment terms, such as for project finance deals or infrastructure, the relatively standardised solutions typical in factoring or forfaiting are often unsuitable.

Credit insurance, bank financing for export, forfaiting and factoring (including supply chain finance) each have their own merits and are more complementary than competitive. Credit insurance works well for standard as well as more complex payment terms, and can also cover so-called pre-credit risk. It is noteworthy that many banks and factoring companies also make use of credit insurance

[2] Dun & Bradstreet, Global Bankruptcy Report 2017

to protect against payment risks when financing exports. This allows them to protect their balance sheet and often also leads to lower regulatory capital requirements. The exporter may not even be aware of this credit insurance at the backdoor of its financier.

Credit insurance not only protects exporters against payment risk – thereby contributing to the continuity of these companies – it also unlocks commercial financing for trade and investment that would otherwise often not be available. It is this finance-catalysing aspect of credit insurance that is of greatest importance to development. Increasing the growth potential of developing countries requires many capital equipment and infrastructure investments for which reliable financing is essential. Public financing alone is often not sufficient to enable this and commercial financing supported by credit insurance is therefore an important contributor to close the financing gap for development.

WHAT PRIVATE AND PUBLIC CREDIT INSURERS CONTRIBUTE TO WORLD TRADE

Credit insurance can be provided by private companies, public agencies and multilateral institutions. All three groups of providers are important for development. As time have passed, their roles and market shares have changed.

Just over half of the near 2 trillion dollars in cross-border trade that credit insurers support is currently covered by the private market. Big names are e.g. EulerHermes, Atradius, Coface, Zurich, Liberty, XL Catlin or Chubb, as well as some specialist Lloyds syndicates. But there are also quite a number of other private insurers. Some of these insurers have developed credit insurance as their specialism (such as the first three companies mentioned, the so-called monolines), others are general insurers – which, by the way, makes them therefore better known with the general public – that provide credit insurance as just one of their (many) insurance lines. In total, there are some 60 private providers of credit insurance worldwide.

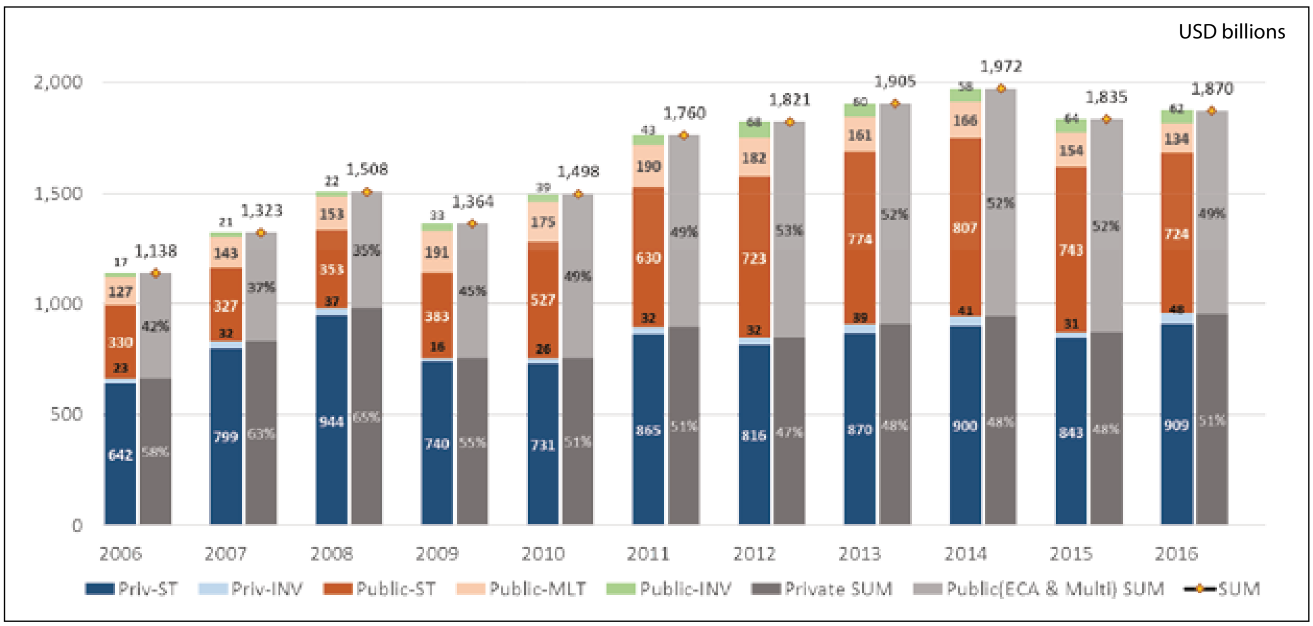
THE ROLE OF PRIVATE INSURERS

Traditionally the role of private credit insurers was limited to the insurance of trade credit – i.e. credits of up to 1 or 2 years – for both domestic trade and for export. These shorter credit terms typically apply to commodities, consumables or other goods with a relatively low unit value. In addition, their customer base was usually confined to companies in developed countries. This situation gradually began to change around two decades ago as private insurers started to expand their business both in terms of customer base and in terms of credit tenors they could support.

Some of them have, indeed, branched out to emerging markets, setting up offices to support local companies and local subsidiaries of multinationals. New online opportunities have facilitated this expansion as well.

In addition, private insurers have stretched the tenors they can support to sometimes even beyond 10 years, including for e.g. infrastructure, telecom and mining projects in emerging markets. This appetite for longer tenors had already started before the credit crisis at the end of the last decade, but really took off after that. This was partly a result of the private sector's increasing confidence as they gained experience and familiarity with these longer risks, but was also encouraged by increasing flows of liquidity. This supply of capital, on its turn, is partly a consequence of the historically low interest rates presently prevailing in developed countries. Investors are seeking higher returns than they can get on traditional assets – government bonds, for instance. Investment in credit and political risk insurance – arguably also in other lines of insurance – can provide these higher returns. One may wonder what will happen if interest rates start to rise again. It may well end up in less capital flowing to the insurance market – including credit insurance – and thus potentially contracting private credit insurance capacity in future. However, even if liquidity decreased, given the current over-liquidity in the market, there would still seem to be sufficient capital remaining to meet demand from exporters and banks for the foreseeable future.

Figure 1. Berne Union New Business - Private and Public



ST: Short Term, insurance for credits up to 1 year
MLT: Medium and Long Term: Insurance for credits of 1 year and over
INV: Investment Insurance

THE ROLE OF PUBLIC INSURERS

Despite the expansion of the remit of private insurers, there is still a large role to play for public insurers. National export credit insurers are also referred to as Export Credit Agencies (ECAs).

Some of the largest ECAs include Sinosure (China), the public arm of EulerHermes (Germany), NEXI (Japan), Bpifrance (France), SACE (Italy), K-Sure (Korea) and ECGC (India). An increasing number of developing countries, including many in Asia, have set up ECAs to support their national exports. In addition to ECAs, but to a lesser extent, some multilaterals also provide cover facilities for cross-border trade.

Although competition does sometimes occur between public and private insurers, their roles are largely complementary. One can safely say that cover for short term credit of exporters in developed markets, to buyers in developed markets, is largely in the domain of private insurers. At the other end of the trade spectrum – long term credits for capital equipment transactions and infrastructure projects commissioned by buyers in developing countries and supplied by companies in developing countries (so-called South-South trade) – only public insurers are really at play. Between these two extremes of the spectrum, it often depends on the particular circumstances, who is best fit to provide the cover against payment default. In this context, the balance tends to shift to ECAs when tenors are longer and buyer countries are riskier.

It is important to note here that ECAs do not have a development objective per se. It is rather through supporting trade and investment that they contribute to development. In line with this, they do not subsidise the exports they cover. According to international regulation they are not even allowed to subsidise trade. Premium income must on the long term at least cover claims payments and administrative costs. This is enshrined in WTO regulation that applies to all WTO member countries[3]. This requirement is codified in European Union and OECD regulation, but it, by virtue of their national WTO membership, also applies to ECAs in developing countries and other non-OECD countries. This brings us to the next topic: The role of ECAs in low and middle-income countries.

THE ROLE OF ECA IN LOW AND MIDDLE-INCOME COUNTRIES

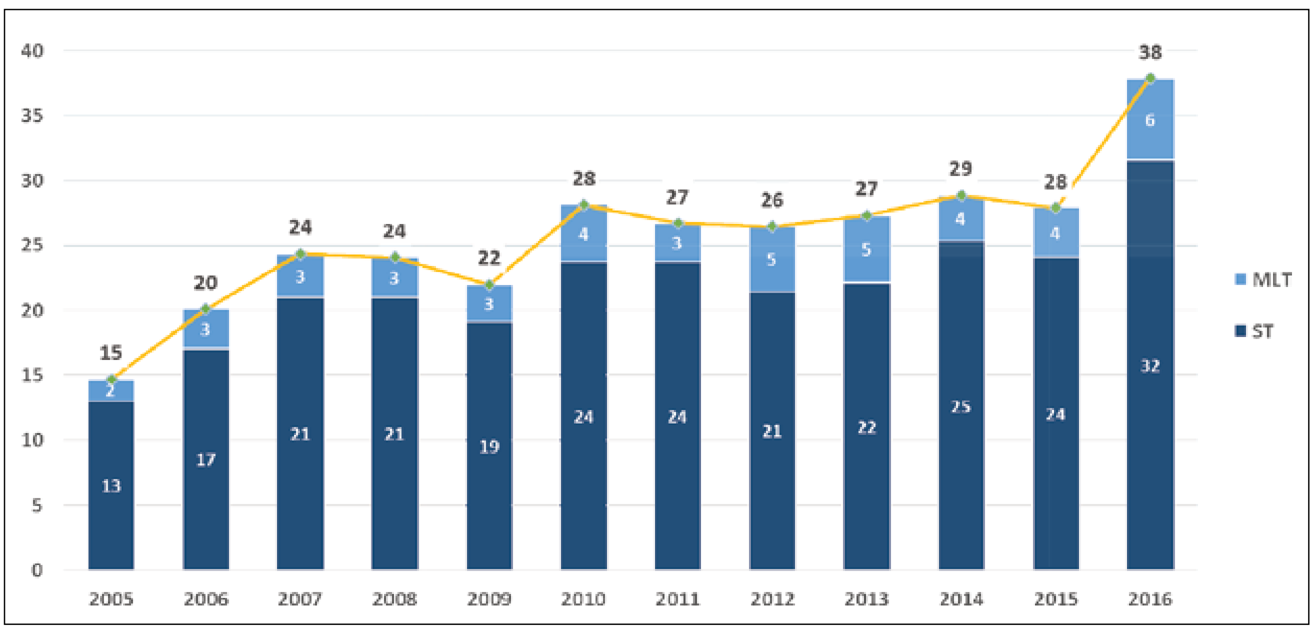
The world's first ECAs were set up in Europe soon after the first World War ended – now a century ago. European countries, ravaged or impoverished by war, realised that supporting their exporters was an effective way to get their economies back on track. By the mid-nineteen sixties, almost all industrialised countries had a national ECA. At that time, only a handful of developing countries, including India, had set up an ECA. Although the circumstances today may not be as dramatic as in the aftermath of the first World War, the argument that ECAs are an effective way to stimulate the economy still holds; and just as much so for low and middle-income countries. This is especially true for some smaller developing countries in which credit insurance from commercial providers is not available; or is only available in a very limited way. Indeed, since commercial insurers require a certain mass to make their business financially sustainable, they may not always be interested in making their products available in these smaller, developing economies.

[3]WTO Agreement on Subsidies and Countervailing Measures

Today, most major middle-income countries and some lower-income countries have ECAs. A key stimulus to the establishment of new ECAs was the collapse of Comecon and break-up of the Soviet Union shortly after. Suddenly Central and Eastern European countries and former Soviet states in Central Asia had to adapt their previously centrally led economies to a market economy. That was a huge, difficult and painful transition. With the help of the European Bank for Reconstruction and Development (EBRD) and sovereign donors such as Korea and the Netherlands, ECAs were soon established in a number of these countries. These ECAs were critical to enable the transition to commercial export in a global, competitive market for former state companies and new start-ups alike. The Berne Union assisted in this process by creating a platform for training and exchange of business information between the newly established ECAs: the so-called Prague Club. Since its inception in 1993, the Prague Club has expanded to become a thriving platform for ECA start-ups and scale-ups worldwide. To date it has 39 members, 11 of which are domiciled in Asia, and as of 2016, it is a fully integrated committee of the Berne Union.

The volume of exports insured by Prague Club members has grown fast. By the turn of this century, their figure for annual new business was just 1.2 billion dollars in total. By 2016 this insured volume had risen to 37.8 billion dollars – an impressive growth indeed. The largest Prague Club members are Exiar (Russia), ICIEC (a subsidiary of the Islamic Development Bank), SID Banka (Slovenia) and KUKE (Poland). SID Banka is quite large relative to the size of the Slovenian economy, as it has grown strongly over the years and offers a very wide range of services to Slovenian exporters.

Figure 2. Prague Club Committee Insured Exports - Figures in US$ Billions



ECA IN ASIA: CHINA AND INDIA AS EXAMPLES

Focussing on Asia, we can see a landscape which is different from either Europe or North America. Although there are some private or semi-private insurers selling credit insurance – such as Tokio Marine, PICC, and some credit insurers originally from Europe – throughout Asia, the credit insurance landscape is dominated by ECAs. In addition to Prague Club members, there are also a number of more established ECAs, including the aforementioned Sinosure, NEXI, K-Sure and ECGC.

Figure 3. Regional Cooperation Group (Established Asian ECAs) as a Share of Total Berne Union New ST Business – US$ Billions

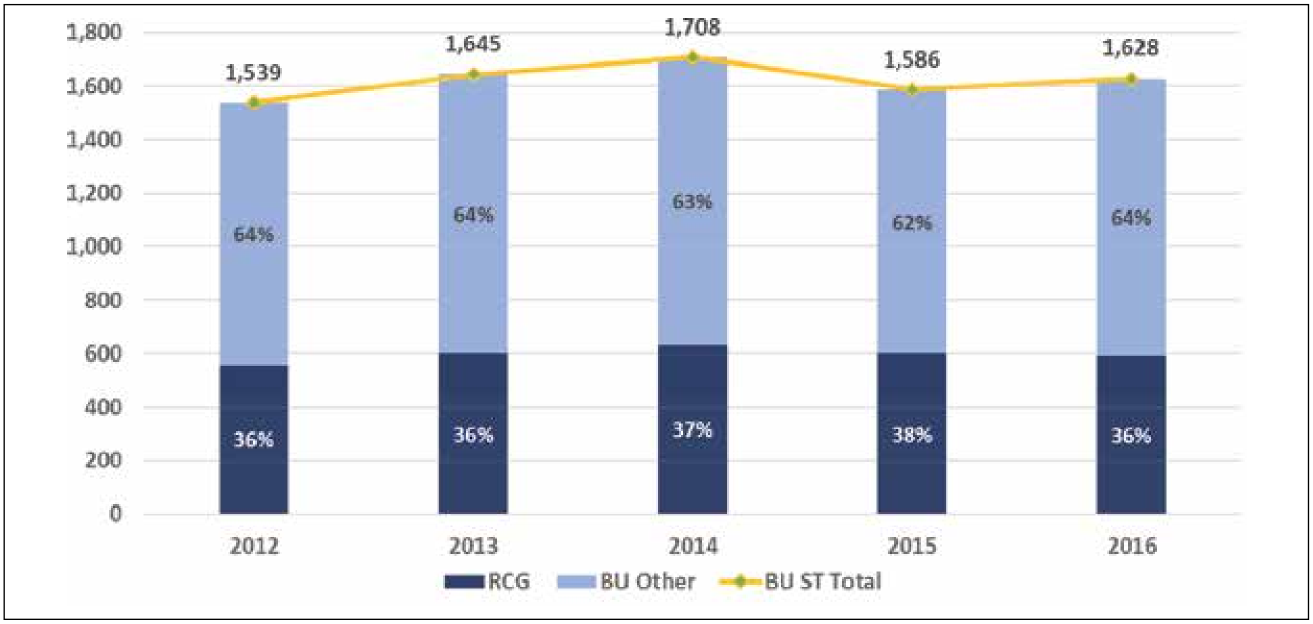
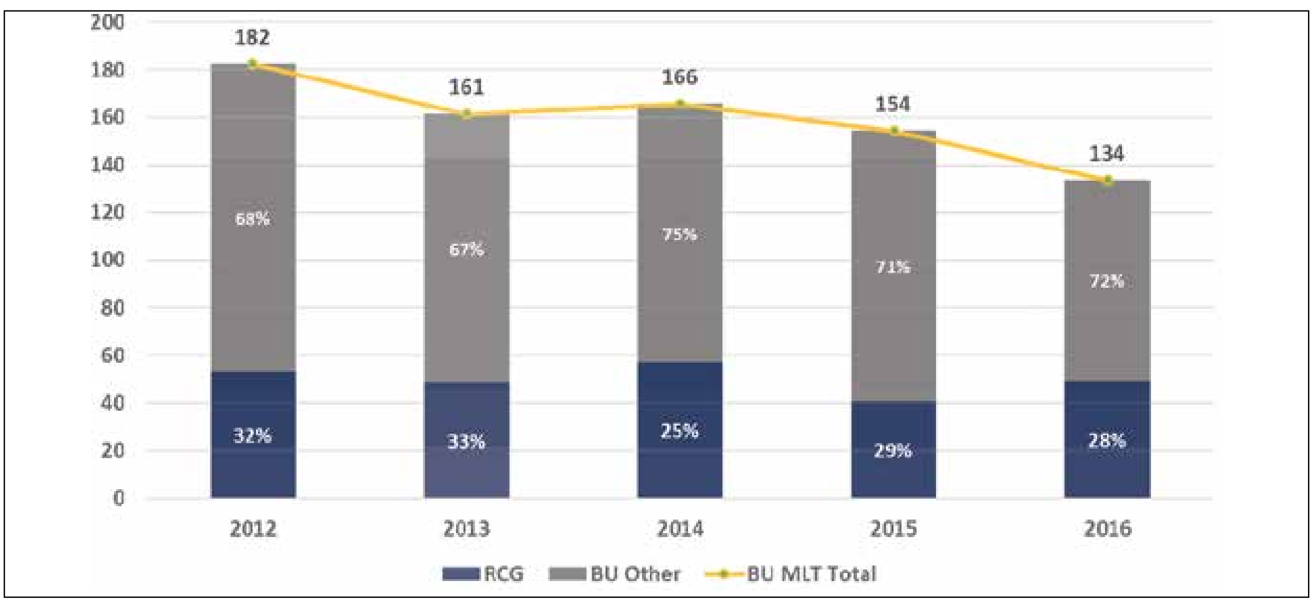


Figure 4. Regional Cooperation Group (Established Asian ECAs) as a Share of Total Berne Union New MLT Business – US$ Billions



The dominance of ECAs in Asia may have a number of causes. One is that many Asian countries – with the notable exception of Japan – started their industrialisation, and the subsequent economic development leap, later than most Western economies. To catch up with industrialised countries, export was necessary and for this export, ECAs were useful tools in the hands of governments.

Another reason may be that in some Asian countries, even after a development leap, ECAs continue to be seen as instruments for the execution of national economic policy – more so than in many Western countries. Sinosure for example, is one of the policy institutions underpinning the Chinese Government's Belt and Road initiative.

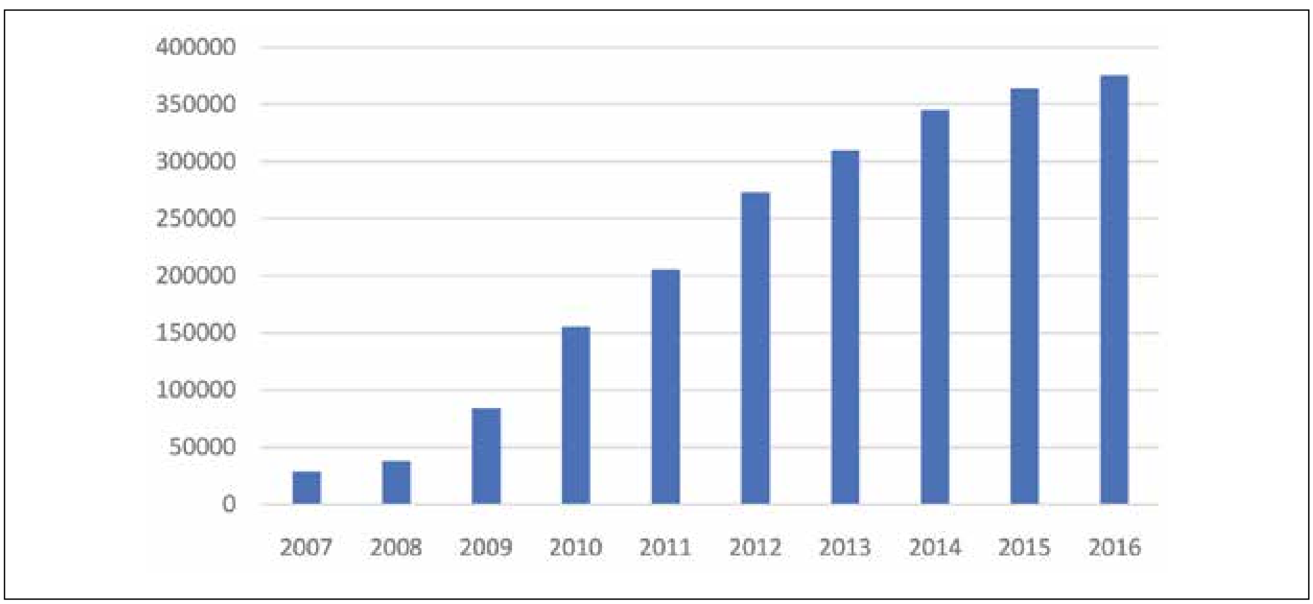
China

Let's take the Chinese example further. Until quite recently China's economic growth was largely driven by exports. In 2007, exports totalled 1.2 trillion dollars. In 2016, this had risen to 2.1 trillion dollars: a growth of 75% in ten years (disregarding the impact of inflation and currency exchange movements between the dollar and the renminbi)[4].

This growth in China's exports is even more remarkable when it is noted that this period includes the global financial crisis, when in 2009 Chinese exports dropped by a staggering 230 billion dollars compared to 2008, but nevertheless quite in line with the drop in world exports in that year. Growth was such that already by 2010 exports had rebounded strongly to achieve record levels. It also includes the years 2015 and 2016, when world trade expressed in US dollar terms decreased, including China's exports. (Note: this was not so much a drop in the actual physical volume of world trade, but rather a drop in dollar prices of these goods).

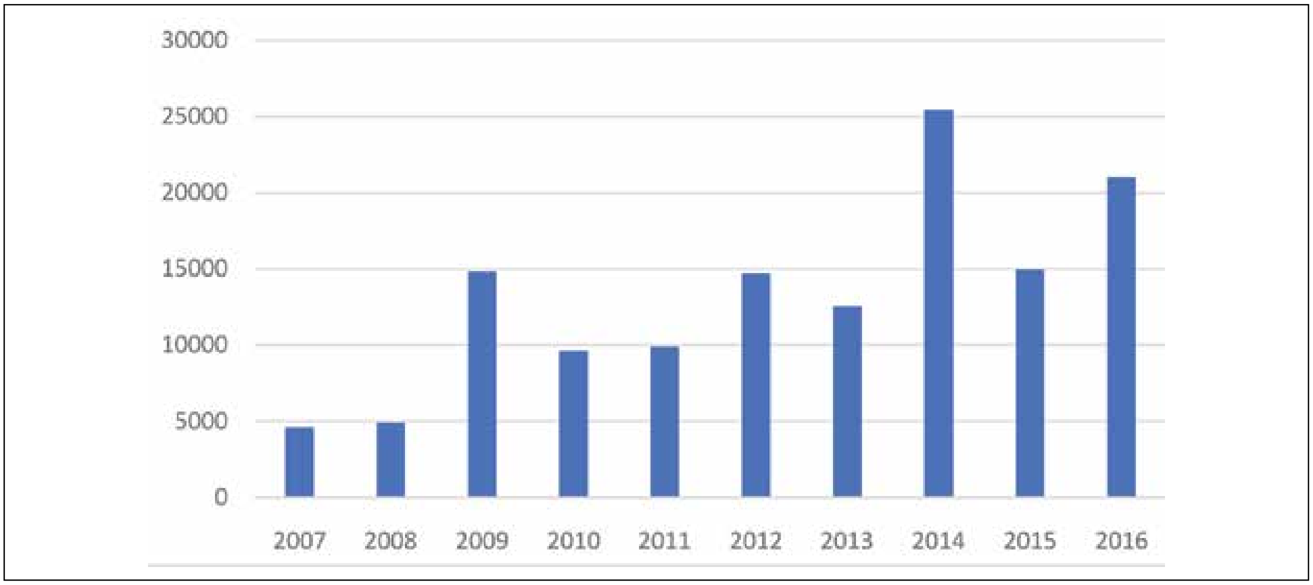
We can see an even faster rise in business covered by Sinosure:

Figure 5. Sinosure New Commitments (Short Term Credits) 2007-2016 – US$ Millions



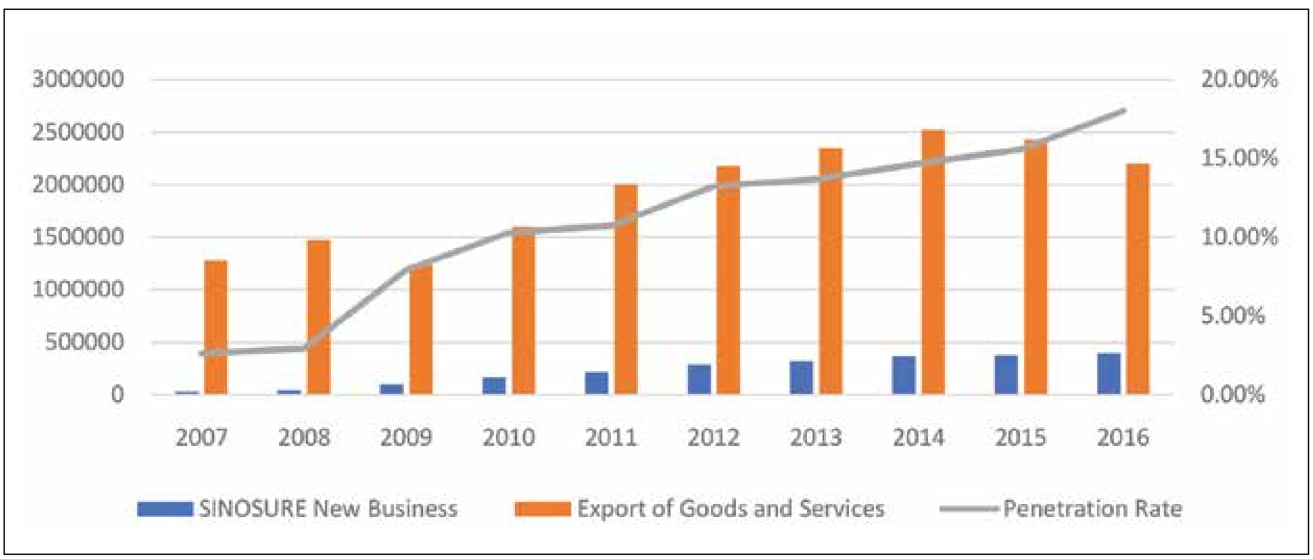
[4]World Bank data

Figure 6. Sinosure New Commitments (Medium/Long Term Credits) 2007-2016, in US$ Millions



In 2007, their new export credit insurance volume totalled 33.4 billion dollars. By 2016, this had risen to 396.3.5 billion dollars[5].

Figure 7. Penetration Rate of Sinosure Cover relative to Chinese Exports



[5]Berne Union data

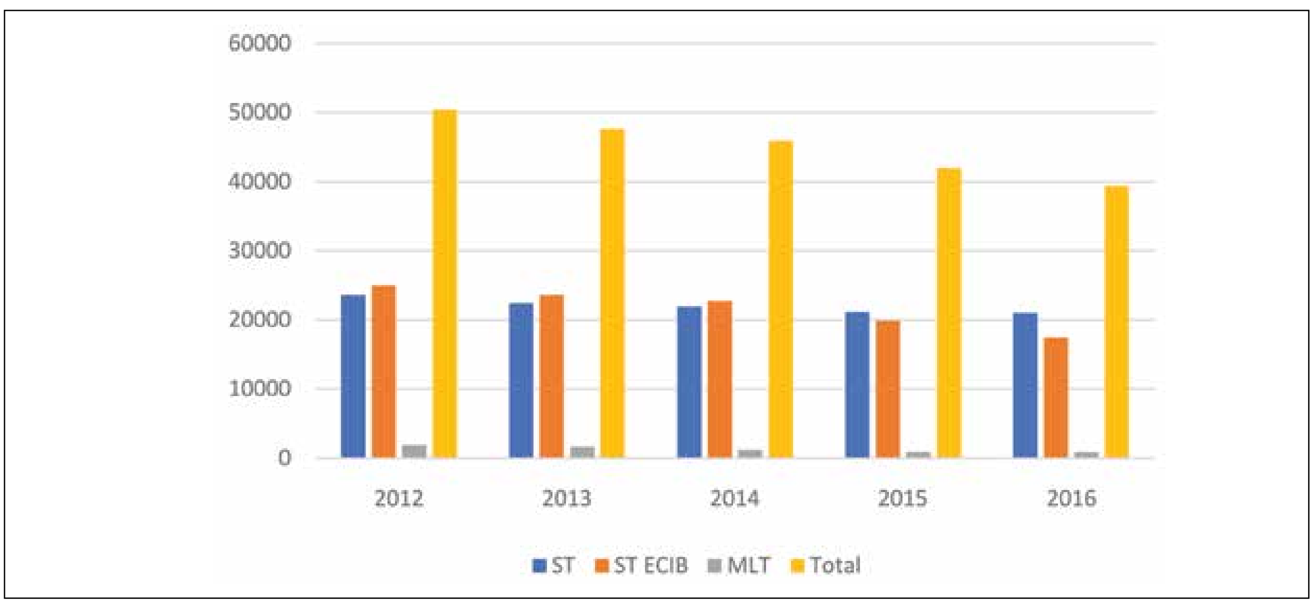
From these data we can deduct a strong correlation between export volume at the one hand, and export credit insurance volume at the other hand, whereby the share of credit insurance is even accelerating. This can be expressed as the penetration rate of Sinosure cover in China's exports, which has grown from 2.6% in 2007 to 18.0% in 2016. The growth in export credit insurance is, therefore, a good, even leveraged, indicator of growth in export and, as a consequence growth in economic development, at least in this Chinese example.

India

India, at least until a few years ago, followed a rather different economic policy to China. Although there were measures to stimulate exports, much effort was also put into protecting domestic production. In addition, economic and fiscal policy in India has traditionally been more decentralised than in China.

As a consequence, India's economy is more domestically driven and the export volume, and its contribution to GDP, is considerably lower than China's. In 2007, Indian exports totalled 252 billion dollars; in 2016 this had risen to 434 billion - a significant rise of 72%, i.e. similar of that of China, but at a lower absolute level. Also if we look at the contribution of exports to GDP, then traditionally this share was higher for China than for India. In 2007, e.g., this was 36% for China and 21% for India. Then years later, in 2016, the percentage for India is just slightly lower, i.e. 19%. While in China, over

Figure 8. ECGC New Business 2012 – 2016 in US$ Millions



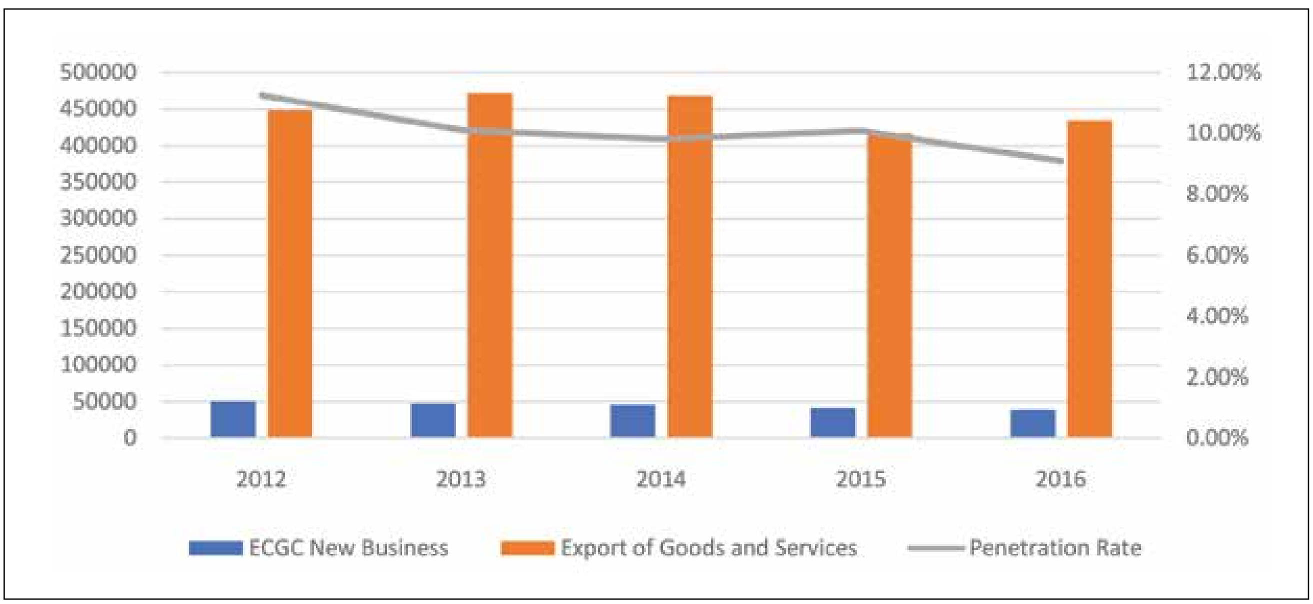
ST: short term cover to exporters
ST ECIB: short term cover to banks
MLT: medium/long term cover to banks]

the same period, this share dropped to 20%, a figure now similar with that of India. This is clearly a sign that economic growth in China has shifted somewhat to domestic consumption, in line with Chinese government policy to become less dependent on exports.

Back to India now. One measure to promote exports should be mentioned. Already in 1957 India set up ECGC, its ECA. Over the years ECGC has grown its portfolio, and it is now one of Asia's largest ECAs, certainly in the trade export credit area (i.e. credits up to one year). Over the last few years, its penetration grade has consistently been around 10% of national exports. As for China, we can see a drop in export value in 2015, following the decrease in commodity process. However, already in 2016, India managed to grow its export value again.

A large part of their support is directly to banks that finance exporters. While this is common practice for export finance (i.e. bank financing with tenors over 1 year), ECGC also provides this for shorter trade credits. As most world trade is on short term credit, this instrument has made a considerable impact on India's export performance. With ECGC's protection, banks – often wary of financing without meaningful or concrete collateral – are more willing to finance even SME's export.

Figure 9. Penetration Rate of ECGC New Business relative to Indian Exports – US$ Millions



CONCLUSION

Trade is an important contributor to economic growth and thus also economic development. Since for many low and middle-income countries the domestic market is too small to grow the economy in a significant way, growth will have to come through exports – preferably exports of goods and services with some added value along the production chain, such as for processed or manufactured goods. We have also seen that large middle-income countries, as in the examples of China and India, equally benefit from exports of goods and services as a driver for growth and development. For financially sustainable exports of these higher end goods and services, credit insurance is an important facilitator. It not only protects the balance sheet of exporters, but also often enables essential bank financing for working capital or during the credit period. Following the example of industrialised countries, many low and middle-income countries have, therefore, set up public schemes for export credit insurance. As China's and India's example have shown, growth of exports goes hand in hand with growth in credit insurance.

Trends in Trade Finance: Globally and Within the Indo-Pacific Region

07

Mr. Rajnish Kumar, Chairman, State Bank of India

INTRODUCTION

Trade finance, despite being a relatively low risk type of lending, was among the first casualties of the reduced credit availability in the wake of the 2008 Global Financial Crisis (GFC). Since then, trends in both international trade and trade finance have been less than satisfactory. Trade finance is a niche area and it is only after 2011 that the subject has attracted considerable attention. This is largely due to the important role of trade finance in facilitating international trade and promoting employment.

This paper tries to understand the recent trends in trade finance globally, in the Indo-Pacific region and specifically in India. The paper talks about the general perception of Indo-Pacific region in 21st Century and how it will impact banking in the region. The structure of trade finance business in general is discussed, followed by a discussion on the trends in business in India. What are areas of concern and how technology can address those concerns are also touched upon.

IMPORTANCE OF INDO-PACIFIC REGION

The Indo-Pacific Region (IPR) also identified as the Asia-Pacific Region has become the center of attention in international discourse. IPR has gained importance because of the US shift to the Asian Pivot. The Asian Pivot can be understood in the following terms: while the US has had an established security arrangement in NATO with Europe for decades after World War II, there was no matching of such a security arrangement in the Asia-Pacific. There are bilateral security arrangements with countries in the region, but that is proving insufficient now. The Rebalance or Asian Pivot is the US effort at exploring a multilateral arrangement which will allow different degrees of commitments in IPR.

Asian Pivot is also a response to geopolitical realignment, catalyzed in part by the rise of China and India that is shifting the global "center of gravity" from the Euro-Atlantic region to the Indo Pacific. The US National Intelligence Council projects that "by 2030 Asia will be well on its way to returning to being the world's powerhouse, just as it was before 1500."

IPR is home to 61% (4.4 billion) of the world's total population and three of its four most populous countries - China, India and Indonesia - together account for 40% (2.9 billion) of the world's population. IPR population was estimated at 4.2 billion in 2010 and is projected to increase to 5.2 billion by 2050.

The developmental needs of the region are huge; rapid urbanization and growing middle class will ensure a stable demand. The need for infrastructure investment in IPR is estimated to be about US$ 750 billion annually during 2010-2020. In contrast to these opportunities, the region accounted for 91% of the world's total death and 49% of the world's total damage due to natural disasters in the last century. Therefore, climate change poses a serious threat to the communities and business in the region. More than 75% of IPR countries face an imminent water crisis unless immediate steps are taken to improve resource management according to the Asian Development Bank (ADB).

IPR can be divided into numerous sub-regions each having its own geo-economic and geo-political dynamics. Economic experiments such as Belt and Road Initiative (BRI), Saudi Arabia 2030, Make in India and ASEAN Economic Union, truncated TPP and Eurasian Economic Union are work in progress in the region. The most pressing frontiers in the world namely – Iran, North Korea and Myanmar are located in this region. The region also houses two important sea routes – the Indian Ocean Region and South China Sea. The Indian Ocean Region (IOR) is not only the site of many territorial/ maritime disputes but also a major trading route. 80% of Japanese and 39% of Chinese oil imports pass through the Indian Ocean en route from the Middle East. India's 55% of trade passes through South China Sea[1]. One-third of the world's liquefied natural gas passes through the Straits of Malacca and into the South China Sea, with the bulk of it originating in the Persian Gulf. Liquefied Natural Gas (LNG) also flows into the region from Southeast Asia and Oceania. Much of this imported LNG is bound for Japan and South Korea.

Indian Navy's 2015 Maritime Doctrine identified the numerous choke points in the Indian Ocean. From a security angle, the Indian Navy assesses that economic development of this region depends on the safety of these sea lanes. Any disturbance along the Choke points can cause disruption across the region. Indian Navy assess that IOR will be prone to other risks such a maritime terrorism, piracy, and armed robbery have been reported in this region in 2016.

A number of States in the IPR region rank high in fragile state index and failure of one or two may put the growth trajectory off the target for the region as whole. Thus, geo-political dynamics and security arrangement are evolving such that various states are now seeking to cooperate with one set of countries for economic gains whilst for security related issues they are dependent on another set of countries. This has made the IPR more contested and potentially, more volatile.

[1]Rajya Sabha Unstared Question No 808, http://www.mea.gov.in/rajya sabha.htm?dtl/28041/QUESTION_NO808_TRADE_THROUGH_SOUTH_CHINA_SEA (Accessed January 6, 2018)

It is in this context the banking and trade finance in the region needs to be seen. Since the global financial crisis (GFC), leading IPR-based banks have outperformed the global banking sector. Forecasts point to the region continuing to offer important growth opportunities, particularly in the emerging markets. As international western banks withdraw on account of de-risking from IPR, domestic and regional banks are stepping in. The region is already seeing new types of competitors from the rapidly developing fintech sector, offering new banking, payments and financing options. Mega banks may rise across the region, hastened by the market integration promised by the upcoming ASEAN Economic Community, which will enable banks to operate more easily across borders.

TRENDS IN TRADE AND TRADE FINANCE[2]

At the most basic level, trade finance consists of borrowing using trade credit (accounts receivable) as collateral and/or the purchase of insurance against the possibility of trade credit defaults. In traditional trade finance contracts, exporters obtain working capital loans, credit lines, discounted prepayments, or credit default insurance based on foreign purchase orders or credit guarantees provided by the importer's bank.

Trade finance can be of two types – bank intermediated or inter-firm credit. Bank-intermediated trade finance performs two vital roles: providing working capital tied to and in support of international trade transactions, and/or providing means to reduce payment risk. One of the most common and standardised forms of bank-intermediated trade finance is a letter of credit (L/C).

The principal alternative to bank-intermediated products is inter-firm trade credit. This includes open account transactions, where goods are shipped in advance of payment, and cash-in-advance transactions, where payment is made before shipment.

A closely related activity affecting the trade finance is correspondent banking relationship. A correspondent banking arrangement involves one bank (the correspondent) providing a deposit account or other liability account, and related services, to another bank (the respondent), often including its affiliates. The arrangement requires the exchange of messages between banks to settle transactions by crediting and debiting accounts. These messages could be associated with payments, trade finance, foreign exchange, or securities transactions. The trend in Global banks selectively withdrawing from the business of correspondent banking since the GFC, often referred to as "de-risking", has been associated with fall in trade financing[3]. However, it needs to be appreciated that relationship is not strictly one-to-one, as correspondent banks perform many other functions besides trade finance (remittances being a very important one).

[2]Based on Trade finance: developments and issues; CGFS Papers No 50, 2014, Bank of International Settlement.
[3]Recent Trends in Correspondent Banking Relationship, IMF, 2017

Global Size and Structure of Trade Finance

The BIS Study Group in 2014 estimated that, globally, some US$6.5–8 trillion of bank-intermediated trade finance was provided during 2011, of which around US$2.8 trillion was L/Cs. The remainder was financed by inter-firm trade credit. Thus, according to this study the bank intermediated trade finance accounted 20-40% of the total trade finance while the remainder was through inter-firm trade credit!

The largest global banks appear to account for a quarter to a third of the global supply of bank-intermediated trade finance, with local and regional banks providing the remainder. Much of global trade is priced and settled in dollars, and so is trade finance. However, trade finance seems to be even more dollar denominated than global trade, with 80% of L/Cs, and a high proportion of the activities of global and local banks denominated in dollars. Therefore, a key condition for the ability of many banks to provide trade finance is their access to US dollar funding and Basel III regulations on liquidity ratios have a bearing on trade finance. Transactions involving L/Cs and guarantees accounted for about half of the aggregate value of global banks' trade finance exposures in the ICC trade register. SWIFT data shows that Asia-Pacific continues to register far greater volumes for both sent (import) and received (export) MT 700s accounting for 73% of the world traffic for the former and 77% of the world traffic for the latter in 2016. Furthermore, most of the Asia-Pacific traffic in SWIFT data is intra-regional[4].

The choice of trade finance instrument differs with industry and changes over time as trade relationships mature and perception of risk undergoes change. Some industries rely more heavily on L/Cs than others. In Korea, for example, L/Cs seem to be the most preferred payment method for exports in the automobile and petrochemical industries (around 50% of payments in 2009), whereas they play hardly any role now for electronics goods whose share in L/C was 40% in 1990. The different intensity of relying on L/Cs may be explained by different business models, the underlying characteristics of traded goods, the relative importance of inter-firm trade and the relationships of the exporting firms with importers. The choice of instrument and its substitution is also impacted by country risk, financial risk perception and level integration with global economy. For instance, in 2013 the APEC region, the issuance of documentary trade credit registered sharp declines on account of deleveraging in European Banking system and increasing competitiveness in the global trade arena, resulting in accelerated shift away from traditional trade finance products such as L/Cs towards open account methods since they lessen the burden of risk for importers[5].

[4]Rethinking Trade & Finance 2017, ICC
[5]Trends in Trade Finance across the APEC Region, APEC Policy Support Unit October 2013

Trends in Bank Intermediated Trade Finance

Globally, bank-intermediated trade finance has increased substantially in dollar terms over the past decade and particularly since end-2006, though its growth was temporarily interrupted after the Lehman bankruptcy in 2008. Easy monetary policy lead to some recovery, which was short lived as European banking crisis precipitated in full. In the second half of 2011, bank funding conditions in Europe deteriorated as a result of weak economic performance and fiscal sustainability challenges. After this period, an examination of the trends in the markets for selected trade finance products – such as letters of credit and factoring – reveals that the recovery for trade finance has been tepid and uneven and varies across region.

Trade flows involving the Asia-Pacific continued to grow strongly post-GFC from US$ 7.1 trillion in 2001 to US$ 11.9 trillion in 2014, and contracted to US$10.6 trillion in 2016[6]. ADB annual global trade finance gap reports suggests that the annual trade finance gap has more or less remained constant at US$1.5 trillion for the last three years, with 40% of the gap originating in IPR region alone. The reasons for the gap include termination of correspondent banking relationships in the region due to the cost or complexity of compliance with regulations designed to stem financial crimes, high rejection rates notably among SME due to inadequacy of KYC compliance, general tendency not to take low volume business due to risk such as falling country credit rating or credit rating of issuing bank.

The larger observed trends suggest an increase in trade finance activity in the future as local banks in emerging market economies start to play a larger role in the provision of trade finance and similar services. In particular, Chinese entities appear to be increasingly active providers of trade finance (Bank of China has 5.7% trade finance as % of total assets, Industrial and Commercial Bank of China has 3.5%) and this trend may accelerate under the Belt and Road Initiative (BRI). There are also signs that some Western Banks such as Standard Chartered Bank who had earlier withdrawn from Asia may re-enter. Under the auspices of 9th UK-China Economic and Financial Dialogue, Standard Chartered announced its support for the BRI by committing to facilitate financing to the value of at least US$ 20 billion by 2020.

Thus, market is currently characterized by intense competition and churning, particularly in Asia and for top-tier clients. Factors behind the intense competition among trade finance providers include not only the ongoing international expansion of banks headquartered in the key emerging market regions of IPR but also rewriting of earlier rules of geo-political engagement with/within the IPR region.

[6] Ibid

TRADE FINANCE IN INDIA

Only a few countries have detailed data capturing large parts of overall trade finance activities in their countries. India is among those few countries. The measured intensity of trade finance over trade for India is more than 40%. Around 80% of trade finance in India is provided by domestic banks (including foreign-owned subsidiaries). Furthermore, in India 90% of import loans and export loans are denominated in US dollars. Trends (y-o-y on monthly data) in trade finance in the last decade are shown in figure 1. The trade finance business in India has largely followed similar trend as seen globally. After a peak before the GFC, the trade finance growth dropped sharply. The 'foreign bills discounted' recovered sharply after 2009 and then started moderating close to the Euro Bank crisis. During the last two years, trade finance has shown negative growth.

Figure 1: Trends in Bank Intermediated Trade Finance and Trade in India

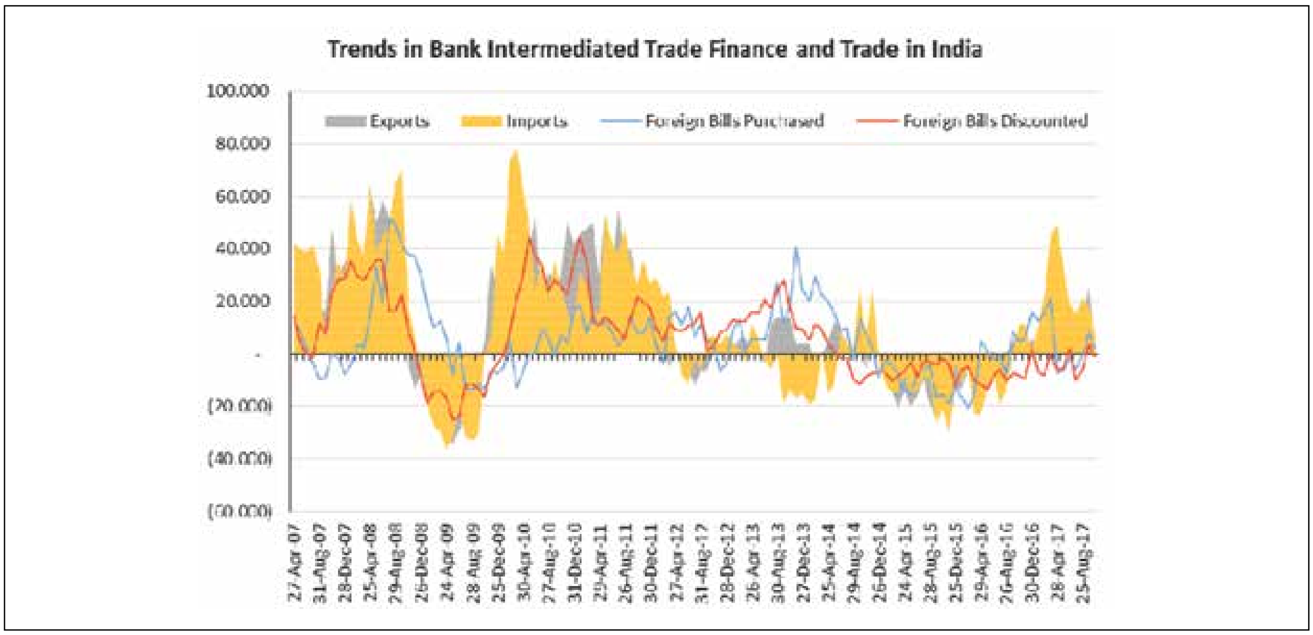
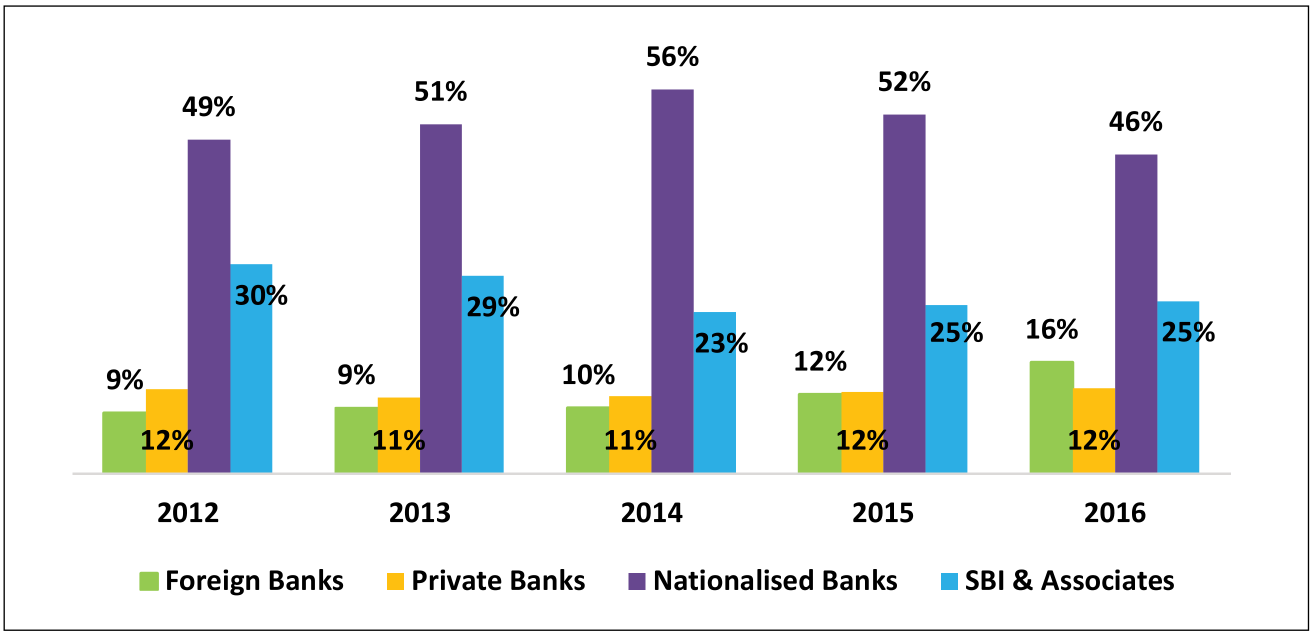


Table 1: Correlation Matrix					
	Foreign Bills Purchased	Foreign Bills Discounted	Exports	Imports	Total Trade
Foreign Bills Purchased	1.00				
Foreign Bills Discounted	0.32	1.00			
Exports	0.26	0.72	1.00		
Imports	0.21	0.57	0.81	1.00	
Total Trade	0.24	0.65	0.92	0.97	1.00
Source: RBI, SBI Calculations					
Note: Foreign Bills represent the foreign bills which cover all import and export bills including demand draft drawn in foreign currencies and payable in India, purchased and discounted by all the scheduled banks.					

The trends in trade finance are not strongly correlated with movements in merchandise trade (Table 1). Only the exports changes have a very high correlation with monthly change in trade bills discounted. The correlation of bills purchased with both exports and imports is weak. This implies that contraction in trade finance in part can explain the protracted period of contraction in exports during 2014-16. A similar contraction in imports should be read with caution because of confounding effects of fall in crude oil prices during that period.

Since the above analysis is largely based on aggregate data, it does not tell anything about underlying shifts in the trade finance business. An internal study of SBI based on internal and publically available data shows that share of public sector banks has declined by 5% over last five years. Foreign banks, on the other hand, increased their market share significantly to 16% in 2016 from 9% in 2012.

Figure 2: Market Share in Bills Purchased and Discounted (As on 31st March)



Within domestic bill discounting business, the share of small businesses has declined, whereas share of mid-corporate and large corporate has increased. Thus, domestic trends largely mirror the trends described in ADB report. Export credit in India includes trade credit (buyers and suppliers), pre-shipment and post-shipment credit. While pre-shipment is both in domestic currency as well as foreign currencies, post shipment credit is entirely in foreign currency. But information on this segregation is not available publically. Our internal figures suggest that all the three heads contracted in 2016-17 by 6.7%, 4.9% and 30.7% respectively. The sharp contraction in post-shipment credit is largely ascribable to lack of demand in external markets.

To arrest this trend, the Union Finance Minister in the Union Budget for 2015-16 had highlighted the need for and use of Trade Receivables Discounting System (TReDS) for improving flow of funds to MSME sector by reducing the receivables realisation cycles. TReDS is an online electronic institutional mechanism for facilitating the financing of trade receivables of MSMEs through multiple financiers.

The TReDS Platform enables discounting of invoices/bills of exchange of MSME Sellers against large Corporates including Government and Public Sector Units (PSUs), through an auction mechanism, to ensure prompt realisation of trade receivables at competitive market. In line with this, after receiving approval from Reserve Bank of India, the following three applicants are operating Trade Receivables Discounting System (TReDS): 1) RXIL - an initiative by NSE Strategic Investment Corporation Limited and Small Industries Development Bank of India (other investors include SBI, ICICI Bank, Yes Bank, SBI Caps, and ICICI Securities); 2) A.TREDS, joint venture of Axis Bank and B2B e-commerce company mjunction and 3) Mynd Solutions Pvt. Ltd., Gurgaon, Haryana.

As per market information, in first 100 days (from its maiden transaction which was done on July 10, 2017), A.TREDS discounted over 3,000 invoices worth more than Rs 100 cr. A rough estimate of PSU procurement from Micro and Small Enterprises is in the range of Rs 30000 cr to Rs 40000 cr (per annum). The new Public Procurement Policy states that 20% of all procurements by PSUs are to be made from MSMEs. Accordingly, Government has made it mandatory for all major public sector units to register on TReDS. This is expected to give a major boost to the MSME sector with transparent price discovery mechanism and an additional avenue for getting their receivables funded.

AREAS OF CONCERN

Trade Outlook

The question therefore arises is: what are the future prospects of trade finance in the IPR and India specifically? The trade finance business has largely been tepid. This is partly due to the plateauing of global trade which before the crisis was growing faster than global GDP. The future outlook of trade in general is only tad optimistic. The UNTAD expects that trade will grow by 2.9% in 2018. The reasons that explain this include general erosion of demand, changes in structure of demand due to demographic aging, changes in production and consumption centers and reordering of global value chains, and rise of protectionism. Some studies using firm level data indicates that exporters whose financial institutions became unhealthy, cut back on exports more than other firms, and imports declined more in sectors that had greater external financial dependence[7].

[7]"Trade Finance and the Great Trade Collapse" in American Economic Review: Papers & Proceedings 2011

Regulations

Nearly all the surveys – ICC 2017 and ADB 2017 – put compliance requirement (KYC and AML) as the biggest area of concern in banks decision to extend trade finance. The other major reasons that are adversely impacting the trade finance outlook include: need for collateral, low profit margins (due to easy monetary policy), shifting trade corridors, volatility in commodity and financial markets. Coincidently, some of the factors which are hampering trade finance are also common to correspondent banking business; rating agencies have also started to factor in correspondent banking withdrawal as a reason for financial institution rating downgrades which explains a high correlation between the two. Furthermore, compliance costs in correspondent banking could further increase as a result of measures aimed at safeguarding against cyber risks. While fintech is not an area of concern for most of the banks undertaking trade finance, as digitalization of trade finance gains momentum, cyber risk will become important variable in determining the outlook of trade finance.

Frauds[8]

Very surprisingly, one of the most important factors (which is also corroborated by our internal experience) which has impacted the attitude of banks towards trade finance and correspondent banking is rising incidence of frauds. This aspect has not got the attention it deserves in either the survey by ICC or ADB.

The most notorious examples date from 2016, when a US$ 147m bill finance fraud was revealed at China Citi Bank when an employee at the bank's Lanzhou city branch allegedly conspired with others to fake trade finance bills. A similar fraud, possibly around four times bigger at US$ 578m was suffered by the Agricultural Bank of China. The financial collapse of OW Bunker in 2014 sent financial shock waves across both the shipping fuel and trade credit insurance industries. Similarly a US$ 3 bn loss arising from the 2014 Qingdao port scandal involved the use of fake warehouse receipts to obtain multiple loans totaling many hundreds of millions of dollars, creating a turmoil in the operations of metals exporters and impacting banks ranging from Citi Bank to Standard Chartered.

Of course, fraud is not restricted to any one region or market. The most frequently-encountered type of fraud in trade finance, which occurs around the world, is double financing. This results when the importer and exporter collaborate to create false turnover to obtain credit for the same trade before vanishing.

[8]Based on "Digitisation: Deleting the fraudsters from trade finance" in GT News, https://www.gtnews.com/articles/digitisation-deleting-the-fraudsters-from-trade-finance/ (Accessed January 6, 2018)

In 2015, the marine indemnity insurance provider International Transport Intermediaries Club (ITIC), issued a warning to shipping intermediaries to check bills of lading and associated documentation after a Belgian shipping agent released six containers of castor oil valued at US$ 270,000 against a fraudulent bill of lading. The containers were to be shipped from India to Belgium and although the bill of lading against which the ship agent released the cargo to the consignee appeared to be genuine, it turned out to be a forgery.

In a one of its kind study at IIM Ahmedabad on fraud in India Banking, it was noted that more than 95% of number of fraud cases and amount involved in such fraud comes from commercial banks. The Study also noted that documentary credit (letter of credit) related frauds have surfaced causing a grave concern due to their implications on trade and related activities. The Finance Ministry informed the Lok Sabha that Banks lost a whopping ₹ 16,789 crore on account of frauds in 2016-17.

No doubt the risk posed by fraud in the US$ 4 trillion trade-financing industry has prompted banks to start exploring distributed-ledger technology. It may explain why the rejection rates for SMEs have been so high in ADB survey at 53%. While on paper, default loss in trade finance is less than 0.2%, the occurrence of high profile fraud does change the perception of risk in the sanctioning stage. This calls for better process for appraisal and manpower training so that genuine cases are differentiated correctly from fraudulent ones.

FINTECH AND TRADE FINANCE

Digitalization in trade finance is a late mover in comparison to other verticals in banking. The efforts at digitalization are in part dictated by need to reduce incidences of frauds as noted. But the other aspects include reducing the operational cost, turnaround time and better compliance with KYC/ AML. Whether digitalization will lead to better accessibility of trade finance is not clear because as noted earlier, a major portion of the trade is not financed by bank intermediation.

Currently, the instrumentation of trade finance is undergoing a period of innovation. For example, the industry recently launched the “bank payment obligation” – a payment method that offers a similar level of payment security to that of L/Cs, but without banks physically handling documentary evidence. “Supply chain finance” is another growing area of banks’ trade finance activities, where banks automate documentary processing across entire supply chains, often linked to providing credit (e.g. through receivables discounting). This year’s ADB survey notes that a greater proportion of banks reported implementing digitization in banking operations, largely with the objective of cost reduction.

One of the most frequently suggested example in trade finance is the use of blockchain technology (BCT). A Study by the Institute for Development and Research in Banking Technology, an institute of the Reserve Bank of India observed that a trade finance solution with letter of credit, bill of lading and multi-signature solutions based on BCT would have features such as: carriers issue bill of lading on the BCT as a digital asset, banks may issue letter of credit as a digital asset on the BCT, multi-signature contracts, smart-contract-enabled, event-based fund release to ensure speed and transparency[9].

Barclays and an Israel-based start-up company have carried out what they claim to be the world's first trade transaction using BCT, cutting a process that normally takes between seven to ten days to less than four hours. BCT usage for trade finance enables automation of LC creation, development of real-time tools for enforcing AML and customs activities, and associated cost savings. Thus, if banks in India decide to implement a BCT and put the letters of credit – on the blockchain, then this shall lead to substantial cost savings. However, this will require the big corporates, the large shippers, and manufacturers, as well as the customs authorities to be on board.

CONCLUSION AND OUTLOOK

The general outlook on trade is largely pessimistic, although interregional trade in IPR is expected to increase with greater integration. However, the outlook is also qualified because the structure of international trade is itself undergoing change. The rise of digital trade and their impact on trade finance is currently not very well understood.

A large part of the financial trade is presently financed using inter-firm credit. Efforts such as the TReDS have tried to address financial exclusion for SMEs in respect of trade finance. But there is another take, the open account trade is difficult to track and is also the preferred route for illicit flows and trade based money laundering. Some of the highest correspondent banking withdrawals have occurred in Caribbean region which also has some of the largest tax heavens. Technology such as the BCT and wider collaboration can arrest this trend but its impact on banking will be difficult to foresee.

[9]Applications of Blockchain Technology to Banking and Financial Sector in India, IDBRT White Paper, 2017

A Developing Country's Perspective On Trade Finance

08

Ms. Padma Betai, Chief General Manager, IDBI Bank Ltd
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Trade is the activity of buying, selling, or exchanging goods or services between people, firms, or countries. When people, firms, or countries trade, they buy, sell, or exchange goods or services between themselves. Various intermediaries such as banks and financial institutions facilitate these transactions by financing the trade. This short term financing for trade which concerns both domestic and international trade transactions, is popularly known as trade finance.

Trade finance is an essential tool and businesses of all sizes require an access to sufficient credit for growth and sustainability. The inadequate availability of trade finance affects companies and may hinder economic development particularly in developing and emerging countries.

TRADE FINANCE GAPS

Asian Development Bank (ADB) in its annual study, "2017 Trade Finance Gaps, Growth, and Jobs Survey" has quantified market gaps for trade finance and elaborated their impact on growth and jobs creation. The study highlights that business of all size continue to struggle to access sufficient credit, resulting in a global trade finance gap of US$ 1.5 trillion in 2016. Emerging economies continue to face the greatest shortfalls. Asia-Pacific region is the largest source of both proposals (i.e. requests by firm to banks for trade finance support) and rejection of the requests. A significant 46% of global proposal came from Asia-Pacific region whereas 40% of global rejections were also from the same region. India's share in global proposal and rejection stood at 9% and 7%, respectively. The Study has further emphasized that Micro, Small, and Medium-sized Enterprises (MSMEs) had the biggest difficulties in accessing trade finance, representing 74% of total rejections during 2016.

Know Your Customer (KYC) concerns, lack of sufficient collateral, request not suitable for bank financing and perception of low returns are few among the various reasons due to which these requests for trade finance were rejected. Trade finance is covered by a host of regulations which are becoming not only more comprehensive but also more strictly supervised, exposing banks to the risk of reputational damage and fines.

Though there are valid reasons for not considering the request favorably, there are various ways in which the industry can adapt not only to bridge the trade finance gap, but also to evolve the industry and to drive healthy competition and revive global growth. Many banks, with an expectation to reduce cost of regulatory compliance and due diligence have started implementing digitization. It is believed that digitization would enhance the ability to assess the risk in lending to MSME as well.

INDIA: CHALLENGES AND OPPORTUNITIES

National policy of the country, which balances the domestic demand supply position, internal price line, and requirement of technical up-gradation, plays a significant role in the international trade and overall GDP growth of country. In Foreign Trade policy 2015-2020, the Government of India has taken a serious review of export promotion scheme for achieving the export turnover target of US$ 900 billion by 2020. With complementary measures like improvenment in ease of doing business, Start-up India, and Make in India schemes, the export-import regulations of the country have been revised to achive this targeted growth.

Still, there are challenges that are hampering India's endeavour in achieving desired objective.

Businesses flourish under pressure. And while every year brings its own set of challenges, it also brings its new sets of opportunities. Thus, as we look forward to the year 2018, it is exciting to consider potential innovations in trade finance. Competitive market dynamics have prompted the need for cost effective strategies and changing technological trends have resulted in greater investment to drive R&D and innovation to sustain the business and performance.

To succeed in this challenging but uncertain environment, banks' trade finance offerings must be responsive and in line with the customers' expectations.

Export factoring services has wide scope to progress in developing country like India. Working capital finance for pre and post-shipment export activity needs to be looked into particularly from the point of view of interest rate and transaction cost to the exporter. Supply chain finance in the domestic and international market is the need of the hour taking into account the interest of all stake holders.

India has a world-class tech industry that has created a tech ecosystem, including skills and capital that is supporting a growing Financial-technology (FinTech) sector, including innovators in payments, digital small enterprise and retail lending. FinTech firms are increasingly shaping the future of trade finance, and make an obvious banking partner, with both parties bringing strengths and expertise to such arrangements.

The demonetization of notes announced in November 2016 has accelerated the shift from paper to electronic payments and added momentum to the technology-driven transformation of financial services in India.

A key element of the support infrastructure needed to reach more customers has been provided by the Unique Identification Authority of India (UIDAI). This government agency, which is the world's largest national identification number project, has already enrolled more than 60% Indian residents. UIDAI issues Aadhaar identification numbers, which can be used for paperless identity verification when opening a financial account, reducing the risk of identity fraud. This allows banks to fulfill their KYC requirements for new customers with ease.

Given the market gaps and the strong tech ecosystem in India, FinTechs and new models of banks have strong potential to dominate significant market segments.

DIGITIZATION OF TRADE FINANCE

Global trade was once mainly conducted on letter of credit (LC) terms. LCs, were favored because of the security and bank credit support they offer.

The rise of the emerging markets has changed the scenario. It has led to a shift away from the LC towards open account (OA) trade. OA offers more efficiency through lower fees and less paperwork, making it an attractive way for trusted counterparties to conduct business.

Digital innovations in the customer interface can create more valuable relationships. And by automating many laborious paper-based processes, digital technology can reduce costs and expand a bank's operational footprint without requiring more people on the ground.

Three potentially innovative technologies have emerged in trade finance over recent years: Bank Payment Obligation (BPO), Electronic Bills of Lading (eB/Ls) and Blockchain. They may push trade finance towards the paperless business long envisaged.

Bank Payment Obligation

BPO uses electronic data matching to facilitate payments between the importer's bank and the exporter's bank. It is quicker and usually economical for companies than LCs (partly because of a shorter credit utilization period), while still avoiding the settlement risk of open-account trading.

Installing this capability is currently costly and the parties on either end of the transaction must be BPO enabled. Despite these obstacles BPO-secured transactions open doors to receivables financing and foreign exchange transactions. Adopting BPO with effective cross-selling and pricing strategies could significantly boost revenue instead of cannibalizing it.

Electronic Bills of Lading

These digital document platforms aim to lead the journey toward paperless trade by transferring shipping documents instantly between parties. The technology can be extended to many other documents supporting trade transactions.

Digitized documentation is economical to process, easily traceable, and more secure. Banks also benefit from its integration with SWIFT and other platforms. However, until it is universally adopted, banks will have to maintain their old paper-based processes.

Blockchain

Blockchain's distributed ledger technology (DLT) provides every party in a transaction with access to the same data at the same time, embedding complete transparency and accountability in every transaction. In short, the application of blockchain technology to trade finance offers greater coordination and a host of process benefits. In the Indian banking sector also it is finding support from regulators. Blockchain can transform supply chains, industries and ecosystems. Interestingly, even organizations like banks, who would seem to be losing out, can see opportunities to use blockchain to streamline their own business. In-depth transformation of supply chains will not happen overnight. However, supply chains can already start using blockchain for small portions of their operations.

The significant back-office savings and transparency that DLT provides are also very attractive from a regulatory and audit perspective.

KEY TAKEAWAYS FOR BANKS

Trade finance is becoming a tough business for banks. And it will only get tougher for those that do not align with the digital revolution. They will then be forced to offer services that are more expensive, slower, and less secure than those of their tech-savvy rivals. Banks seeking a long-term future in trade finance must embrace digitization. Following principles can guide them:

- Banks need to deliver value-addition and cannot rely on playing the traditional role of document processor.
- Growing importance of best-in-class operations cannot be underestimated. Digital compliance will be rewarded with lower costs and increased agility and speed of service.

- There are significant opportunities to digitize trade finance. Banks, if explore these and collaborate with technology partners, will come out ahead rather than risk of being left behind when adoption increases.

If banks do not embrace these digital advances, their challenges will only grow. They are likely to find that tech-savvy upstarts have shunted them out of the lucrative role they have played for centuries, costing them not only the revenue from trade finance but the customers that came with it.

Trade finance customers seek the same things that other corporate banking customers want i.e. process transparency, risk reduction, credit when needed, and the rapid, low-cost facilitation of transactions.

We cannot let the trade-finance gap incapacitate trade. Clearly, there are steps that the trade-finance industry can take to help meet unmet demand. Looking ahead, improving attitudes and raising understanding, encouraging collaboration and making progress towards innovation in the industry will support the growth of businesses of all sizes. It is therefore essential to consider awareness about trade finance as top priority.

One way to possibly boost the provision of trade finance is to make it more efficient and attractive. Certainly, the digitization of trade finance holds huge potential. Automating trade finance can make overall processes more effective and reliable, increasing capacity for banks, corporates and other stakeholders along the supply chain.

The legal and financial processes involved in trade are still predominantly paper based, requiring a large, inflexible, and expensive operational footprint. Digitally documented trade promises to increase agility and reduce costs.

Completely paperless trade is thus unlikely to happen anytime soon. Nevertheless, banks can gain most of the benefit by going paperless internally, creating a digital ring fence around their operations. In this way, banks incur the effort and cost of handling paper only at points of entry and exit.

Technology has its own role to play but customer friendly attitude of the banks will go along for trade finance business growth in a developing country like India. A special skill-set and strong desire for customer service is the need of the hour. Banks have to have the due diligence and commercial judgement before undertaking any transactions to facilitate flawless customer service and also to avert undesirable elements misusing the provisions.

Latin American Foreign Trade Challenges and Solutions for Building Sustainable Financial Architecture

09

Latin American Association for Development Financing Institutions (ALIDE)

WORLD TRADE OUTLOOK

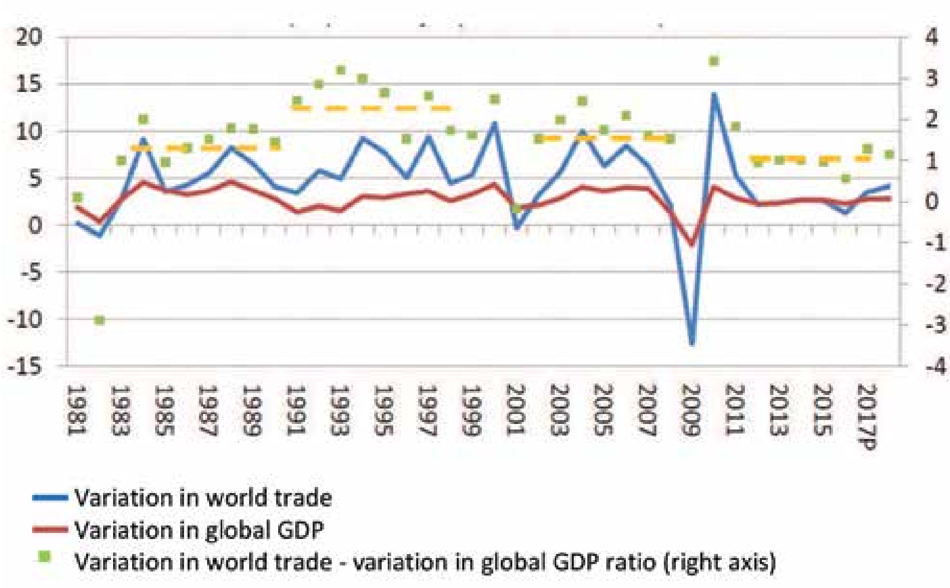
World trade is expected, according to the latest report of the World Trade Organization (WTO), to close the year 2017 with 3.6% recovery, after having dropped to 1.3% last year. For the first time since 2010, world trade in goods will reach growth in excess of the gross domestic production (GDP) forecast of 2.8%. This can be attributed to the resurgence of Asian trade currents brought about by growing intra-regional trade and recovery of the U.S. demand for imports, after having stagnated in 2016. Recovery of the greater part of the member countries of the Organization for Economic Development (OECD) was instrumental in this showing, as well. Rising raw materials prices are also working as a stimulus to the emerging economies. Even so, it should be stressed that trade has not yet returned to pre-crisis growth levels.

As (Maqueda, 2017) mentions, China's accelerating trade and inter-annual increases of up to two digits in the exports of countries like Taiwan or South Korea did much to improve world trade. The OECD, for its part, indicated that the partial recovery of oil prices also appears to have given a boost to investment in the United States, which slowed abruptly in 2016, particularly in the energy sector, which has since then shown growth in the first half of 2017. And it is precisely this that is fueling imports and, consequently, trade.

A comparison of the ratio between trade and global production (Figure 1) reveals that trade had not outpaced GDP since 2010, in a course similar to the normal situation starting in 1984, save for 2001 and 2009. This weakening of world trade can be explained, according to the Economic Commission for Latin America and the Caribbean (ECLAC), by the poor growth in global demand, the slowing spread of world value chains and reduced trade liberalization, or even rising protectionism. The IMF, for its part, attributes this loss of vigor to the poor performance of demand and investment in recent years (Figure 2). Low growth in investment on the part of the developed countries is detrimental to growth and world trade.

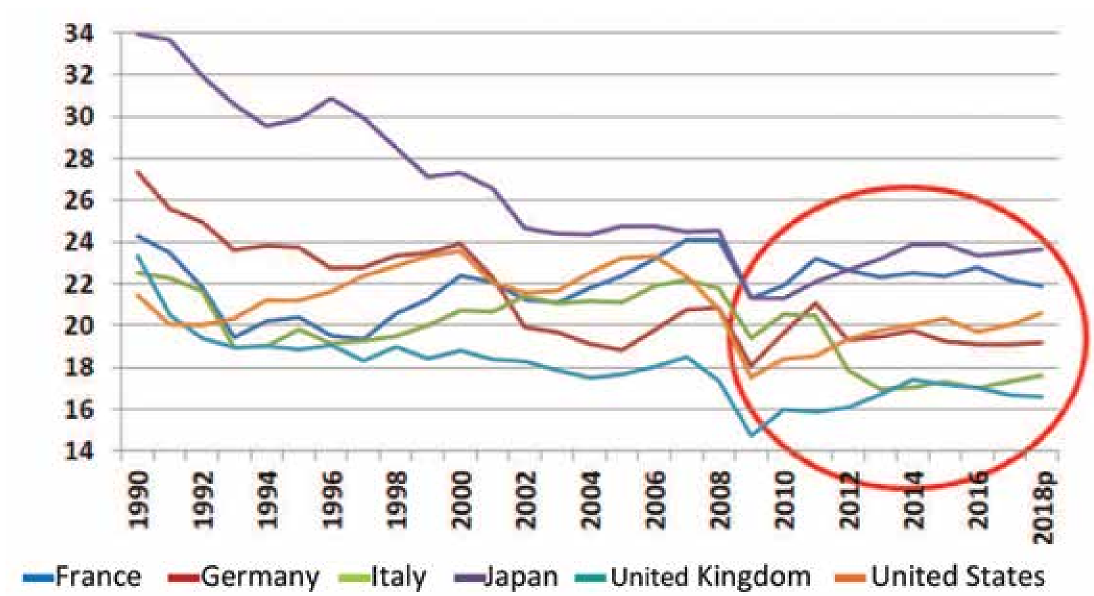
The WTO claims that it is unlikely that the world trade growth rate reached in 2017 will hold steady and expects it to moderate in 2018 to close to 3.2%. The organization adduces the following reasons

Figure 1: World Trade Growth
(In percentages and number of times)



Source: ECLAC

Figure 2. Selected Developed Countries: Share of GDP Investment, 1990-2018a



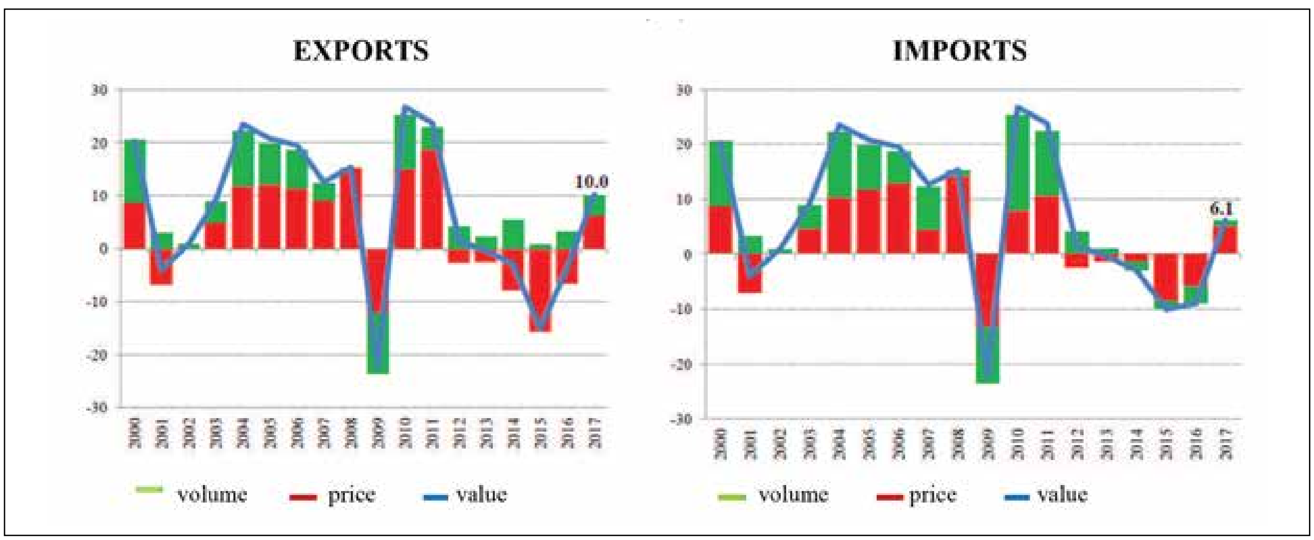
Source: ECLAC / IMF
(a) 2017 and 2018 projections

for this: trade growth in 2018 will not be measured against a weak reference year, as was the case this year. The developed countries are expected to tighten their monetary policy, inasmuch as the U.S. Federal Reserve System is gradually pushing up its interest rates and the European Central Bank is working to progressively do away with measures for quantitative easing in the Eurozone. At the same time, trade agreement negotiations are flagging, as can be seen in the U.S. withdrawal from the Trans-Pacific Partnership and the paralysis of the agreement between the U.S. and the European Union (EU). The renegotiation of the North American Free Trade Agreement (NAFTA), which is to be replaced by a NAFTA 2.0, has created uncertainty, as do matters relating to Brexit. To conclude, it is quite likely that China will moderate its fiscal spending and credit facilities in order to avoid economic overheating. And here, the fact that it is moving from an industry- to a service-oriented economy must not be overlooked, for this means that its import needs will be reduced.

INTERNATIONAL TRADE IN LATIN AMERICA AND THE CARIBBEAN

ECLAC, in its recent annual International Trade Outlook for Latin America and the Caribbean (LAC), pointed out that in 2017 the region would emerge from half a decade of dropping export prices and weak increases in export volume, to reach growth of 10% in the value of its foreign sales[1]. At the same time, imports would also show recovery after four straight years of declining values, with projected growth of 6.1% in 2017.

Figure 3 : Latin America and the Caribbean: Evolution of Foreign Trade, 2000-2017*(%)

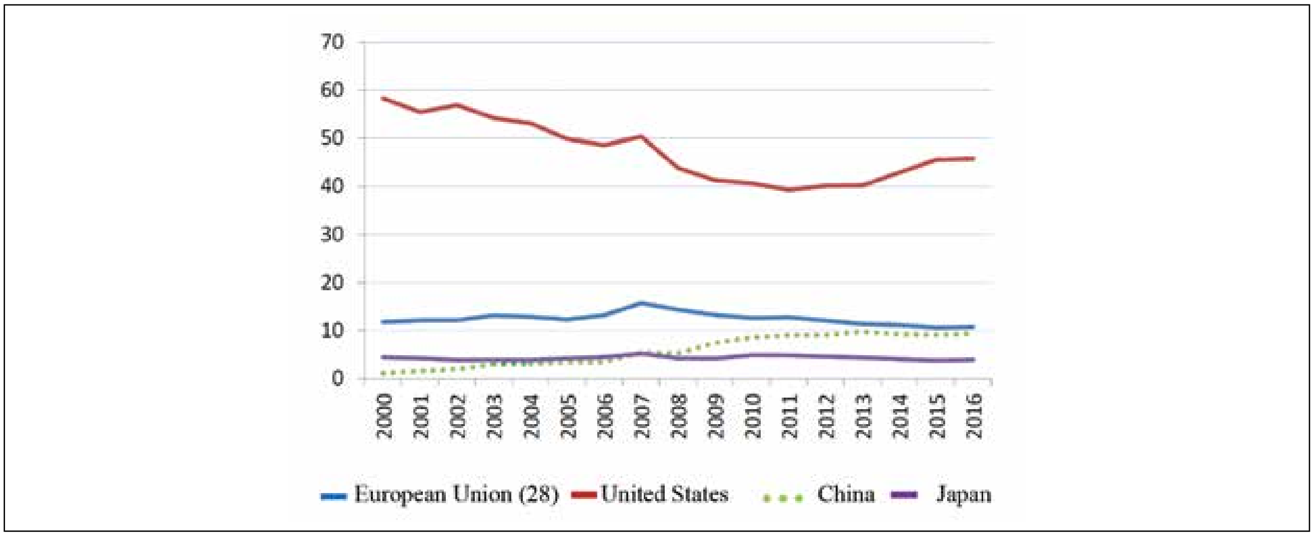


Source: ECLAC/ (*) January-July 2017

[1]It should be noted that raw materials are of basic importance to Latin America, accounting as they do for over 54% of its exports (over 60% in Mercosur's case and 80% in the Andean region).

Although considerable uncertainty is seen to be reigning in the international macroeconomic, technological and geopolitical spheres, stronger aggregate demand on the part of some of its main trading partners, recovery of growth in the region itself - which is expected to reach 1.2% in 2017 and 2.2% in 2018, after two years of recession, higher prices of some of its basic export products, and the removal of tariff and non-tariff restrictions in some of its countries have contributed to the resurgence of LAC trade, according to the report.

Figure 4: Latin America and the Caribbean: Partner Shares of Total Exports, 2000-2016 (%)

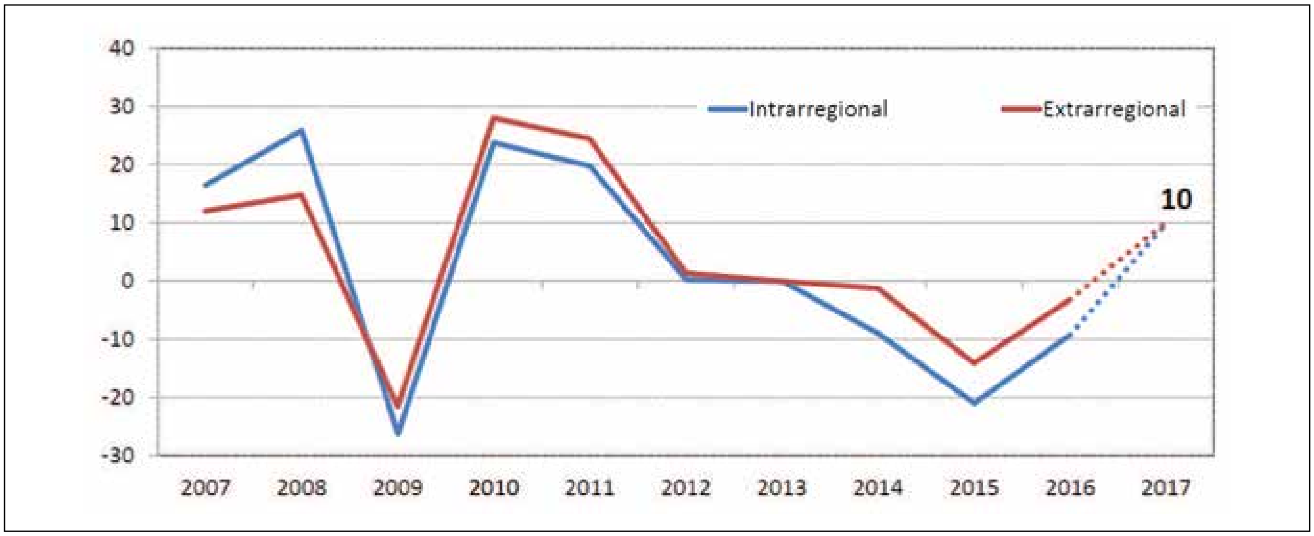


Source: ECLAC

Continuing with that document, shipments to China and the rest of Asia (for rises in value of 23% and 27%, respectively) will spearhead regional export recovery in 2017, while exports to the U.S. and the region itself will achieve expansion close to the average (9% and 10%, respectively). At the same time, sales to the EU will evolve less dynamically (up 6%). Insofar as intra-regional trade is concerned, an upsurge is expected in all of its regions, particularly South America. Intra-regional exports are projected to rise some 10% over the year as a whole. Their weight among the region's total sales to the rest of the world will amount to 16.8%, below the maximum level of almost 22% reached in 1994 (Figure 5).

The report goes on to add that intra-regional trade holds great potential for the export of manufactured goods and of products with a greater value added in general. "This highlights the pressing need to deepen regional integration, even more so considering the recent new turn in U.S. trade policy and uncertainty over the NAFTA," it points out.

Figure 5: Latin America and the Caribbean: Annual Variation in Intra-regional and Extra-regional Export Values, 2007-2017a- (%)



Source: ECLAC/ (a) Projections

Furthermore, as the Latin American Export Bank (Bladex) warns, the Region must become accustomed to a new form of moderate growth, whose acceleration is subject to greater diversification of exports into more elaborated links of the production chain. In this scenario, the major challenge continues to be the implementation of growth-oriented policies, together with economic reforms to eliminate rigidities, thereby contributing to the diversification of the region's exports and the enhancement of its competitive capacity.

Trade between Latin America and the Caribbean and India

LAC trade in goods with India took off over a fifteen year-period to reach US$30 billion in 2016. Over that same period, Indian imports from individual Latin American countries rose at an annual rate of 22%, while exports expanded at an annualized rate of 16%, according to data taken from the TradeMap trade analysis platform. Recent years, however, have witnessed a slowdown, which can be attributed to lower fuel prices and the economic difficulties plaguing some Latin American countries (Granados, 2017). While LAC accounted for barely 0.3% of India's total imports in 2001, by 2016, this figure had risen to 5.1%.

Despite the early stage of their relations, thanks to the trade between the two, India has been able to take a leading position as a trading partner with some of the region's countries. It has become Argentina's fifth-ranking export market, Chile's sixth, Brazil and Paraguay's eighth, and Bolivia's tenth. LAC, for its part, allocates 2.1% of its exports to India and receives 1.5% of its imports from that country.

Figure 6: Regional Trade Integration in Latin America and the Caribbean

Source: IMF

Latin American and Caribbean Intra-regional Trade

LAC trade volumes, despite the passage of time, still account for roughly 6% of world trade. While in 1975, the region accounted for 5.1% of total global exports, 42 years later that figure was only 6%. This is in complete opposition to the situation of East Asia, whose share rose from 5% to 22% over the same period, due to its strong industrialization and the bloc's consequent export of manufactured goods.

Similar results can be seen on comparing trade within the Region with other regions of the world. LAC trade is less intra-regionally integrated than that of the rest of the world. Its intra-regional trade flows are still far smaller than those of other regions, representing only 15% in 2015, while trade within other regional blocs is up to four times greater. Intra-regional trade within the EU stands at about 70%; in Asia, 54%; and in North America, 30%. According to ECLAC, this phenomenon is not of recent standing, but dates back over two decades; although intra-regional exports multiplied tenfold over that period, they never climbed above a 20% share of the region's total exports. This can be attributed largely to weak connectivity among its countries because of geographic factors and low investment in infrastructure, as can be seen in the lack of adequate highways and railways, together with inefficient ports and airports, although the situation varies considerably from one country to the next (Cerra, 2016).

Moving on with the analysis, at the subregional level, intra-subregional trade within the Central American Common Market (CACM) alone has accounted for almost 25% of its total exports over the past 10 years. At the other extreme, no more than 10% of the Andean Community's (CAN) total exports have targeted the intra-subregional market.

INTERNATIONAL TRADE FINANCE

In this section, we are going to set aside the operations that involve capital flows --in other words, investments, whether productive (foreign direct investments, FDI) or stock market investments-- to concentrate, instead, on foreign market sales operations.

The Bank of Spain (2010) indicates that trade finance can be provided through a series of different instruments, such as by any of the companies involved in the transaction (the importer or exporter of the product or service), or may be intermediated by a third party. In the light of this definition and according to the WTO, 80% to 90% of world trade depends upon trade finance (commercial loans and insurance/collateral), most of which is short-term. Even so, this estimate has been questioned, for although less than 20% of world trade is known to receive some type of intermediated finance [International Chamber of Commerce (2009)], non-intermediated finance is hard to estimate.

As a result, it is difficult to describe how trade finance has evolved, due, in the first place, to the fact that --as pointed out-- a sizeable portion of it is not intermediated and, in the second, that consistent data are lacking on the intermediated portion (Bank of Spain, 2010).

Although a smaller proportion of trade is financed by finance institutions than by means of loan arrangements between companies, the former contributes heavily to the growth of international trade. This reflects the fact that countries are able to enhance their trade potential and their international role in the degree to which their exporters and importers are able to accede to foreign trade finance and risk coverage mechanisms that are tailored to their needs (ECLAC, 2014). It is for that reason that the International Monetary Fund – IMF (2003) pointed out that the dwindling of such finance can seriously impair the real economy. Inasmuch as international supply chains have globalized trade finance on a par with production, their complex finance operations, which also cover SMEs, are now of decisive importance for trade, inasmuch as any risk aversion can be created at any stage of the production process.

It is for that reason that the WTO has been concerning itself since the onset of the Asian financial crisis with the shortage of trade finance for developing countries and low-income countries, for those are the countries most strongly affected by the general revaluing of risks and lack of liquidity characteristic of financial crises (Auboin and Meier-Ewert, 2008).

STATE OF LATIN AMERICAN AND CARIBBEAN FOREIGN TRADE FINANCE

According to the Bank for International Settlements (BIS)'s report "Trade finance: developments and issues", trade finance in the region is still in short supply compared with that available in other developed economies and emerging markets of Asia. As can be seen in Table 1, the finance flows applied to trade by Brazil and Mexico, of US$57 and US$8 billion, respectively, are minimal in comparison with those of other countries.

Table 1: Bank-intermediated trade finance markets in 2011

Country	Trade finance (US$ billions)		Percentage of merchandise
	Stocks[1]	Annual flows[2]	trade[3]
Global estimate	1625-2100	6500-8000	36-40
			Adjusted: 30-354
International data sources			
L/Cs (SWIFT)		2,782	15
ICC trade register		1,958	11
National data			
Comprehensive domestic coverage			
Brazil	25	57	24
China	218	871	47
Hong Kong	44	131-175	29-38
India	82	164	41
Italy	83	249-332	47-63
Korea	76	304	56
Spain	25	76-101	23-31
Partial coverage			
Australia	9	35	1
France	50	149-199	23-31
Germany5	47	187	53
Mexico	8	8	2
United Kingdom	23	92	16
United States	69	274	14
Sum national data	736	2,500-2,700	
Average	All countries		31-34
	Comprehensive coverage	38-43	

[1]Average quarterly stock for 2011. [2]Annual flows for national data are derived by assuming a 90-day maturity of stocks, except in India and Mexico, where maturities are known to be six and 12 months respectively, and in Brazil, where the information on of the flow of new loans is used. For countries where trade finance data capture short and longer maturities (France, Hong Kong SRA, Italy and Spain), a 120-day average maturity is also assumed giving rise to the range in the table. [3]Trade is measured as the average of exports and imports of goods. 4The adjustment accounts for some trade transactions receiving support from more than one trade finance product if for example an L/C is used as collateral for an export loan or banks refinance underlying exposures to exporters or importers with other banks, wich accounts for around 15% of the ICC trade register exposures. 5Both trade finance and trade are only vis-à-vis emerging markets and developing economies.

This can also be explained by historical preferences, legal frameworks and legislative and regulatory differences. Participants in the market suggest that in Asia letters of credit can be a relatively inexpensive and effective instrument for financing working capital. It can be applied particularly in countries with exchange restrictions or strict regulations applicable to ordinary bank loans, and/or where local banks follow efficient practices for letter of credit-based loan finance (BIS, 2014).

Table 2. Regional Dependence on Letters of Credit

	2015 share global export L/Cs	2015 regional world trade share
Asia and the Pacific	**70%**	**33%**
North America	**13%**	**15%**
Middle East	**4%**	**3%**
Africa	**2%**	**1.4%**
Central and Latin America	**1%**	**5.7%**

Source: Export Letters of Credit: SWIFT 2016, world trade share: UN Comtrade 2016

Trade Finance Mechanisms offered by Banks

- Direct Financings: "Advance account" credits are a facility that foreign banks grant to local banks for given purposes (they can only be used to finance exports and imports). The local bank acts as intermediary and assumes the risk of granting the loan. It can take the form of a pre-shipment or post-shipment credit or be granted through the purchase of documents (forfaiting).
  - Pre-shipment: finances production of the good for export and is prior to the shipment of the merchandise.
  - Post-shipment: demanded by customers to cover capital expenditures or needs after shipment of the goods or for installment sales.
  - International Factoring is a tool that enables export companies to resolve their liquidity problems stemming from unpaid foreign debts; it gives SMEs the opportunity to gain access to financing to help them cash their receivables.
  - Forfaiting consists of selling letters of exchange or promissory notes with bank guarantees or all export documents or letters of credit to a financial institution. The seller cedes its rights to collection in exchange for advance payment. The "forfaiter" purchases the documents at

a discount and charges a fee for the operation, thereby freeing the exporter from the risk of non-collection.

- Indirect Financings: Letters of credit (L/C) are the most common form of bank-intermediated commercial financing and are normally short-term (less than 90 days). Banks also offer security or stand-by letters of credit that underwrite the exporter or importer's contractual obligations. Generally speaking, these are off-balance sheet liabilities that are not financed until the exporter or importer complies with its contractual obligations. A letter of credit or stand-by letter of credit is particularly useful when reliable credit information about an importer is lacking, but the exporter or its bank trust in the financial standing of the importer's bank.
- Medium- and Long-term Financings: International financial leasing or cross-border leasing is a rental contract for goods covering a given period of time and through which the lessee agrees to the irrevocable payment of a series of installments and their maintenance fees and taxes, together with other expenses for the conservation of the contractual good, when the lessor and lessee live in different countries.
- International Trade Guarantees: Export credit insurance is a coverage mechanism that protects exporters against ordinary and extraordinary international trade risks by allowing them to recover the damages produced by given events that could impede the collection or recovery of credits agreed with their overseas buyers. The customary risks involved in the commercial activity are ordinary risks and those connected with disasters are extraordinary risks. Guarantee funds, for their part,--as their name indicates--, supplement the availability of the real guarantees required by merchandise exporters in applying to a banking institution for an export finance credit.

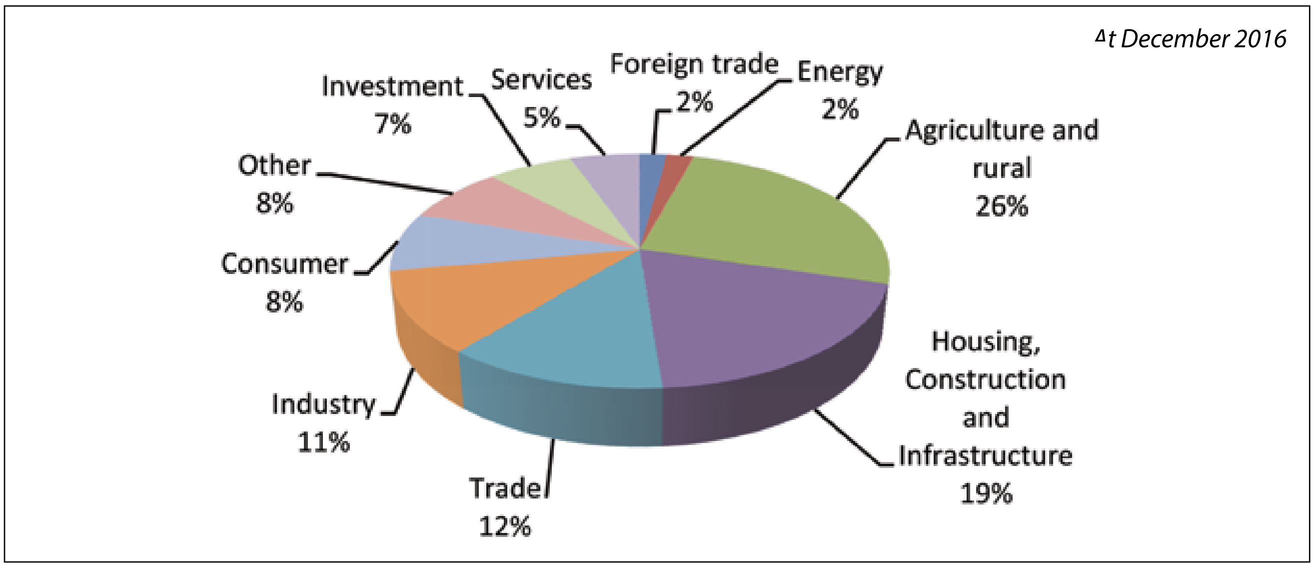
The Role of Development Banks

As a result of the shortage of export finance in many developing countries and its worsening during financial crises because of the lack of liquidity they produce, the WTO, at the request of a series of members, has brought its efforts to bear on boosting and maintaining trade flows in order to mitigate at least one of the causes of their diminishment.

In this connection, the need has been perceived since as early as 2003 for inter-governmental institutions to find global solutions to the challenges posed by trade finance. This led the Managing Director of the IMF, the President of the World Bank and the Director-General of the WTO, under the WTO mandate on coherence, to gather together the principal interested parties for the purpose of seeking a way to improve trade finance for developing and less developed countries. Particular insistence was placed on the need to encourage regional development banks and the World Bank to expand innovative means for financing trade activities, while respecting WTO regulations.

The response of the regional development and national banks since then has been positive and continuous. They have deployed their greatest efforts to provide trade finance, either directly or by intermediating resources through credit lines intended for foreign trade financing institutions and agencies. Insofar as the development banks' credit portfolio is concerned, at December 2016, they had mobilized US$807,427 million, up 14.9% on the previous year's figure, with the agricultural and rural; housing, construction and infrastructure; and trade and manufacturing sectors as the foremost recipients of the financing. International trade lines and programs accounted for 2.1% of those resources.

Figure 7: Latin American and Caribbean DFIs: Credit Portfolio Sector Distribution (%)



Source: ALIDE Database

Development banks draw upon a wide range of instruments for supporting foreign trade and insuring its related operations. The finance lines and programs include export pre-financing and post-financing, credit lines for the procurement of capital goods, financing of SME leasing contracts, coverage of loans to exporters, credit lines for financing working capital, quality and management program administration, development credits for free trade zones, financing of sales and the acquisition of imported equipment, etc. Foremost in the area of export credit guarantees and insurance are insurance against commercial risk, political risk and extraordinary contingencies for short-, medium- and long-term operations; guarantee funds for small businessmen; and export credit insurance for cases of bankruptcy or inability to pay, etc.

Among the export finance methods, pre- and post-shipment stand out as being used by 67.7% of the multi-sector development banks, followed in importance by letters of credit at 64.5% and guarantees at 41.9%. The other, less frequent, mechanisms are used by banks specializing in foreign trade. By way of example, Banco de Inversión y Comercio Exterior S.A. (Bice), of Argentina, Banco Nacional de las Exportaciones (Bandex), Banco de Comercio Exterior (Bancoex) and Banco Nacional de Comercio Exterior S.N.C. (Bancomext) provide medium- and long-term financing. The latter bank offers financings to meet both short-term requirements for consumer goods and medium- and long-term requirements of foreign trade institutions, dependent offices and companies for 2- to 10-year-old intermediate goods.

These financial instruments (programs) are provided for the most part by retail banks, above all for cases of pre- and post-shipment, letters of credit and other banking services offered to the sector, like: foreign currency transfers, export/import collections, and financings of sales and the acquisition of imported equipment, etc. In the case of the remaining programs, it is the wholesale banks that provide the finance. This is in line with the functional characteristics of the development banks, consisting today mainly of retail banks (64%) and wholesale banks (27%).

Table 3: Development Banks with Foreign Trade Finance Programs (%)

Direct Finance	
Pre/Post Shipment	67.7%
International Factoring	16.1%
Forfaiting	22.6%
Import Financing	38.7%
Indirect Finance	
Letters of Credit	64.5%
Medium- and Long-Term Finance	19.4%
International Trade Guarantees	41.9%
Miscellaneous	38.7%

Source: ALIDE

Along this same line, if we consider that the possible recipients of foreign trade finance programs include exporters, importers, foreign importers, exporter suppliers and import substitution companies[2], we will find that most of the programs offered by development banks are oriented exclusively toward exporters (61%), with 20% going to importers (ECLAC, 2014).

Generally speaking, export financing is not restricted to a given company size; even so, major efforts can be seen on the part of specialized institutions to support SME internationalization and to promote the growth of these export companies by means of effective mechanisms that facilitate their access to credit. Once again, the latter are served mainly by specialized banks. We will proceed to analyze the experiences of five development banks that target the export sector.

BICE's Experience in the Areas of Long-term Financing and the Financing of Export SMEs

BICE operates as a wholesale bank by offering credit directly and through lines maintained with financial institutions and reciprocal guarantee companies. It aims to promote foreign investments and trade through medium- and long-term credits. Along this line, it is currently boosting the financing of export SMEs, whose entire business cycle it finances from the moment of their creation, through their bankarization, to the start of their export activities. The bank also maintains credit lines to support the internationalization of companies that have grown, exported and wish to expand their activities abroad and does this by providing long-term financings.

According to its President, "banks today provide short-term financing of two or three months with fixed-term sight deposits. What BICE seeks is to encourage them to lend on a long-term basis and to that end it covers the mismatch, but it is the banks that assume the long-term risk. BICE also participates in direct long-term financings by taking on the long segments. For example, if there is a very long operation amounting to US$50 million that needs a 7-year term, we will seek to enter together with other banks by syndicating the operation and could assume the longest segment."

Figure 8: Argentina: Lack of Instruments for Foreign Trade Finance

Export Pre-Financing	Developed
Export Post-Financing (i.e., Forfaiting/Factoring)	Incipient
Import Financing (i.e., ECA guarantees)	Incipient
Bank Guarantees (i.e., Letters of Credit)	Developed
Export Credit Insurance	Incipient
Political and Disaster Risk Insurance	Non existent

Source: BICE, 2017

[2]Import substitution companies, according to Bancomext.

Foreign trade support instruments: At September 2017, 39.2% of the loan portfolio corresponded to documentary credits, amounting to 9% less than the previous year on the same date (48.4%), and which consist basically of financing granted under the program for exports and the finance of investment advances to public energy and technological companies. Secondly, 36% of the financing consists of loans to the financial sector (13.8% in September 2016) granted in the context of the investment and financial leasing project regimes. Mortgage guarantee-backed loans account for 20.8% of the total finance.

Among the instruments offered by the Bank are credit lines to support company internationalization and short- and long-term lines with multinational agencies for financing machinery procurement. Forfaiting, another of the new instruments, is a nonrecourse finance operation that will permit the exporter to place its products in the world market and offer its buyers a 10-year term in which to pay off their debt. Under this mechanism, the company will collect the cash value of the export from BICE through the discounting of letters of credit, promissory notes and/or guaranteed bills of exchange. The Bank, for its part, assumes the risk of default in payment of the receivables by requiring an additional bank guarantee needed to make the collection in the event that the importer fails to pay. The launching of this line proved possible thanks to a joint effort between BICE, the Central bank and the Trade Secretariat that resulted in the amendment of a regulation requiring exporters to convert their foreign currency earnings within a 365-day period. The amendment first extended the period to five years and then its current ten year-term, thereby producing a basic instrument that places Argentinean export companies on the same level as the rest of their competitors throughout the world. The line is intended for use in the export of industrial manufactures, agricultural manufactures, capital goods and services in amounts ranging from US$200 thousand to US$6 million.

Lastly, in order to improve access, it launched the "Impulsa COMEX" credit line to enable Argentinean SMEs to export their goods. This is a pre- and post- export finance line with a fixed rate of 1.5%, through which the Bank seeks to promote productive development by providing financial assistance to SMEs that are not yet able to secure access to international markets and support to large companies requiring more financing for further growth.

Foreign Trade Finance in Brazil

Brazilian exports are financed through public and private instruments differentiated according to the origin of the funds used. In the case of public funds, the main instruments for supporting foreign trade are the Programa Federal de Estimulo a las Exportaciones (Proex) (Federal Export Boosting Program) and Banco Nacional de Desenvolvimento Econômico e Social (BNDES) (National Economic and Social Development Bank) financing lines, while the finance provided from private resources, established under the control of Brazil's Central Bank, favor exchange contract advances and export pre-payments.

Banco do Brasil: The Proex, created in 1991 by the Brazilian government, seeks to provide the necessary conditions to enable Brazilian export companies to compete in the international market. The program operates using National Treasury funds allocated every year in the public budget and disbursed by the Bank of Brazil. A limitation is based on the gross billings of the companies applying for the available resources, which is expanded annually by the Chamber of Foreign Trade.

Financing can be granted in the following forms: *Proex financing* provided for the post-shipment of goods and services and *Proex equalization*, which requires a financing contract signed beforehand with another institution. As designed, the Program is not of interest to large companies, which are able to negotiate better terms directly with the financial market. It does favor small companies, however.

The instrument is applicable to almost 80% of the country's exportable supply and particularly benefits sectors like textile machinery, woodworking and leather-footwear. Proex equalization is provided to the transportation, machinery and equipment sectors having received prior loans and financings from BNDES-Exim. To give an idea of the importance of this instrument, in the first half of 2017 alone, of the US$ 98.5 billion produced in export foreign currency earnings, the Bank of Brazil was the source of US$ 19.2 billion and was responsible for almost 20% of those operations recorded in the Brazilian Central Bank. In 2016, the bank accounted for 21% of the US$ 176 billion in foreign currency trading. It should be stressed that the Bank of Brazil has over 100 Managers specializing in International Business, together with teams of consultants who promote courses for company training in foreign trade-related issues, consultancy and foreign currency trading, who help their customers prepare their business solutions. Currency exchange operations can even be carried out 100% digitally, including commissioning, document remittance, signing and management of the operations.

PROGER Exportación was created to deal with the exports of micro and small Brazilian companies. It targets companies with gross annual billings of up to US$ 1.5 million and its purpose is to finance the pre-shipment[3] export of goods and export-related promotional expenses. Its budget up until 2016 was US$ 44 million.

[3] The payment period is up to twelve months and the financing limit is US$ 80 thousand.

BNDES- BNDES has a series of products and programs to support company exports and internationalization lines. These products are: BNDES Exim (Pre- and Post-Shipment), BNDES Finem (with lines supporting company internationalization and the procurement of capital goods) and BNDES Automático. Each of these has specific mechanisms and objectives, but the financing lines may be combined should the Bank choose to do so. From 1998 to 2016, 12% of the Bank's financing went to the export sector; in this sense, it operates similarly to an export credit agency, in being empowered to provide official assistance by means of finance, insurance and guarantees.

In order to support the internationalization of Brazilian companies, Decree N°4,418 was amended in 2002 to allow the Bank to take the following actions: a) finance the acquisition of assets and investments made by Brazilian companies abroad, provided that they contribute to the country's economic and social development; b) finance and promote the export of goods and services, including installation services and expenditures abroad in connection with export operations; c) commission technical studies and provide technical and financial assistance for structuring projects that will promote Brazilian economic and social development or the country's integration within Latin America; d) use funds raised in the foreign market to finance the procurement of assets and implementation of projects and investments abroad by Brazilian companies, subsidiaries of Brazilian companies and foreign companies in which the majority shareholder with a voting right is, directly or indirectly, an individual or a legal entity domiciled in the country, and to acquire in the market securities issued by those companies or for which they are responsible (Bruno, 2014). As of that moment, it became possible to open representative offices outside Brazil; as a result, an office was opened in Montevideo, Uruguay in August 2009; in London (now known as BNDES Limited), and in Johannesburg, South Africa, in December 2013.

BNDES-Exim operates on a pre-shipment and post-shipment basis. In the case of post-shipment, the financing is intended for the marketing of export products and the payments are made by BNDES. With pre-shipment, the finance is used for the production and draws on funds transferred by financial institutions. BNDES Automático finances the post-shipment marketing of Brazilian goods through a network of overseas banks accredited by BNDES.

Instituto Brasileño de Análisis Sociales y Económicos (Ibase), (Brazilian Institute of Social and Economic Analyses) states that approximately 87% of the investments made under the Exim post-shipment program over the past 10 years went into LAC infrastructure and capital goods purchases. By 2012, the Bank had already disbursed US$2.17 billion in that category (Post-Shipment). More recently, export finance more than doubled in 2016, compared with the previous year, to reach US$ 4.1 billion. The main category, accounting for 80% of the disbursements, was the financing of capital goods exports. This support represented 11% of Brazil's total exports of capital goods. In 2016, US$ 2.6 billion were spent on pre-shipment operations and US$ 1.5 billion on post-shipment. Repayments and interest on post-shipment financings each year are a stable source of foreign currency for Brazil. In 2016 alone, the country received US$ 2.1 billion in payments for these operations.

The BNDES Exim Automático line, for its part, raised the number of Brazilian exporters, expanded its network of partner banks abroad (11 new institutions were incorporated) and simplified operational processing. The average financing granted during the period was US$ 600 thousand, half its historical average, which is indicative of the instrument's growing use. The sectors most favored were farming machinery and tools, buses, trucks, industrial machines and construction machinery that exported goods for projects abroad.

The Experience of Colombia's Bancoldex

Banco de Comercio Exterior de Colombia (Bancóldex) (Colombian Foreign Trade Bank) is one of Colombia's foremost wholesale banks and through its rediscount credit lines and administration of special programs, it promotes corporate development, financial inclusion and entrepreneurship in Colombia. In its role of promoting foreign trade and economic internationalization, at November 2016, the institution disbursed some US$ 510 million to 784 export companies whose total exports added up to US$2,724 million. On this point, the company expressed its assurance that the Bank would have over US$ 1.7 billion available for export finance starting in 2018.

The Bank, through its financial intermediaries, has an ample portfolio of products and services that enable it to ensure that companies involved in the foreign trade sector, among others, have access to the peso and dollar-denominated resources to cover the needs of their economic activity.

It is able to accordingly offer Colombian exporters different international banking services like the confirmation or report of sight, acceptance or differed payment export L/C; management and negotiation of documentary collections; confirmation of stand-by L/C; and reception of post-shipment bank transfers deriving from the export of Colombian goods, among others. It is also endowed with exchange coverage mechanisms, buyer credit lines and financing for engineering and construction projects and other services. In some cases, there are special credit allotments that target specific sectors or company sizes, according to the particular economic situation.

Bancóldex also offers supplier and buyer credit as a mechanism whereby importers of Colombian goods and services abroad are able to finance their purchases with a financial intermediary that is one of the Bank's correspondents. It further provides facilities for negotiation abroad through the purchase of dollar-denominated invoices for all exporters holding credit insurance policies. Businessmen interested in gaining a practical knowledge of the most important points of an international payments flow negotiation can turn to the Bank for a range of non-financial services known as "management advisor in international business," that will help the company to recognize and identify the risks inherent in an international operation of this kind. It will also enable it to describe and use the Bank's products and services and to learn about the financing an exporter can provide to its overseas buyer, in keeping with its type of business, product, the approximate costs and, of course, the benefits. The financing strategy for export companies with little access to the commercial banking system has been shored up with the Fondo Nacional de Garantías' (National Guarantee Fund's) guarantee program that offers backing drawing on the resources of Bancóldex and the traditional banking system.

Bancomext and international factoring

Bancomext is a public financial institution that operates as both a retail and a wholesale bank. Among its primary aims are to promote foreign trade finance and the internationalization of Mexican institutions abroad and to enhance participation in global value chains. Over its entire history of operation, the Bank has given financial assistance to companies involved in Mexico's foreign trade, including exporters and their suppliers, importers and import substitution companies. In 2016, it placed almost US$5.6 billion, of which 48% was provided through syndicated financings with commercial or development banks. Furthermore, suppliers were offered US$360 million in factoring lines that benefitted 266 companies.

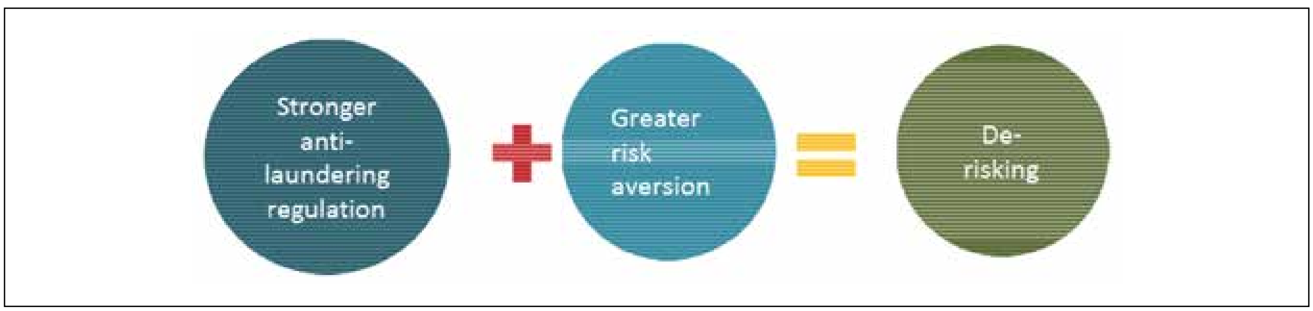
The purpose of the financial products and programs through which Bancomext's financing is channeled as a retail bank is to provide direct assistance to companies involved in foreign trade by means of credits and structured operations, export and import factoring, supplier factoring, inventory finance, letter of credit servicing and financing, and the provision of guarantees and avals. The Bank also offers direct credit, corporate financing and letter of credit servicing with the option of providing funds to the public sector. Insofar as its wholesale finance activities are concerned, a multiplier effect is sought in the channeling of support through banking and non-banking financial intermediaries that provide credits (discount), grant speedy selective and automatic guarantees, motor vehicle parts and buyer credit for overseas financial intermediaries and a letter of credit service with banks abroad. In addition, Bancomext has a Financing Program for SME exporters and importers, under which financings of under US$3 million are provided. In the event that a company's needs are in excess of that sum, the institution must be contacted directly in order to accede to financing.

International factoring: launched in 2012, this is a short-term financing mechanism through which a company or an individual engaged in a business activity promotes its growth by selling off its effective receivables to a factoring company. The program was initially developed to channel financings to exporters in the form of: 1) Prime Revenue, 2) Factoring guarantee and 3) Export factoring through financial counterparts. International import factoring was later added and by the close of 2016, a total of US$122 million had been granted for the financing of receivables in 29 countries, of which it should be stressed that 85% of the exporters are SMEs. A total of 15,659 export invoices have been financed for a six-fold growth compared with the 2,200 invoices initially financed in 2012, when the program was launched.

DE-RISKING

A study conducted by the Global Provider of Secure Financial Messaging Services (SWIFT) warns that the streamlining of correspondent banking over the past two years by several U.S. banking institutions with Latin American and Caribbean banks in a trend known as "de-risking," is affecting international transactions and the flow of remittances from that country to the region, the Caribbean subregion being the most heavily affected by it.

This policy was adopted by the international banking system in response to the implied risk of being penalized with large fines for being open to money laundering and terrorist financing (ML/TF) as a result of the ineffectiveness of their anti-laundering controls. A further reason was to put obstacles in the way of the appearance of new and dynamic competitors representing a threat to traditional financial institutions[4].



But which are the lines of business most heavily affected by "de-risking?" According to a survey carried out by ASBA[5] (Association of Supervisors of Banks of the Americas) in 2016, these are the products, services and channels most subject to money laundering and the financing of terrorism. Those most prone to this risk are therefore: remittances (60%), followed by correspondent banking

[4]Wall Street Journal. "After Crisis, Banks´ Model Faces Disruption". January 2016
[5]Riesgo de Cumplimiento/Regulatorio en la Actividad Financiera ("De-risking") en las Américas (ASBA, 2016).

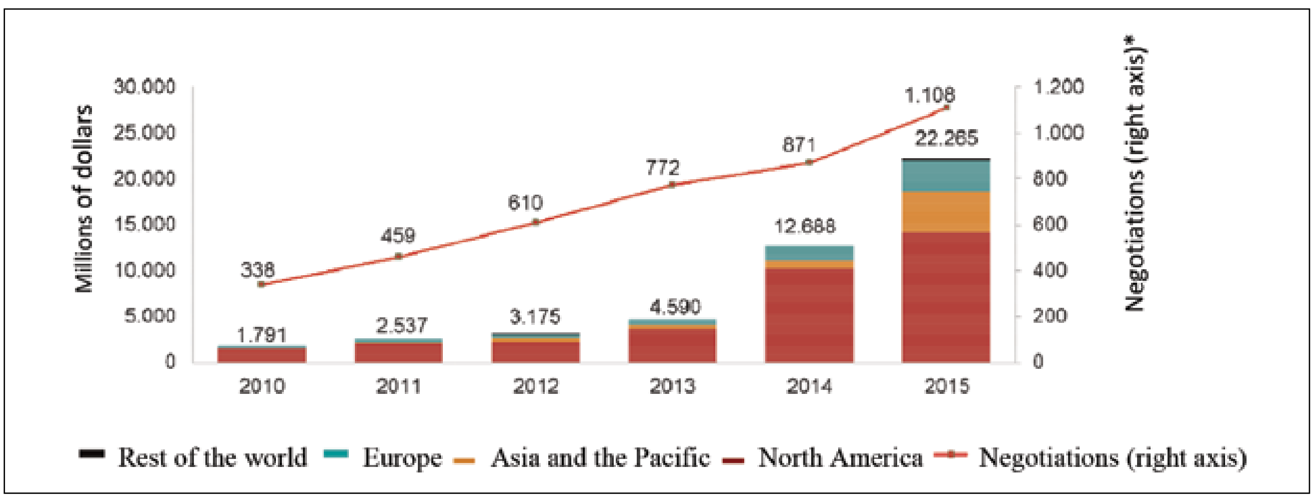
(50%), trade finance (28%) and currency exchange (12%). On the other hand, mobile banking, electronic money and electronic payments, each with 8%, are associated with the ML/TF risk and technological regulatory demands.

This leads to an increase in operating costs and/or the loss of market access by the region's economic agents[6]. The differences in approaches to regulation taken in the various jurisdictions are a key element in raising costs. According to ASBA, this could also bring about an advance in "shadow banking," which includes fintechs or unregulated investment funds that are potential suppliers of services to agents not served by the regulated system.

It should be stated here that according to the Financial Stability Board (FSB)[7], "Shadow Banking's" share of the financial system is growing and rose from 14.5% in 2012 to 15% in 2014. That is why it is important to level the playing field by establishing similar conditions for the operations of all participants in the financial market.

EY is of the opinion that digital connectivity, consumers' lack of interest in traditional products and limited innovation are motivating consumers to move to the fintechs. Technological innovations pose new challenges for ML/TF management and customers' knowledge should evolve with the advance of the new technologies.

Figure 9: Global Fintech Financing



Source: Fintech, An Evolving Landscape: Leading Points for the Industry, Accenture (April 2016)
*Includes partnerships, mergers or acquisitions

[6]78% of compliance professionals reported increases in regulatory charges over the past 3 years to the KPMG Global Anti-Money Laundering Survey.
[7]Financial Stability Institute. "Global Shadow Banking Monitoring Report 2015". November 2015.

De-Risking Effects[8]:

- Migration of high-risk customers to institutions with poor management capacity: Although de-risking aims to reduce financial sector vulnerability, its effects have been precisely the opposite. The most risky customers are migrating to institutions lacking the capacity to manage the risk.

- Use of less regulated channels: The conclusion of relations with given actors has forced them to migrate to less regulated channels. This is an element that may promote the growth of "shadow banking.

- Reduction of trade finance and retreat of financial inclusion: The global closure of various channels and operations has reduced the access of emerging economies to other currencies. This could impact the development and financial inclusion of emerging countries. According to the Financial Times, the offering of correspondent banking services in the Eurozone declined from 25,000 in 2002 to 15,000 in 2015 [9].

- Greater risk concentration among fewer institutions: The risk is becoming concentrated in the few institutions that have decided to continue pursuing lines of business that are considered high-risk. There is a growing risk of abuse by institutions that are assuming risks vis-à-vis customers that are excluded by the rest of the formal financial sector.

By way of conclusion, in order to avoid the effects of de-risking, innovative mechanisms need to be adopted to ensure due diligence in the customer's knowledge, without resorting to the use of traditional mechanisms (interviews and questionnaires). New methods of money laundering are emerging, prompted by technological advances together with the development of new business models. As a result, systems for the prevention and management of ML/TF risk need to advance in parallel and align themselves with the pace of innovation in the market. This cannot be construed to mean the imminent relaxation of the processes for identifying, gauging, controlling and monitoring ML/TF risk. What is being called for is the update of the mechanisms being used without overlooking the risks.

REGIONAL FINANCIAL INSTITUTIONS THAT SUPPORT FOREIGN TRADE

The Latin American Export Bank (Bladex) was founded in May 1975 by twenty-three Latin American and Caribbean central banks as a specialized bank to support the region's foreign trade. As a result,

[8]Based on the presentation made by Gerardo Hernández Correa, Colombia's Office of the Financial Superintendent, July 2016.
[9]http://www.globalcenter.org/wp-content/uploads/2015/11/rr-bank-de-risking-181115-en.pdf

66% of its transactions have to do with that sector. Later, in the past decade, a growing series of products and services (trade, leasing, factoring, financed sales, syndicated loans and structured loans) covering all stages of foreign trade was added to its business.

Bladex's target market has expanded in recent years to take in medium-size companies and an amendment of its bylaws now allows it to lend to corporations domiciled outside the Region whose line of business is to import/finance the Region's imports.

A total of US$ 243 billion in loans have been disbursed since 1979, with South America having received the lion's share, amounting US$138.5 billion. The geographic distribution of its commercial portfolio[10] at 2016 revealed that 57% went to South America; 21% to Central America and the Caribbean; 18% to North America and 4% to other regions. Segment-wise, these loans favored the corporate sector (61%), followed by the financial institutions (39%).

In 2014, Bladex devoted its efforts to offering financial solutions and structures to Latin American multinational corporations. It also reinforced its supplier credit product to achieve growth of 48% in income deriving from the spread compared to that of 2011, with a volume of transactions in 2012 of over US$ 2.5 billion, 33% more than in 2011.

The Andean Development Corporation, for its part, invested a total of US$ 18,344 million between 2010 and 2016 in foreign trade projects, company internationalization and the creation of business opportunities. With this same aim in mind, the Inter-American Development Bank (IDB), through sovereign guarantee operations, granted a total of US$ 772.6 million to the Region's export sector; of this amount US$ 654 million were allocated to the promotion of exports, with its trade facilitation, trade logistics and customs lines receiving US$ 118.6 million.

Lastly, the Central American Bank for Economic Integration (CABEI) has designed a series of international trade facilitation and promotion programs, policies and strategies. Foremost among these is the Foreign Trade Program (COMEX) that facilitates resources to intermediary financial institutions for promoting the import and export of goods and services within the existing credit lines of the International Trade Facilitation Initiative. At 2015, CABEI had channeled US$ 192.1 million in funds intermediated within the scope of COMEX and holds an active portfolio in the neighborhood of US$ 46.4 million.

[10]The trade portfolio includes the book value of loans, placement of selected deposits, investments in shares, acceptances and contingencies (letters of credit, standby letters of credit, guarantees covering trade risks, and loan commitments).

CONCLUSIONS

Even though global trade is expected to recover and reach 3.6% after its slipup of last year, when, for the first time since 2010, it dropped to 1.3%, Latin America must accustom itself to a new, more moderate rate of growth than that of the past decade, given that it is up to the Region to diversify its supply of exportable goods into more elaborated links of the supply chain. The major challenge in this scenario continues to be the need to implement new policies to boost growth and economic reforms that do away with inflexibility, so that exports can be further diversified and competitive capacity can be enhanced in the area of international trade.

In this scenario, governments in the Region are able to make use of their development banks as public policy instruments for promoting the diversification of their export baskets and boosting the internationalization of companies, particularly of SMEs and their tie-in with global production chains. Although the foreign trade loan portfolios of these development banks represent a little over 2% of their total portfolios, this percentage could be far larger, above all in the case of banks specializing in foreign trade. As the International Chamber of Commerce mentioned in 2009, although less than 20% of global trade is known to receive some form of intermediated financing, the amount of non-intermediated financing is very difficult to estimate.

Trade finance in the region is still extremely limited compared to that of other developed and emerging countries of Asia. This shortage and the lack of liquidity produced during periods of crisis have led the governments of several countries and international organizations like the WTO, the IMF and the World Bank to insist upon the need to encourage regional development banks to add innovatively to the methods for financing trade activities, while respecting the rules and regulations of the WTO.

The response of the development banking system and national banks of the Region has been positive and continuous ever since that time. Their greatest efforts have gone into the financing of trade, either directly or by intermediating resources through credit lines extended to financial institutions and foreign trade agencies, with the result that a wide range of instruments for supporting foreign trade and guaranteeing related operations have been deployed.

These financing lines and programs include export pre- and post-financing, credit lines for the acquisition of capital goods, financing of leasing contracts for SMEs, coverage of loans to exporters, credit lines for financing working capital, quality and management administration programs, credits for the development of free trade zones, financing of sales and the procurement of imported equipment, etc. Standing out in the area of export guarantees and credit insurance are insurance policies against trade risk, political risk and extraordinary contingencies for short-, medium- and long-term operations, guarantee funds for small businessmen, export credit insurance for confronting bankruptcy or payment defaults, and others.

Foremost among these export finance methods are pre- and post-shipment financing, which are employed by 67.7% of the multi-sector development banks, followed in importance by letters of credit (64.5%) and guarantees (41.9%). The other, less frequently used, mechanisms are employed by banks specializing in foreign trade. By way of example, medium- and long-term financing is provided by CABEI, Bandex, Bancoex and Bancomext, and Bancoldex.

These financial instruments (programs) are in use mainly by retail banks, above all for the cases of pre- and post-shipment, letters of credit and other banking services offered to this sector, including: foreign currency transfers, export/import collections, financing of sales and procurement of imported equipment, etc. In the case of the remaining programs, it is the wholesale banks that offer the financing, in keeping with the functional characteristics of the development banks, 64% of which are presently retail banks and 27%, wholesale banks.

Export financing is generally not limited to a given company size, although major efforts can be seen on the part of specialized institutions to assist with SME internationalization and to promote the growth of these small export companies. While their business horizon is no longer limited to the local market and they are looking beyond national borders, they run up against serious problems when seeking to break into the regional market, where demands are more numerous and stringent, forcing them to reveal some of their shortcomings. That is why it is so important for development banks to offer not only financing, but also training and advisory assistance.

It should also be considered that development banks, by sustaining good relations with both multinational development organizations and governments, offer great advantages for bringing together interested parties and advancing initiatives to promote foreign trade and investment. In addition, they have access to privileged information, like knowledge of major investment projects, bilateral initiatives between countries occasionally agreed at the political level, or initiatives among national and foreign entrepreneurs proposed for consideration by the governments.

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The Role of the Trade Finance Program in Lifting Impediments to Trade

10

Ms. Janet Hyde, Investment Specialist, Trade Finance Program, Asian Development Bank

KEY POINTS:

- Fundamental change in global trade flows, driven by geopolitical and economic shifts, has generated a fulsome response from the Asian Development Bank's Trade Finance Program in terms of the products and services offered and to ensure that local banks in developing Asia benefit from such change.
- In collaboration with the Asian Development Bank's trade finance partners, the key aims are to close trade finance gaps and to provide a level-playing field for small and medium-sized entrepreneurs, promoting job creation and sustained economic growth in the 21 Trade Finance Program countries of operation.
- Much attention is currently focused on the potential for technological advances to enhance the process of trade. This is a look at early developments, the issues that still need to be addressed, and the implications for banks around the world.

Data from the International Chamber of Commerce (ICC) shows that all the multilateral development banks (MDBs) increased their limits and resources in 2015 and the Trade Finance Program (TFP) of the Asian Development Bank (ADB) continues to extend its range of products and initiatives to ensure that trade continues to flow. The TFP is a nimble crisis response vehicle, able to mobilize resources when disaster strikes in the more vulnerable countries. Most recently, ADB established an emergency trade facility for the banks in Nepal to provide additional capacity for aid and reconstruction following the earthquakes of 2015. ADB is also aware of a continuing need in the region for greater knowledge and the building of expertise. TFP is committed to the fulfilment of this role in trade finance, responding to the specific needs of individual banks, countries, and subregions, by holding training seminars and workshops in a variety of trade finance and related topics, improving staff expertise, and helping to mitigate risk. ADB is also supporting local banks in four countries by providing advice and expertise in the formulation of gender inclusive policies.

MORE FUNDED SUPPORT OF TRADE

ADB is close to launching a new true sale distribution product designed to support the regulatory capital requirements of global financial institutions, so that trade is not hindered by the setting aside of additional capital. Capital rules are becoming so stringent that resources go to the biggest clients in the most familiar markets thereby squeezing out our developing member partners. This new product will increase the capacity for international banks to support trade in developing Asia. Moreover, TFP is prepared to support medium-term cross-border transactions, such as those for capital equipment purchases that feed infrastructure-building in the Asian region, but which require longer lead times and payment terms.

SUPPLY CHAIN FINANCE PROGRAM

ADB has started a Supply Chain Finance Program (SCFP), which to date has been active in the People's Republic of China (PRC) and Malaysia. In 2016, ADB supported US$ 200 million in trade by partnering with its major banking partners in their post-shipment supply chain finance activities. Unlike the TFP, SCFP assumes risk on companies instead of banks and is focused on providing post-shipment working capital finance to small and medium-sized entrepreneurs (SMEs) who are often suppliers to larger corporates and can be subject to unfavorable payment terms. The SCFP eases their cash flow and can help defray the cost of large scale capital expenditure.

TRADE FINANCE REGISTER

In 2009, ADB initiated the creation of a trade finance register to quantify default and loss rates for trade finance on a global industry basis. Partnering with the ICC the first Trade Finance Register report demonstrated to Basel III regulators that trade finance carries an extremely low risk of default, at around 0.02%-0.05% each year worldwide. This information was critical to banks engaged in trade finance since it helped persuade the regulators to change the capital requirements for their business: reducing the leverage ratio on letters of credit (LCs) to 20%, lifting the 1-year maturity limit and removing the sovereign weighting on trade instruments for capital adequacy purposes.

TRADE FINANCE PROGRAM AND THE TRADE FINANCE GAPS, GROWTH, AND JOBS SURVEY

ADB's Trade Gap Study is now in its fourth year. The 2016 survey received 337 responses from banks in 114 countries. The trade finance gap or shortfall in trade finance, defined as the value of proposed trade finance transactions rejected by respondent banks, amounted to US$ 1.6 trillion worldwide. In developing Asia alone, 43% or US$ 692 billion exists, including the PRC and India. This is corroborated by a World Trade Organization (WTO) report from 2015, which estimated the gap at US$ 700 million.

Trade finance markets are huge, estimated to be US$ 10 trillion on an annual basis supporting trade valued at US$ 18 trillion per annum. A US$ 1.6 trillion gap is therefore significant especially for SMEs in developing countries and SMEs known for creating a high proportion of new jobs, particularly in smaller communities. Among developing regions, Asia and the Pacific continues to have the highest proposal rate at 40% of the total, and the highest rejection rate, at 34% for trade finance, largely driven by the PRC. Further, 56% of SME trade finance proposals are rejected worldwide compared to 34% for large corporates and 10% by multinationals. Those firms owned by women face higher than average rejection rates. The lack of trade appetite risks drive all these businesses to unofficial finance providers. The survey also established a link between the trade finance gap and growth and jobs. Firms reported that since receiving trade finance they hired more staff and that 25% more trade finance would enable them to hire 20% more people. These findings demonstrate that trade finance has a direct economic and social role to fulfil.

ADB responses to the reasons for the impediments to trade finance fell into two main categories; regulatory (including anti-money laundering/know-your-client [AML/KYC] at 90% and Basel III at 77%) and risk (including a country's credit rating: 82% or that of a bank: 85%). When their clients were surveyed, companies responded that the main reasons for rejection was the inability to fulfill standard bank requirements, including collateral (47%), documentation (37%), and valid company record-keeping (34%).

DE-RISKING

The process by which global banks withdrew from operations in certain parts of the world, where the risk/return ratio proved untenable in a more stringent regulatory environment now appears to have slowed, but the ramifications are still emerging. Developing countries and emerging markets have been disproportionately affected and there is a real risk that some markets are close to being completely cut off from the global payments network. The so-called de-risking phenomenon is already a problem for local banks in countries such as Myanmar and the Pacific Islands, which are unable to clear payments in hard currency through the international banking system. This leads to a dampening of appetite for trade credit from within banks especially for smaller companies in difficult markets for whom the cost of compliance with KYC and AML regulations does not match the value of business they can immediately generate. The aspirations of SMEs in developing countries, faced with the greater challenge of providing financial information and collateral, consequently remain unmet, directly impacting economic growth and job creation.

ANTI-MONEY LAUNDERING/KNOW-YOUR-CLIENT INITIATIVE

Another unintended consequence is that de-risking creates unregulated financial spaces causing a higher risk of illicit financial flows outside of the system. These developments require a robust and meaningful response from the countries affected, to implement international standards of AML and KYC so that they may reengage and integrate into the global financial system. To this end, in 2017, ADB announced an investment of $2 million in technical assistance to its developing member countries to counter money laundering and the financing of terrorism; to maintain tax integrity;

to tackle tax secrecy, evasion, and aggressive tax planning; and to promote domestic resource mobilization.

ADB is also pulling together a few private sector banks to pool data on AML/KYC infractions to better understand trends or patterns. The aim is to create an early warning system. Such information would help banks better understand the risks associated with the client on-boarding process and can contribute to a more substantive discussion with regulators on AML/KYC requirements. Financial technology (Fintech), too, can support a more sustainable AML/KYC regulatory framework making it more efficient and affordable, and pooling information worldwide.

SOCIETY FOR WORLDWIDE INTERBANK FINANCIAL TELECOMMUNICATION KNOW-YOUR-CLIENT REGISTRY

Without seeking to exclude competition, ADB recognizes it is important for one single body to set a minimum standard for KYC worldwide for a workable and a trusted global system to be implemented. The Society for Worldwide Interbank Financial Telecommunication (SWIFT) has a long-established market presence within the financial system. Its Registry is a not-for-profit initiative that collects KYC/AML information on banks in one central repository available to all participants, making compliance within the financial institutions industry easier and cheaper. One of the obstacles to its development to date has been the paucity of information and the inability to populate all the fields required for such a database to be effective. ADB is encouraging its partner banks to submit information to the SWIFT's Registry to keep it current. There is no cost to submit the information and making it publicly available makes it cheaper and easier to form and maintain essential correspondent banking relationships so that trade can continue to flow.

FINTECH AND THE POTENTIAL OF LEDGER TECHNOLOGY IN TRADE FINANCE

The movement of physical goods around the world and the storing of documentation trade is an intensive and time-consuming process. The excitement around advances in digital trade is generated because it offers solutions to such a cumbersome activity largely unchanged for centuries. Digitization, ledger technology, and blockchains may conjure up a dystopian vision of the future for some and the 2016 Trade Gap study revealed that 70% of firms were unfamiliar with digital finance. The digitization of trade is not a new phenomenon, although so far it has developed on a bilateral or online platform basis while paper verification remains common especially within the banking sector and for shipping companies and freight forwarders. But the pace of technological change has been gathering momentum over the past year. Banks are beginning to respond to growing client interest in digital methods of doing business but will also be mindful of the initial cost of investment and the increasing complexity of the legal ramifications.

The Benefits of Ledger Technology

A distributed ledger is a database that can operate across multiple sites, institutions, and jurisdictions and where information is stored in one continuous ledger rather than in blocks that are chained to one another. Both block chain technology and distributed ledgers fall under the definition of shared ledger databases, either open to all or permissioned at some level. For distributed ledger technology to be successfully applied to trade, it will need to be operated by identified parties with a shared business purpose in accordance with a pre-agreed arrangement between those parties so that instead of running their own individual ledgers, all parties have shared control of data that facilitates the trade process. However, for the use of such permissioned ledgers to become widespread, indeed accepted, the market and the technology must determine the terms, validation, and integrity of such arrangements.

Nevertheless, such bespoke technology lends itself well to the process of trade and its financing, since it can be operated and managed by the many necessary entities along the chain of supply and often across several jurisdictions: buyer, seller, their bankers, a shipping company, freight forwarder, inspection agency, insurer, and so on. Proponents of this technology say it will ease the time-consuming process of conducting trade: exchanging contracts, issuing LCs, carrying out inspections, and issuing certifications and other paper-based process involved in moving goods around the world. The information generated and stored can demonstrate the existence and origin of goods, allow the transfer of title, and the physical movement of goods, and facilitate payment once certain conditions are satisfied. This provides traceability, accumulated performance, and payment data, which can assist credit assessment. It also offers the opportunity to enhance the proper registration of collateral and to establish transparency in the priority of rights. Its aim is also to reduce the operational costs of trade by simplifying the workflow and improving accuracy, so that the risk of documentary disputes associated with trade is minimized.

Creating a platform where all these parties, located across several jurisdictions for any one transaction, will not happen overnight. A critical mass will need to be established before meaningful regulation can be put in place and for confidence and trust in the technology can be built. The process will also need to demonstrate that they can overcome the operational differences in the conduct of trade across companies and geographies. This is where the TFP has concerns, since the investment in technology in developing Asia lags behind other parts of the world. The 21 countries of TFP operation still rely heavily on paper-based processes to execute contracts, obtain licenses, and to clear customs. Clearly, it is essential that the users agree in advance how they treat all types of information and how the ledger will be managed. Moreover, the rights and responsibilities of all parties associated with a distributable ledger must be clearly defined and accepted by all if trust and confidence in the new technology is to be established. But more searching questions are already being asked of developments in Fintech and whether individual projects can or should be integrated on a worldwide and systematic basis. How far should ledgers be verified and searchable to meet compliance and audit requirements? Who takes responsibility for this oversight? Will multiple platforms be able to transfer information from one to another? What is being done to guard against cyber-attack?

Such a vast and not yet fully comprehended prospect will need the engagement of all to properly evolve. Banks in the United States (US) and Europe, as well as in the PRC and India, and the monetary authorities of Hong Kong, China and Singapore, are at the vanguard of such developments probably because the more advanced economies of Asia do not have the longstanding systems and practice of countries in the US and Europe. But many more banks worldwide need to develop their digital capabilities in-house or to partner with Fintech if they are to retain their trade finance business capability. In fact, it will need the participation of information technology (IT) companies, lawyers, auditors, central banks, regulators, and probably governments too, and a long-sustained effort to devise not just the technology but also equitable commercial solutions and the laws and regulations that realize such a vision to its fullest extent. A system that provides information on which the process of trade depends must guarantee authenticity: this will need clear underlying agreements, regulatory acceptance, and the engagement of the insurance industry. Industry standardization will ease acceptance of the process but equally, excessive governance could defeat the potential for operational and cost efficiencies, ultimately impacting the wealth of nations.

The legal framework that supports digitization of trade will be crucial. Law and regulation has yet to keep up with the pace of technological advances and it is now becoming imperative to ensure the risk of forgery and fraud is minimized, by establishing the identity of distributed ledger technologies (DLT) participants, and to avoid driving trade and the benefits of technological gain into the shadow economy.

The Risk of Disintermediation

It is therefore easy to understand why further disruption might be perceived from the prospect of such far-reaching technological advances and the yet unknown impact on global trade but the process, in some form, already seems irreversible. The need for the closing of the trade finance gap is now well documented, so banks will have a crucial role to play in shaping the meaningful digitization and perhaps even the harmonization of trade on a global basis while still meeting the high standards of compliance and security incumbent upon them. The cost of KYC could be reduced considerably, if the technology and its associated agreements prove reliable. In fact, greater efficiencies and cost savings will be to the benefit of all participants given the potential for economies of scale. Further, the technology could mark a return to more transactional-based lending backed by facilities determined at a customer level providing both transparency and creditworthiness to trade finance and reinforcing the value of such low risk lending for the purposes of bank regulation and capital adequacy efficiency. Yet, it is also an ambitious endeavor that will need cooperation, debate, and eventually cohesion if it is to benefit trade and by extension, economic advancement, on a genuinely global scale. ADB intends to show leadership in the realization of such potential and to ensure that developing Asia remains part of the process by working with its partner banks and IT companies, sharing knowledge and understanding with industry bodies and regulators, and collaborating with multilateral partners. The link between the provision of trade finance, Fintech, and economic growth and job creation would gain greater credence.

Global Legal Identifier Foundation

The establishment of a Legal Entity Identifier (LEI) will assist in establishing the integrity of digital functions within the trade finance sector. The Global Legal Identifier Foundation (GLEIF) is a not-for-profit organization created by the Financial Stability Board in 2014, following a mandate from the Group of Twenty (G20), the international forum for the world's leading industrialized and emerging economies, to implement a globally harmonized digital identifier for all companies including financial institutions. GLEIF is overseen by a committee whose members are drawn from regulatory authorities and central banks from around the world. The system would verify three things: who is who; who owns who; and who owns what, with the aim of assisting the flow of trade and other cross border transactions and making KYC and other forms of due diligence easier and cheaper. It would complement the growing number of shared information sources, such as SWIFT’s KYC Registry, that would make the assessment of risk more transparent and credible, and leading to easier access to finance especially for SMEs and developing countries. A truly global system will also enable government to improve its tax collection capability.

Companies would pay a nominal fee to establish and maintain an LEI, a 20-digit alpha numeric code based on an ISO standard. Around 500,000 companies with identifiers now exist, including ADB, but most are based in the US and Europe. ADB is working in conjunction with the ICC and the World Trade Board to promote global adoption via legislation agreed by G20 countries. The LEI Index is free to access online, providing open, standardized, and high quality due diligence data. It therefore reduces the costs of conducting due diligence and helps facilitate lending to SMEs, which often struggle to maintain full business records that provide access to finance. The more widespread use of the LEI Index could soon lead to a verified set of transactions that track credit history, payment performance, and commercial dispute data. It is vital that emerging markets become involved in this system since it will promote a more open, transparent, and inclusive form of finance.

LOOKING AHEAD

TFP has seen growth of over 25% in 2017 compared with the previous year. There is much future potential for trade support to feed ever growing infrastructure projects and ongoing economic diversification in the region. Asia also needs to compete more effectively in global export markets and become more integrated in supply chains. TFP's clients continue to be hungry for knowledge and TFP continues with its efforts in enhancing knowledge and skills sets of banking and regulatory staff in TFP's countries of operation.

The importance of their participation in the discussion and formulation of thinking around current issues that are determining deep-seated change in the financing of trade and management of its risks cannot be emphasized enough. It is only by contributing to the debate that countries in the Asian region will be part of the solution, putting across their point of view so that they may influence outcomes that are as suited to their circumstances as those of more developed countries. Workable systems and frameworks that enable trade to flow and feed growing economies will only survive if they are put in place for the good of all.

TFP, backed by ADB's AAA credit rating, provides guarantees and loans to over 200 partner banks to support trade, enabling more companies throughout Asia to engage in import and export activities. With dedicated trade finance specialists and a 24-hour response time, the program has established itself as a key partner in the international trade community, providing fast, reliable, and responsive support to fill gaps in the region's most challenging markets. TFP complements its financial support with a regular series of workshops and seminars to increase knowledge and expertise in trade finance products and operations, risk management, and fraud prevention. Since 2009, TFP has supported more than 10,000 small and medium-sized businesses across developing Asia—through over 15,000 transactions valued at over US$ 28 billion—in sectors ranging from commodities and capital goods, to medical supplies and consumer goods. The TFP website (http://www.adb.org/tfp) provides more information.

ADB, based in Manila, is dedicated to reducing poverty in Asia and the Pacific through inclusive economic growth, environmentally sustainable growth, and regional integration. Established in 1966, ADB is celebrating 50 years of development partnership in the region. It is owned by 67 members—48 from the region. In 2016, ADB assistance totaled US$ 31.7 billion, including US$ 14 billion in cofinancing.

Hedging in Trade Finance: The Need for a Safe Framework

11

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In a world of liberalised and volatile exchange rates, agents exposed to foreign exchange commitments to be met after a lag are susceptible to losses because of currency fluctuations. Hedging against currency risk is therefore a must. In what follows we examine the currency risks faced by exporters whose contracts have to be denominated in a foreign currency, but for whom a significant share of costs is to be paid for in local currency. This, for example is true for a large number of exporters from India.

The issue is rather straightforward. Consider a firm executing an export order of say, US$ 100,000 with delivery due 3 months from the date of the order. The US$ 100,000 value would have been accepted because at the prevailing exchange rate of Rs. 68 to the dollar, or Rs. 6.8 million, the price per unit covered costs and offered a respectable margin. But, if by the time of delivery when the contract is settled, the rupee has appreciated to Rs. 65 to the dollar, the firm would receive in rupee terms 300,000 less than originally expected, wiping out a significant share of the margin. It is to ensure against potential losses of this kind that firms insure against them at a small explicit or implicit cost. Needless to say, those producing goods for the domestic market that have a significant imported input component, can similarly lose out on committed sales if there is a depreciation of the domestic currency in the interim.

Trade transactions are, *inter alia*, subject to two kinds of currency risk.[1] One is *transaction risk*, when exporters exposed to committed payments due in a relatively short period of time lose on account of exchange rate movements that affect the domestic currency value of those dues during the period between placement of the order and delivery. In addition, dedicated exporters, who make investments geared to earning revenues from foreign markets, are subject to *economic risks* because the future value of the revenues and, therefore, net cash flows are uncertain, because of unpredictable currency movements.[2]

This unpredictability has increased significantly in recent decades because of the liberalisation of capital controls and the subsequent increase in cross-border flows of capital. Capital flows are now not driven by the current account financing needs of the host country, but by the appetite of foreign investors for equity and bonds available in host country markets and open for investment

[1]Bjorn Dohring, *Hedging and invoicing strategies to reduce exchange rate exposure*: a euro area perspective, Economic Papers 299, Directorate General Economic and Financial Affairs, European Commission, Brussels, 2008.
[2]Economic risks are more difficult to mitigate since repeated hedging transactions would be needed in environments where the forward rate is bound to change over time.

of foreign capital. Since the volume of inflows and outflows is determined largely from the supply side, or by the decisions taken by foreign investors, there is an inherent unpredictability about the size of net cross-border flows. Further, since these decisions are very often driven by developments outside the host country (such as an increase in US interest rates , for example) that uncertainty is even greater. With India having moved in the 1990s to a liberalised, market-determined exchange rate mechanism, managed by the central bank only through its open market operations, this has increased exchange volatility and, therefore, exchange rate risks considerably.

Volatile exchange rates have made foreign exchange and foreign currency derivative markets attractive, for profit activities of financial investors. A large part of the trade in these derivative occurs over-the-counter, and therefore the total volume of such trading is difficult to fix. But figures on the volume and value of exchange traded currency derivatives point to significantly high, though extremely volatile, levels of trading. If hedgers have to participate in these markets, while they may benefit from the liquidity that speculation brings, they are susceptible to engage in transactions in which the risk which may be difficult to assess.

Yet, to mitigate foreign currency risks, exporters and importers need access to hedging instruments. Hence components of trade finance that are crucial are (i) the availability of relevant financial instruments that allow agents to hedge against currency risk; and (ii) presence of an institutional architecture that allows for the easy and safe use of such instruments.

Table 1: Business Growth in CD Segment (Number and Rs. Cr.)

	Currency Futures		Currency Options			Total		
Year	No. of contracts	Turnover	No. of contracts	Notional Turnover	Premium Turnover	No of contracts	Turnover*	Average Daily Turnover*
2017-18#	29,88,48,324	19,80,268.30	30,23,05,695	19,64,421.66	6,136.01	60,11,54,019	39,44,689.96	20,125.97
2016-17	36,26,15,931	24,89,778.94	34,98,35,508	23,67,296.92	7,153.09	71,24,51,439	48,57,075.85	20,070.56
2015-16	40,97,59,364	27,49,332.96	26,38,23,800	17,52,552.62	6,059.00	67,35,83,164	45,01,885.58	18,602.83
2014-15	35,55,88,963	22,47,992.34	12,50,75,731	7,75,915.32	3,164.45	48,06,64,694	30,23,907.67	12,705.49
2013-14	47,83,01,579	29,40,885.92	18,18,90,951	10,71,627.54	7,297.15	66,01,92,530	40,12,513.45	16,444.73
2012-13	68,41,59,263	37,65,105.33	27,50,84,185	15,09,359.32	10,109.99	95,92,43,448	52,74,464.65	21,705.62
2011-12	70,13,71,974	33,78,488.92	27,19,72,158	12,96,500.98	7,100.69	97,33,44,132	46,74,989.91	19,479.12
2010-11	71,21,81,928	32,79,002.13	3,74,20,147	1,70,785.59	946.7	74,96,02,075	34,49,787.72	13,854.57
2009-10	37,86,06,983	17,82,608.04	-	-	-	37,86,06,983	17,82,608.04	7,427.53
2008-09	3,26,72,768	1,62,272.43	-	-	-	3,26,72,768	1,62,272.43	1,167.43
Note:	# Till January 18.							
* In case of Option Contracts "Turnover" represents "Notional Turnover"								
* ADT is computed at segment level based on total trading days in the respective year across products.								
* Daily turnover data is presented after rounding off.								

Typical hedging instruments are plain vanilla forward contracts, standard derivatives such as futures and options and more complex derivative products. Standard derivatives are available both "over-the-counter" (OTC, i.e. non-exchange traded and with the contractual parties freely choosing amounts and maturities) and in the form of exchange-traded products.

Simple forward contracts promise to deliver a pre-specified amount of domestic currency for a specified amount of foreign currency on a particular date. The implicit forward exchange rate should reflect the spot exchange rate and the interest rate differential between the foreign currency borrowing/lending rate and the domestic interest rate. This is because any exporter expecting to be paid a certain sum of foreign exchange (say US$ 100,000) in, say, three months' time, can enter into a forward contract with a counterparty to buy that foreign exchange at a specified exchange rate, which would be the three-month forward exchange rate.

He also has another option. If the prevailing interest rate for dollar loans is 4%, he can borrow US$ 99,010, with the commitment to clear the loan with interest (by paying US$ 100,000) in three months' time. He can then convert the US$ 99,010 at the spot exchange rate and invest the sum at the rupee interest rate that currently prevails, which is say 6%. At the end of three months he can collect the US$100,000 due to him as an exporter and clear his dollar loan. Simultaneously, he can collect the rupee sum due to him for having placed the rupee equivalent of US$ 99,010 in domestic debt.

Since either of the above two options are open to the exporter, arbitrage would ensure that they yield him equivalent sums. This would require that the forward exchange rate that prevailed at the time either of these transactions could have been undertaken should reflect the spot exchange rate and the interest differential that prevailed at that point in time. This equilibrating mechanism would, however, not function, if markets are segmented and some exporters do not have access to the relevant credit markets.

Forward contracts allow exporters to freeze the exchange rate at which future foreign currency earnings can be converted into domestic currency, and do away with foreign exchange risk. Forward contracts are normally direct OTC agreements between the contracting parties, and are closed when the exchange is actually made. These contracts are therefore customised in terms of magnitudes and maturities, depending on the actual needs of the hedger. Unlike forward contracts, currency futures are standardised instruments available from exchanges, and can be bought in fixed amounts. They too are commitments to purchase foreign exchange at a pre-specified rate on a particular future date. Since the instruments are designed for exchange of standardised amounts, one disadvantage for the hedger is the difficulty of matching maturities and amounts to the actual exposure. But, if the need arises, these instruments can be traded on the exchange prior to the date on which the futures contract matures, and therefore they are more liquid than forward contracts are. This also makes standardised contracts attractive for those wanting to place bets based on predictions of the way exchange rates would move.

Flexibility is even greater with currency options, which gives the hedger the right to exercise the option of currency transformation at a particular rate for a cost. Options have a “strike price” specified, which is the price at which the currency can be bought or sold, and also a date beyond which the option cannot be exercised. But there is no obligation to exercise the option. So, if the domestic currency has depreciated significantly between the date when the contract was signed and when it was settled, the hedger can walk away from the option, assuming that the additional rupee sum obtained at the prevailing exchange rate (relative to the contracted rate) exceeds the cost of the option. In sum, exporters can protect themselves against currency risk, though hedging has a cost in the form of fees and commissions charged by the bank.

An option thus insures an exporter against adverse moves in the exchange rate, while giving her the opportunity to benefit from favourable movements. However, this asymmetric risk distribution implies that the seller of the option suffers a loss if the option is exercised but does not gain if it is not exercised. So, the benefit for the seller of the option is only the premium charged, which tends to make this a costly option reducing demand. To address that financial agents design ‘exotic’ options that combine regular options of different kinds. Option sellers can combine buy and sell option with different strike prices, and in the process reduce the premium charged to the buyer. While this cost reduction can make the option attractive to the buyer, it also increases the complexity and opaqueness of the product, making it difficult for the buyer to assess risk.

In practice, the cost of hedging can prove to be much higher than expected, even leading to losses. This is because banks or exchanges either directly place or offer a platform for others to place bets on the foreign exchange market. This encourages them to design complex or ‘exotic’ derivatives and offer them as hedging instruments or alternative investments, in which the buyer is offered opportunities to not just neutralise currency risk but take on risk to gain from holding the derivative. But the risk can result in losses as well, often to the benefit of the banks that design these exotic instruments.

Very clearly, the business of derivative products, especially currency derivatives has found favour with banks. A feature of banking in India that has not received the attention it deserves is the business reflected in the off-balance sheet or contingent liabilities of banks. Typical of such liabilities are swaps, options and forward rate contracts involving exchange and interest rates. Globally, financialisation has involved the diversification of traditional banking firms into a host of new activities such as derivative contracts and guarantees and acceptances of various kinds. These instruments are non-funded in the sense that there is no actual lending, but the bank can be called upon to compensate borrowers for losses from exposures named in the contract. Since such losses and calls are most likely when the market is "tight", the banks concerned may be forced to draw down capital at a time when accessing additional funds from the market is difficult, threatening their stability.

Exposures to these instruments have different degrees of counterparty risk, that may result in losses that erode the capital of the banks. However, in most jurisdictions, unlike in the case of credit assets, there are no guidelines to provide for regulatory capital against these off-balance sheet liabilities as part of capital adequacy requirements. Combined with the prospect of lucrative incomes from fees and commissions, this exemption from capital adequacy requirements encourages banks to diversify into activities that increase the volume of off-balance sheet liabilities, so long as the regulatory framework permits such diversification. But associated with an increase in such contingent liabilities is an increase in exposure to risk which is not easily assessed. An early, 1986 study of off-balance sheet instruments by the Bank of International Settlements had noted that "some of these are technically very complicated and are probably only fully understood by a small number of traders and market experts; many pose complex problems in relation to risk measurement and management control systems; and the implications for the overall level of risk carried by banks is not easily assessed"[3]. Overall, diversification into off-balance sheet, contingent liabilities increases the volume of risk that is not adequately assessed and is likely to be poorly managed.

PROLIFERATION OF DERIVATIVES

In India too, during the years of rapid financial proliferation starting in 2005, the volume of off-balance sheet exposures of commercial banks registered a more than five-fold increase from Rs. 28,325 trillion in 2005 to Rs. 152,130 trillion in 2015, around which figure it has hovered since. Moreover, there has been a clear shift in the pattern of these exposures, in which forward exchange contracts (or all derivative products, including interest rate swaps) and other contingent liabilities (which includes inter alia items like (a) claims against the bank not acknowledged as debt, (b) liability for partly paid investments, (c) bills re-discounted and (d) letters of credit) dominate. But, while in 2004-05 forward exchange contracts accounted for 77.6% of all contingent liabilities and other instruments for 13.1%, those figures stood at 86.3% and 2.6% in 2016-17 (Figures 1 and 2). Clearly, derivatives have come to account for an overwhelming share of all off-balance sheet exposures.

[3]Bank of International Settlements, *The Management of Banks' Off-Balance-Sheet Exposures*, March 1986, available at https://www.bis.org/publ/bcbsc134.pdf.

Figure 1: Pattern of Contingent Liabilities of SCBs 2004-05 (%)

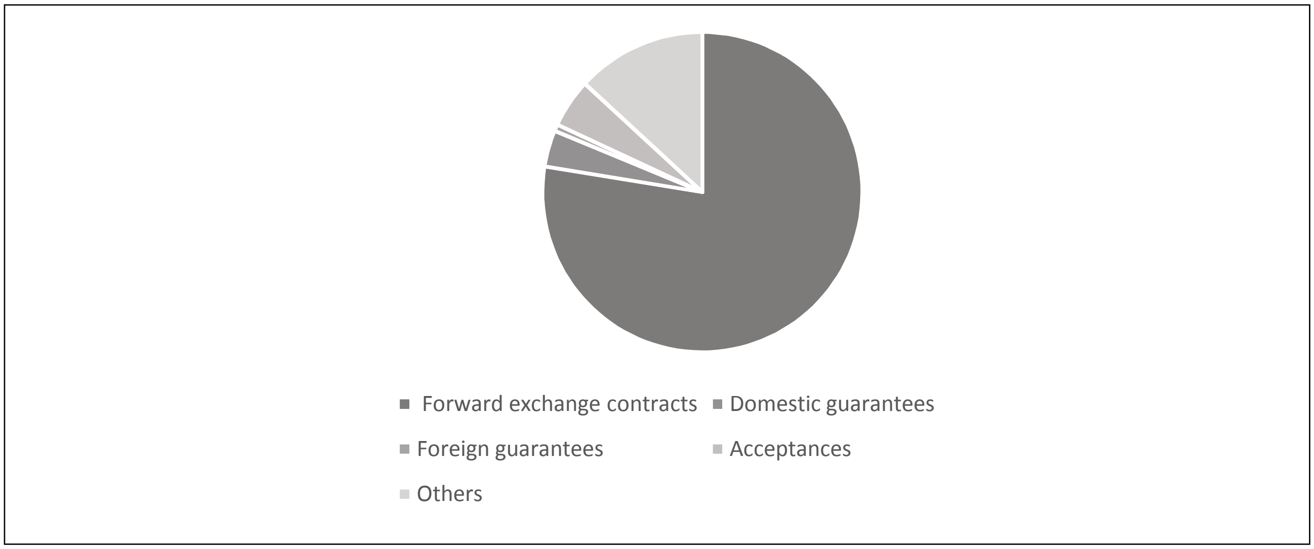
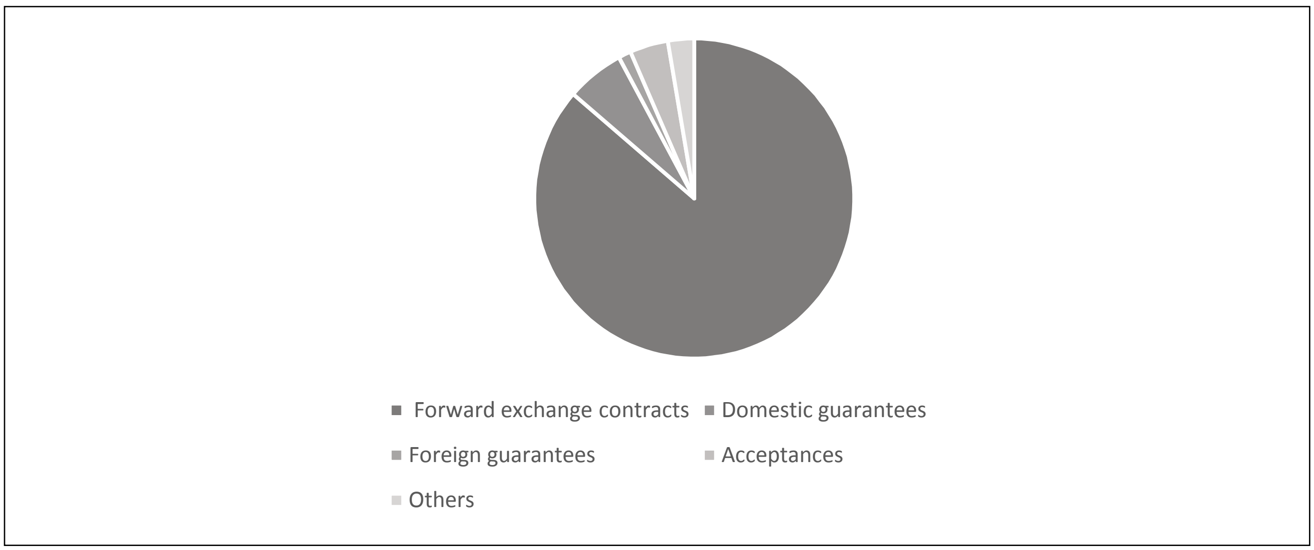


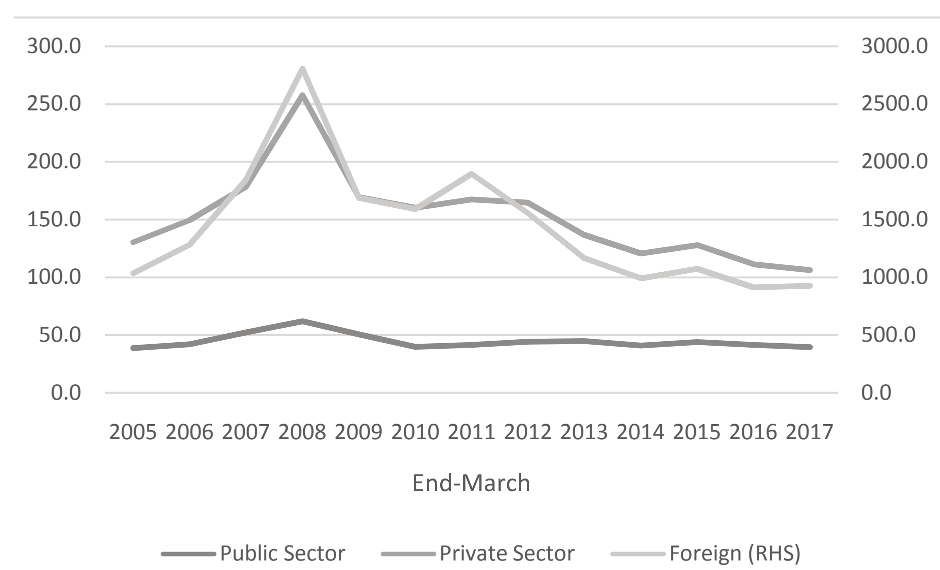
Figure 2: Pattern of Contingent Liabilities of SCBs 2016-17 (%)



This is striking, since cautious bankers would refrain from exposing their institutions to these risks despite the fact that interest rate spreads on traditional deposit-taking and lending may be small and such activity requires setting aside costly regulatory capital to deal with credit risks and potential losses. Interestingly, this diversification in favour of contingent liabilities as an important area of business appears to be less true of public sector banks. The ratio of such liabilities to total assets of the public sector banks which rose from 38.6% to 61.8% between 2005 and 2008 (Figure 3), or the years prior to the global financial crisis, subsequently shrank to touch 39.4% in 2016-17. Thus, Indian public sector banks, which also initially increased their exposure to contingent liabilities, have cut them down and have in general kept them low.

On the other hand, private sector banks and especially foreign banks, have relied hugely on contingent liabilities, exploiting the opportunities offered by the post liberalization. Though they too show similar inter-temporal trends in off-balance sheet exposure after 2005 as do the public sector banks, the magnitudes involved are much larger. Domestic private sector banks saw the ratio of their contingent liabilities to total assets on their books rising from 130.4% in 2005 to 257.5% in 2008, before registering a decline. But even in 2016-17 the ratio at 106.2% for private sector banks was substantially higher than the 39.4% recorded by the public sector banks. Finally, foreign banks saw their contingent liability to total assets ratio rise from a huge 1035.3% in 2005 to 2804.4% in 2008, and the decline after that took it to a still high 926.7% in 2016-17. At the end of financial year 2016-17, while foreign banks accounted for a little more than 5% of the total assets of the scheduled commercial banks, they held nearly 50% as much of the contingent liabilities held by the latter.

Figure 3: Ratio of Contingent Liabilities to Total Assets (%)



These trends have four implications. First that private banks pay less attention to the traditional intermediation role of banks, of mobilizing deposits and creating credit assets, which is less profitable. Second that these private banks are exposed to much larger risks, which are only rising, and therefore are subjecting their depositors, often attracted with higher interest rates, to excessive risk of loss. Third, very few foreign banks pursue the traditional banking business in India, preferring instead to focus on so-called hedging instruments in foreign exchange and interest rates, that really involve speculative forays rather banking activity. Finally, the claim that liberalization would result in private banks displacing public banks from their traditional activity has been substantially belied.

The public sector remains the nation's banker, while the private banks seem to seek out profits from speculative activity.

MARKETING DERIVATIVES

Needless to say, this expansion in the number and value of forward exchange contracts could not have taken place without an effort at marketing such instruments to buyers. In the case of foreign exchange derivatives, the buyers are exporters who are not finance savvy. This is a problem because increasingly these instruments tend to be non-transparent or opaque, and buyers are most often not in a position to assess the risk they are taking on. An example from India was the losses textile exporters from Tirupur suffered in 2007. It is well known that Tirupur emerged as a leading knitwear exporting cluster in a short period of time, with exports rising from less than Rs. 20 crore in 1985 to over Rs. 10,000 crore in 2008. Besides entrepreneurship and local circumstances, one factor that contributed to this success was the long-term depreciation of the rupee, from about Rs. 13 to a dollar in 1991 to some Rs. 50 in 2002-03. But multiple factors combined to weaken the dollar against many currencies including the rupee. For example, early in 2007 the dollar fell from Rs. 44 to the dollar in March to Rs. 40 to the dollar four months later. With the annual value of exports from Tirupur being US$ 2.2 billion, such short term fluctuations could deliver significant losses to exporters.

Sensing an opportunity here, banks and other financial players, especially the new private banks, stepped in and offered the exporters foreign exchange derivatives that they claimed would not just allow them to hedge against losses due to currency fluctuations, but also possibly earn an additional tidy sum. The products on offer were by no means transparent, and would have left most of the financially uneducated and even inexperienced knitwear exporters at the mercy of the derivatives salesmen.

One report[4] on the activity that led to large losses for the exporters reads as follows: "An illustrative derivative deal dated July 3, 2007 (with 'Tokyo cut' 'European style option' and 'American barriers' as features) expiring on May 23, 2008 reads: 'The exporter buys (and the bank sells) USD Call/CHF Put at strike 1.2300 for USD 4 million with Knock Out @1.2400; The exporter sells (and the bank buys) USD Put/CHF Call at strike 1.2300 for USD 8 million with Knock Out @ 1.24, Knock In @1.12"; "Double One touch option with trigger 1.2270 and 1.2330 with pay off USD 50000 on maturity"

[4]S. Gurumurthy, "Will the RBI probe and unravel the derivatives scam?", Business Line, July 5, 2008, and "Forex derivatives and 'Armstrong' Palanisamys" , Business Line, July 4, 2008.

"Option legs? European style? American barriers? Tokyo Cut? Double one-touch option? Knock In? Knock out? How would the school dropouts-turned exporters in Tirupur have grasped these bizarre terms? Its effect, which even some experts cannot easily comprehend, is this: (a) if the Swiss Franc (CHF) trades at 1.2270 or 1.2330 to the dollar during a term of the derivative, the exporter would get US$ 50,000 (equal then to Rs. 22.5 lakh); (b) if the Swiss Franc trades below 1.12 to the dollar, the exporter is obliged to buy US$ 8 million at 1.23, and incur a loss of US$ 880,000, or Rs. 4 crore, which will multiply if the dollar falls, as it actually did, below 1.12 Swiss Franc."

"The dollar dipped as low as 1.05 Swiss Franc in May 2008. Every cent's rise in the Swiss Franc against the dollar meant a loss of Rs. 36.37 lakh to the Tirupur exporter under the deal. The Swiss Franc rose by 18 cents, and caused a loss of Rs. 6.57 crore to the exporter's account. What excited the exporter was the prospect of a small gain — Rs. 22.5 lakh — the belly dance of the exotic derivative."

According to this observer, initially the derivatives sold did deliver profits. This attracted more exporters into the derivatives net. But subsequently losses multiplied, turning out to be much larger than warranted by the extent of the dollar's fall. One exporter, known as 'Armstrong Palanisamy' because of the brand of the knitwear he sold, was by around March 2008 reportedly asked by the banks to pay more than Rs. 30 crore to cover losses on the derivatives he bought to offset a loss due to the dollar's fall, which was ostensibly only around Rs. 3 crore.

In sum, the spread of complex derivatives builds risks both in the balance sheets of the banks and in the books of those buying into them because of the need to hedge and the dangerous allure of high profits. That can be destabilising, and damage those whose primary activity is production for export and not speculation. This does make a case for building an institutional infrastructure for safe hedging and separating it from markets for speculative assets. The framework must work to ensure adequate liquidity for the purpose without relying on the presence of speculators offering products which exporters needing a hedge cannot just unpack and understand. If the behaviour of the public banks is illustrative, the role of state-sponsored entities in such an institutional framework geared to strengthening an aspect of trade finance can be crucial.

Collective Solutions for a Resilient Trade Finance Infrastructure

12

Mr. David Rasquinha, Managing Director, Export-Import Bank of India

The developmental narratives for each country is different, shaped by their policy priorities of the past and defined by their vision of future. Nevertheless, there remain intertwined challenges to growth across countries which cannot be delinked. One such encumbrance is access to trade finance, a feature which bears remarkable concurrence in the policy agenda of developing countries, especially in the aftermath of the Global Financial Crisis.

The 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 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 compound 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 support the increase in South-South trade.

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.

TRADE FINANCE AND DFI

Trade finance 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. 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[1]

Trade finance assistance is generally provided by commercial banks and Development Finance Institutions (DFIs). Banks are the major providers of trade finance and act as a means to reduce payment risks. Alongside, the role of DFIs, including export credit agencies as providers of long term loans, project finance, guarantees/insurance, and other risk mitigating products is also crucial.

A well-functioning trade finance market enables firms which would otherwise be considered too risky, to link into expanding global value chains and thus contributes to employment and productivity growth. According to estimates, an increase in access to trade finance by 5% increases the production by 15% and induces the firms to hire 12% more staff[2]. Cleary, trade finance can help revive the faltering trade and output growth being currently faced by many countries, and thus needs to be one of the key instruments under any DFI's suite of finance programs.

Since 1990, real GDP in the Asia-Pacific region has grown by 80%, with increase in exports contributing to nearly half of this growth[3]. For the long term growth prospects for the region to remain resolutely positive, revival of exports will be a sine qua non. Micro, Small and Medium Enterprises (MSMEs),

[1]ITC (2009), How to Access Trade Finance: A Guide For Exporting SMEs, International Trade Centre
[2]DiCaprio, A., Beck, S., and J. Daquis (2014), ADB Trade Finance Gap, Growth, and Jobs Survey,
[3]Tammy L. Hredzak and Quynh Le (2013), Trends in Trade Finance across the APEC Region, APEC Policy Support Unit

which account for nearly 90% of all enterprises in most Asia-Pacific economies, have substantial latent potential to export as, at present, less than 15% of MSMEs in most of these economies are currently engaged in exports[4].

Exports growth in the region will hinge critically on a well-functioning trade finance market. The increasing regulatory constraints on commercial banks, and the need to enhance access to trade finance for MSMEs presents a case for DFIs in the region to join hands to fill the financing gaps. The credit and risk mitigation mechanisms provided by DFIs and ECAs in the region will be pivotal in infusing a new vitality to exports and economic growth.

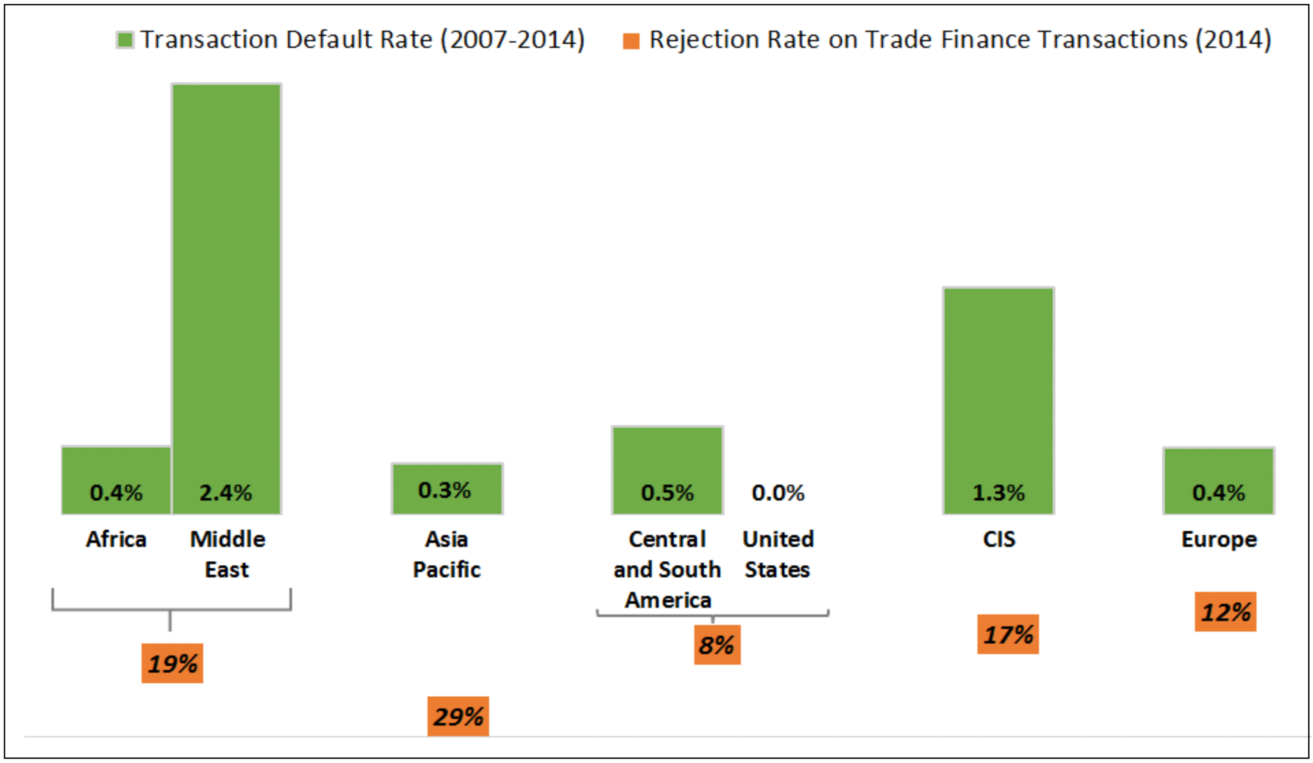
TRADE FINANCE INFRASTRUCTURE: THE CURRENT LANDSCAPE

Almost 80-90% of world trade today relies on trade finance. It is one of the safest forms of financing with less than 1% of transactions facing default. In spite of such low default rates, the global trade finance gap was estimated at US$ 1.6 trillion in 2016. For Asian developing economies alone, the estimated shortage is US$ 692 billion. The access to trade finance is further constrained in case of MSMEs. According to a survey by the Asian Development Bank (ADB), rejection rates for trade finance applications are as high as 56% in case of small and medium sized companies[5]. As MSMEs account for the majority of firms in most countries (95% on average[6]), and for the vast majority of jobs, these rejections have far reaching outcomes for the overall economy. According to WTO, trade financing gaps arise due to a mix of structural and development factors. The disinclination of the global financial sector to invest in developing countries after the 2008-09 financial crisis compounds this problem as local banking sectors are often not equipped to fill the market gap.

A region-wise analysis of the rejection rates in trade finance transactions indicates that the rate is the highest at 29% 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% and 8%, respectively. Ironically, the actual level of risk, as reflected in the default rates, was substantially lower at 0.29% for Asia Pacific as compared to 0.38% in case of Europe (Figure 1). This gap between actual and perceived risks tends to increase in periods of crisis, even though the payment record does not differ much[7].

[4]Ibid.
[5]2016 Trade Finance Gaps, Growth, and Jobs Survey, ADB
[6]World Bank
[7]Marc Auboin and Alisa DiCaprio (2017), Why Trade Finance Gaps Persist: Does it Matter for Trade and Development? Asian Development Bank Institute

Figure 1: Actual Risk of Trade Finance (Default Rates) vs Perception of Risk (Rejection Rates for Trade Finance Requests)



Source: Why Trade Finance Gaps Persist: Does it Matter for Trade and Development? Asian Development Bank Institute

These high risk perceptions in the end translate into lost opportunities for firms in developing countries. According to a survey, nearly 71% of firms facing rejection reported that when a bank declines to finance a trade transaction, they do not seek alternative financing for that transaction[8]. 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.

Apart from high risk perceptions, trade finance markets in emerging and developing economies are also characterised by lack of regulations needed to offer different instruments, limited capacity of local markets, and the inability of banks to establish correspondent relations globally. Low profits and demand in some of the countries also contribute towards low level of market development.

Cost and complexity of compliance with regulatory requirements such as Basel III and financial crimes is also a major impediment for trade finance. In fact, according to ADB's 2016 Trade Finance

[8]Asian Development Bank

Gaps, Growth and Jobs Survey, the major impediments to trade finance fall into two categories: regulatory (including Anti-Money Laundering (AML): 90% of respondents cited having impediments and Basel III: 77%) and risk-related (including credit rating of country: 82%, or issuing bank: 85%). The implementation of Basel III puts higher margin requirements on trade finance business and induces banks to either raise new capital or reduce trade finance business. The underdeveloped credit market in developing countries impacts the scope and cost of raising new capital. Borrowing from the international market may also not be a feasible option for local banks as they have to compete with borrowings from advance country financial institutions and governments. These regulatory challenges therefore exacerbate the already precarious position of trade finance in many countries.

BRIDGING THE TRADE FINANCE GAP: SEARCHING FOR SOLUTIONS

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 Multilateral Development Bank (MDBs) such as the International Financial Corporation (IFC), the ADB, the African Development Bank (AfDB), the Inter-American Development Bank, Islamic Development Bank and the European Bank for Reconstruction and Development, 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 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. Going forward, the support from these entities will remain critical for supporting trade finance transactions till the time alternative local capacity can be augmented.

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 the Export-Import Bank of India (Exim India).

There have also been cases, where co-financing has enabled ECAs to finance transactions and support domestic companies which it 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[9]. 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 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[10].

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 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.

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

[9]Berne Union Yearbook 2017
[10]Berne Union Yearbook 2016

and enhancing regional cooperation, forging stronger links among member institutions, and exchanging information and sharing ideas in a structured manner. 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 (UNCTAD) 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 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 (formerly Export Credit Guarantee Corporation of India Ltd), 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[11].

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% or more[12].

[11]Auboin, Marc (2007), Boosting trade finance in developing countries: What link with the WTO?, WTO Staff Working Paper, No. ERSD-2007-04
[12]ICC (2017), Rethinking Trade and Finance

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 digitalise 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[13]. 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[14]. 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 Letter of Credit (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.

[13]Cargill and Wells Fargo in trade digitisation first, Global Trade Review
[14]Demystifying Blockchain, Cognizant

Going forward, it will be important for governments in developing countries, development finance institutions and 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, 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.

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.

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[15].

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 financial crisis, these players have played an increasingly crucial role in meeting unmet demand, and have experienced considerable growth.

[15]Michaela Erbenová, Yan Liu, Nadim Kyriakos-Saad, Alejandro López-Mejía, Giancarlo Gasha, Emmanuel Mathius, Mohamed Norat, Francisca Fernando, and Yasmin Almeida, The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action, International Monetary Fund, June 2016

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.

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 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% of Asia's total trade.

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 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 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.

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.

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Dr. Bejoy Das Gupta is an accomplished economist with extensive experience in the analysis of economic policy, growth, capital flows, financial sector, financial inclusion, digital finance and country risk. He is an expert on Asia/Pacific economies, providing advice to the private sector on investing and managing risk, and to central banks, regulators and governments on policy choice and reforms. His is currently CEO of the advisory services firm, Das Gupta Strategy LLC. He was formerly Chief Economist for Asia/Pacific at the Institute of International Finance (IIF), serves on the Advisory Board of the Mandiri Institute and is Adjunct Professor at the Maxwell School, a leading US public affairs school.

After graduating from the London School of Economics, he received M.Phil. and D.Phil. in Economics from Christ Church, Oxford. He is a recipient of several prizes, including the AMEX Bank Review Awards in International Economics and Finance in 1988. He was born in Kolkata, India, where he completed his early education.

Dr. Marc Auboin,
Counsellor,
Economic Research and Statistics
Division, World Trade Organization

Dr. Marc Auboin is Counsellor in the World Trade Organization in charge of the trade and finance agenda, including trade finance, and WTO relations with the IMF and World Bank. He is running the WTO expert group on trade finance and has participated in various initiatives in recent years with a view to increasing the availability of trade finance when needed (G20 support package, dialogue with the Basel Committee). Marc has previously worked for the International Monetary Fund (IMF), the European Union and the French Treasury. He holds a Ph.D in economics from Sciences-Po Paris and was a research fellow at the London School of Economics and Yale University. He wrote many pieces on trade finance in IMF and WTO publications, as well as in books and the wider economic press.

Mr. Daniel Schmand,
Chairman of ICC Banking
Commission

Daniel Schmand is Deutsche Bank's Global Head of Trade Finance and located in Frankfurt. He drives the Trade Finance business and is responsible for the global Trade Finance strategy, encompassing Financial Supply Chain and Structured Trade and Commodity Finance products. Additionally he is the chairman of the International Chamber of Commerce (ICC) Banking Commission.

Daniel joined Deutsche Bank in 1987 as a trainee. He holds a Bachelor's degree of Business Administration as well as executive education at INSEAD and the International Leadership Program at Ashridge, IMD and Duke.

Ms. Diana Smallridge,
President, International Financial
Consulting Ltd.

Ms. Diana Smallridge is President of International Financial Consulting Ltd., a firm she founded in 2000. Ms. Smallridge has worked with client development finance institutions and agencies from around the world, including multilateral development banks, national development banks, SME banks and export credit agencies, on projects in over 50 countries. Her primary focal areas are institutional strategy, performance evaluation, and corporate governance. She has an extensive network within the development banking community and knowledge of best practices. Ms. Smallridge is also the Chairman of Green Capital Advisors Ltd. (GCA), a branch of IFCL focusing on the advancement and financing of climate-related technologies and services. Diana holds a master's in Economics from Queen's University, and she speaks French and English.

ECGC Ltd.

ECGC Ltd., wholly owned by Government of India, was set up in 1957 with the objective of promoting exports from the country by providing Credit Risk Insurance and related services for exports for improving the competitiveness of Indian exporters. The business of an exporter is fraught with risks resulting from geopolitical turmoil, economic downturns, currency collapses and a host of other uncertainties and they need financial protection and risk minimisation.

The Corporation has introduced various export credit insurance schemes to meet the requirement of exporters and banks. The insurance covers to exporters provides protection against the risk of non-payment from the buyer, the country of export and the bank, in cases, where the export contract is backed by a letter of credit. The insurance covers to banks enable the banks to extend timely and adequate export finance facilities to the exporters. ECGC continues to fulfil its mission to promote exports from India.

Mr. Vinco David,
Secretary General, Berne Union

Vinco David was appointed Berne Union Secretary General in March 2017. Prior to this, he has served as a Management Committee Member and as the Chair of the Investment Insurance Committee. A Dutch national, he has over 30 years' experience in various aspects of credit and investment insurance, including more than 20 with leading international credit insurer Atradius, in diverse management roles across strategy, product development, economic research, project finance, marketing, underwriting and claims.

Before joining the Berne Union as Secretary General, Vinco David served as a Management Team Member of Atradius Dutch State Business, the Export Credit Agency of the Netherlands. Prior to this he has held positions at the Berne Union Secretariat and the Netherlands Ministry of Finance.

He holds an MA in political science and international relations and a BA in economics and Italian language and literature from the Free Reformed University of Amsterdam.

Mr. Rajnish Kumar,
Chairman, State Bank of India

Mr. Rajnish Kumar assumed charge as Chairman of State Bank of India in Oct. 2017. Prior to his elevation, he was the Managing Director of the National Banking Group (NBG) at State Bank of India, since May 2015. As head of NBG, Mr. Kumar led the Retail and Digital Banking initiatives of the Bank apart from driving the vast network of over 24,000 branches of SBI.

In a career spanning over 36 years with SBI, he had held various assignments which include Managing Director (Compliance & Risk) and prior to that served as the head of SBI Capital Markets, the Investment Banking arm of SBI Group. Mr. Kumar held several key positons across various business verticals like Mid- Corporates Group and Project finance. He also served as the Chief General Manager of North Eastern Circle of SBI. As part of SBI's overseas operations, Mr. Kumar served in SBI Canada and later as Regional Head of SBI's UK Operations.

Ms. Padma Betai,
Chief General Manager,
Trade Finance, IDBI Bank Ltd.

Ms. Padma Betai is at present Chief General Manager in IDBI Bank Ltd. heading the Trade Finance Department. She has 28 years of experience in Banking and Finance. A Chartered Accountant by profession, Ms. Betai has profound experience in Treasury besides having headed various Departments of the Bank viz. Finance and Accounts, Balance Sheet Management Group, Budget and Planning, and Compliance. She has also acted as Zonal Head, and was on Deputation as Dy. CEO to IDBI Mutual Fund. Prior to joining IDBI, Ms. Betai has also worked with LIC Mutual Fund.

A Certified Associate of Indian Institute of Banking and Finance (CAIIB), Ms. Betai also holds Diploma in Treasury Investment and Risk Management.

Mr. Siddharth Sinha,
Assistant General Manager,
IDBI Bank Ltd.

Mr. Siddharth Sinha is currently working as Assistant General Manager-Trade Finance in IDBI Bank Ltd. Mr. Sinha has nearly 15 years of experience in various departments of banking. He has headed three different Trade Finance Centres in IDBI Bank and is currently associated with product and policy related to trade finance.

Mr. Sinha started his career as a Probationary Officer with Andhra Bank and worked in its Investment and International Banking Division as a FX Dealer, apart from working in Corporate and Retail lending. He has also worked with Axis Bank.

He holds a M.Sc. in Statistics and PGDBA (Finance), and is a Certified Associate of the Indian Institute of Banking and Finance.

ALIDE

Latin American Association for Development Financing Institutions

The Latin American Association for Development Financing Institutions (ALIDE) is the "Community of financial institutions that creates solutions in development banking for the development of Latin America and the Caribbean." ALIDE's aim in the activities it promotes and develops is to achieve a cohesion and to strengthen the actions and participation of financial institutions in the social and economic process of the Region.

Within the framework of a meeting promoted by the Inter-American Development Bank (IDB), held in Washington D.C., on January 24, 1968, representatives from 37 development entities from 16 countries in the region signed the articles of incorporation and bylaws of the Latin American Association of Development Financing Institutions.

Ms. Janet Hyde,
Investment Specialist, Trade Finance Program, Asian Development Bank

Ms. Janet Hyde is the Relationship Manager for the Trade Finance Program (TFP) of the Asian Development Bank, headquartered in Manila. TFP works with the financial sector in developing Asia to increase the capacity for trade which in turn supports economic growth and job creation in the region. She has responsibility for the local banks in Sri Lanka, Nepal and Bhutan that are members of the TFP, as well as for Myanmar, Cambodia and Lao PDR. Prior to joining ADB, she was based in London as a Relationship Manager in Trade and Commodity Finance for a variety of international banks including ANZ, Standard Chartered Bank and DBS, with a primary focus on financing the trade flows between Europe and Asia.

Dr. C.P. Chandrasekhar,
Professor, Jawaharlal Nehru University

Dr. C. P. Chandrasekhar is currently Professor at the Centre for Economic Studies and Planning, Jawaharlal Nehru University, New Delhi. He has published widely in academic journals and is the co-author of Crisis as Conquest: Learning from East Asia (Orient Longman), The Market that Failed: Neo-Liberal Economic Reforms in India (Leftword Books) and Promoting ICT for Human Development: India (Elsevier). He is a regular columnist for Frontline (titled Economic Perspectives) and Business Line (titled Macroscan).

Mr. David Rasquinha,
Managing Director,
Export-Import Bank of India

Mr. David Rasquinha has been appointed by the Government of India as the Managing Director of the Export-Import Bank of India. David joined Exim Bank in 1985 and since then has had a wide ranging exposure to the broad fields of Export Credit, Structured Finance, Project Exports, Risk Management, Resources and Treasury. He was a member of an Exim Bank team that conducted a feasibility study for setting up an export credit agency for the Gulf Co-operation Council countries. He has also served as a member on several Working Groups set up by the Reserve Bank of India on issues of relevance to exports and export credit. From 1999 – 2004, he served as Resident Representative at the Bank's Washington DC Representative Office, where he was instrumental in boosting Indian companies' efforts to secure procurement business. He also spearheaded the formation of an export factoring joint venture with the International Finance Corporation.

David secured a first class graduate degree in Economics from the Bombay University and followed it up with a post graduate qualification in Business Management from the XLRI, Jamshedpur where he was awarded the Gold Medal in Economics.

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