ASIA-PACIFIC RESEARCH AND TRAINING NETWORK ON TRADE
POLICY BRIEF

BRIEF NO. 47 | JUNE 2015

Financing trade and supply chains

ALEXANDER R. MALAKET *

1. Summary

International trade is widely acknowledged as a positive force in the creation of economic value and in the advancement of global development efforts and poverty-reduction initiatives. Imperfections and inadequacies in the system of global commerce aside for the moment, it is correct to consider trade to be one of the few truly global drivers of economic activity, and, as was illustrated during the global crisis, one area where national and international policy levers can be effective and highly impactful.

The dependency of international trade on access to timely and affordable financing is now well established and widely acknowledged, as the contraction in trade activity at the peak of the global crisis was traced back in part to a sudden and drastic shortage of trade financing, including vital pre-export finance. Consequently, the profile of trade finance, and of emerging propositions in supply chain finance, has been irrevocably raised and brought sharply into focus. This esoteric branch of finance, which some years ago would have yielded limited material even through a Google search, is now the subject of significant discourse, deliberation and analysis, including robust research by academics, specialists in international institutions, top-tier consultancies and industry bodies and practitioners.

Political leaders, heads of international institutions, trade and development practitioners and private sector finance and treasury executives are putting more focus on the role of financing as a key enabler of international commerce, and there is consequently, significant attention on several areas of policy that hinder or restrict access to trade finance, or areas that can positively affect the availability of trade financing, including specifically in support of small and medium sized enterprises, and trade involving developing or emerging markets.

Several major issues impact the trade financing market today, and present opportunities for the development and deployment of effective policy initiatives and measures:

- The determination and setting of appropriate levels of reserve capital to be held against trade financing transactions and portfolios

* Alexander R. Malaket author is CITP, President, OPUS Advisory Services International Inc. The author is grateful to the ARTNeT Secretariat for technical support. The views are of the author alone as are any errors or omissions. Any enquires should be sent to ar.malaket@opus-advisory.com.

UNITED NATIONS ESCAP
Economic and Social Commission for Asia and the Pacific

- Appropriate balancing of the conduct of legitimate business, against the opportunity and the need to engage banks in enforcement activities related to anti-moneylaundering (AML) and terrorism finance, through AML and client due diligence requirements captured in "Know Your Customer" requirements
- Policy initiatives aimed at increasing global capacity from a credit, risk and capital perspective, to provide trade financing
- Globally consistent policies related to the accounting treatment of supply chain finance
- Policies aimed at increasing global professional competency and human resource pools linked to trade financing
- Policy initiatives aimed at linking financing to international development and poverty-reduction
- Policy effort aimed at supporting the development of the more promising new models and sources of trade finance and supply chain finance

Policy initiatives should aim to achieve an appropriate and equitable balance between prudential oversight and the support and enablement of legitimate business through access to adequate levels of financing and liquidity. Benefits in international development and poverty reduction can flow directly from the assurance of access to trade and supply chain finance for small and medium-sized enterprises, which often make up a majority of business sector in developing economies.

2. Introduction

The techniques, products and solutions typically utilized in the financing of international commerce are not well understood outside of a small, specialist audience of practitioners. While there are long-established, “traditional’ mechanisms such as documentary letters of credit, and evolving propositions in the context of financing global supply chains, it can be argued that trade financing, even at its most complex, is about four ‘elements’ (figure 1).

Figure 1. Four Elements of Trade Finance

Source: Financing Trade and International Supply Chains, Malaket, 2014

Traditional trade finance (and increasingly, the newer propositions under supply chain finance) involves some combination of the four elements listed in Figure 1: the enablement of secure and timely payment across borders from buyer to supplier, the provision of some form of financing to one or more parties engaged together in international commerce, with supply chain finance programs potentially covering hundreds or thousands of supplier relationships, the provision of risk mitigation solutions including insurance and guarantees of various types, to protect companies engaging in trade in high-risk markets or circumstances, and finally, the flow of transactional and financial information between parties.

The post-crisis global environment around international trade is showing signs of normalizing, with at least two major changes to the environment that are likely to have long-term implications for business leaders and for policymakers around the globe.

First, the peak of the global financial and economic crisis demonstrated, clearly and convincingly, that there is a direct link between the successful conduct of trade, and the need for adequate, timely and affordable financing.

Second, the link between trade and economic value-creation, long acknowledged in development circles, remains important, but is now seen to operate best when complemented with appropriate measures linked to robust domestic economic activity and policy initiatives. Relatedly, the central role of Access to Finance (A2F) is increasingly understood to encompass trade finance and its more recent incarnation, supply chain finance, just as trade financing is increasingly acknowledged as an effective

source of financing in support of international development.

Trade financing then, has taken a rather more visible and central role in dialogue related to trade, trade policy, international development, poverty reduction, and national and well as international policy.

Industry estimates (for example, Asian Development Bank, December 2014) suggest that there is a gap of demand over supply of trade finance in the range of about $1.9 trillion per year, with over $1 trillion of the gap experienced in Asia, and a significant shortfall experienced by small and medium enterprises.

"Gaps in trade finance affect SMEs more negatively than other company respondents. This is a particular problem in Asia where more than 90% of all firms are SMEs, the majority of which do not engage in direct exports. Lack of financial access is a well-known contributor to the export shortfall. Global rejection rates of trade finance applications are highest for SMEs. Fifty percent of their proposals for trade finance were rejected in 2013, as compared to only 7% for MNCs."

Source: ADB Brief "Trade Finance Gap, Growth and Jobs Survey" December 2014

The need for adequate and affordable trade and supply chain finance is increasingly being acknowledged at all levels, including among heads of state and leaders of international institutions. There remains a significant need for education and training around the nature of trade and supply chain finance, but it is equally clear that there are ample opportunities for supporting policy initiatives that could materially and positively impact access to trade finance, and by extension, the successful conduct of trade, the creation of economic value and the reduction of poverty and the advancement of development objectives.

The post-crisis research and analysis conducted around trade finance has been critically valuable to the industry in lifting a historical veil of mystery and complexity around what was a poorly understood and specialized branch of finance. Even as the important contributions of trade and supply chain finance to the conduct of trade and to the creation of economic value are acknowledged, the industry faces serious challenges. The industry exists in an environment where well-considered policy initiatives could materially impact the availability and accessibility of financing in support of international trade.

It is helpful to explore such policy initiatives in light of the evolution of the financing of international commerce. So-called "traditional" trade finance, including well-established instruments like documentary letters of credit and others, still facilitates about 10-20% of global trade, often involving high-risk markets. At the same time, roughly 80% of trade today is conducted on the basis of open account terms, with emerging solutions in supply chain finance (SCF) aiming to respond to those high-growth trade flows.

A notable market reality is that banks remain largely focused on traditional trade finance, with less than 20% of their portfolios involving supply chain finance business (ICC banking Commission, Rethinking Trade and Finance, 2014). Traditional trade finance has been and remains largely the purview of international banks, export credit agencies and multilaterals. Emerging SCF solutions by

contrast are also provided by non-banks, technology and platform providers and others, sometimes specialist trading platforms targeting specific industry sectors.

The importance of public policy and international institution support in the area of trade and supply chain finance to complement the work of private sector providers, has been clearly and undeniably demonstrated through the global crisis, particularly at the peak of the crisis when bank-intermediated trade finance all but evaporated, and public sector and international institutions were forced to step in and address the resulting market gap.

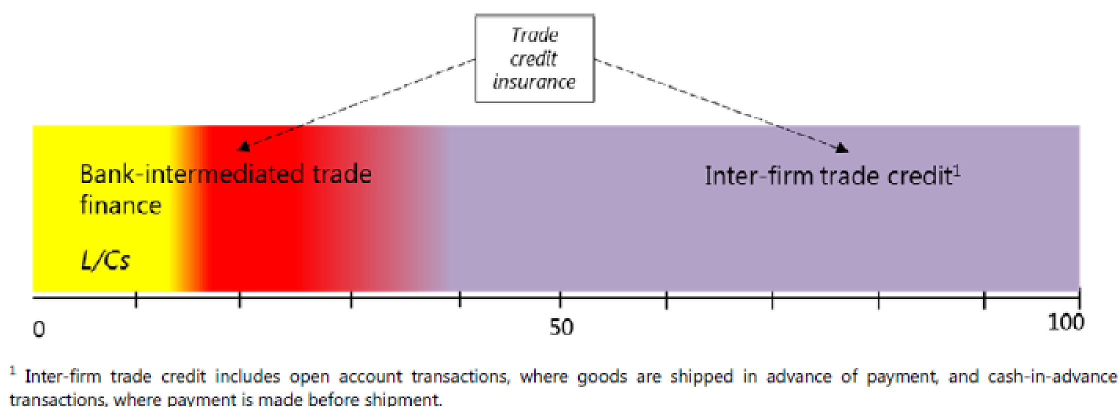
There are several major, potentially transformational areas where thoughtful public and international policy can positively impact the financing of trade and international supply chains, enabling trade by SMEs based in developing markets, contributing directly to the creation of significant economic value. High potential policy areas, elaborated from the summary list above, include:

- Capital adequacy and reserve requirements as implemented by national authorities, aimed at assuring the appropriate capital treatment of trade financing activity
- Due diligence requirements related to the need for international bankers in particular to demonstrate adequate knowledge of the parties and the transactions they finance (so-called “Know Your Client” and related requirements), as well as the expectation that banks assist in identifying and countering money laundering terrorism finance
- Policy initiatives aimed at increasing global capacity (from a credit, risk and capital perspective) for the provision of trade finance, to address the global gap and the limitations in industry capacity to provide trade financing
- Policy clarity on accounting treatment relative to emerging supply chain finance programs, aimed at providing assurance to bankers and corporates around the viability and advantages of evolving supply chain finance programs, as well as aiming at consistent cross-border treatment of these structures
- Initiatives aimed at encouraging the development of trade finance competencies, in recognition of the aging demographic of trade finance practitioners, and the inadequate flow of next-generation resources to the industry
- Policy initiatives aimed at linking financing to international development and poverty-reduction, including the establishment of linkages between, for example, trade facilitation and promotion activity, and trade financing, Policy effort aimed at enabling and supporting, through regulatory support, legal infrastructure, technology and intellectual property protection and other possible elements, the development of emerging modes of trade and supply chain financing

3. State of the Trade Financing Industry: What do We Know?

The trade finance business has historically operated 'in the shadows', with little recognition of the importance of this esoteric branch of financing in the enablement of trillions of dollars' worth of commercial activity every year, involving the full spectrum of complex and challenging markets around the world. The difficulty in sizing and articulating the variations of trade finance at play in the market today is one manifestation of this opacity.

Figure 2. Financing Global Trade: A Schematic Overview



Source: Committee on the Global Financial System: Trade Finance Developments and Issues, 2014

As illustrated in Figure 2, the clear majority of trade financing is categorized as inter-firm credit, which would include supply chain finance – an area which is increasingly attracting the interest of banks (among other providers). Export and trade credit insurers, both public sector and private sector, support approximately 1 trillion in annual trade flows (Berne Union, 2014), and play a critical role, along with multilateral development banks, in enabling access to difficult or high-risk markets.

Exact market sizing and distribution of transaction volumes across product types or categories of trade financing activity is difficult to achieve given the limited data available, thus the colour bands can be seen to represent the reality that categories of trade finance can overlap into each other. While Letter of Credit (L/C) volumes can be relatively easily ascertained through related message flows between banks, other categories shown above are less easily quantified by volume or by value, and thus are shown as merging into the next category.

The global financial crisis and the economic crisis which followed, and persists in many markets, resulted in an unprecedented visibility and positive acknowledgment of the value of trade and supply chain finance. Political leaders and heads of international institutions are working actively today to ensure the availability of adequate and affordable levels of trade-related financing, including specifically for SMEs and for emerging and developing markets.

4. Reserves and Capital Adequacy

Industry associations and organizations like the International Chamber of Commerce (ICC) Banking Commission have undertaken data collection and analysis aimed at objectively demonstrating the very favourable risk profile of trade finance, through the ICC Trade Register, with the result that regulatory authorities have recalibrated the treatment of trade finance in terms of reserve and capital adequacy requirements, to better align with the risk profile of this form of financing.

The issue of capital adequacy and maintenance of adequate reserves and capital structure in financial institutions can be complex and multi-faceted, but in its simplest form, comes down to the notion that banks, as regulated lenders and as critical actors in the global financial system, should maintain certain levels of capital in "reserve", based on certain regulatory targets determined in part by the risk profile of an institution's business.

While trade financiers have long argued anecdotally that the business of financing international commerce is low-risk, and has a low incidence of default and loss, regulatory authorities required objective demonstration of these claims as a basis for reconsidering what otherwise would have been disproportionately severe requirements, leading to an increase in the capital cost of trade finance.

Table 1 below, extracted from an annual ICC report on trade finance default and risk experience, is the most recent publicly-available data and clearly illustrates the negligible default experience in traditional trade finance, across a large pool of data drawn contributed by the leading global trade finance banks and representing perhaps 60% of global volumes.

Table 1: Default and Loss Data, Trade Finance

TOTAL 2008-11	TRANSACTION DEFAULT RATE	DEFAULTED TRANSACTION LOSS RATE	M (IMPLIED, DAYS)	SPECIFIC TXN-LEVEL LOSS RATE
Import L/Cs	0.020%	42%	80	0.008%
Export Confirmed L/Cs	0.016%	68%	70	0.011%
Loans for Import	0.016%	64%	110	0.010%
Loans for Export: Bank risk	0.029%	73%	140	0.021%
Loans for Export: Corporate risk	0.021%	57%	70	0.012%
Performance Guarantees	0.034%	85%	110	0.029%
Total	**0.021%**	**57%**	**90**	**0.012%**

Source: Global Risks Trade Finance Report 2013, ICC Banking Commission

To put the above data in some perspective, one can review corporate loan default data reported through rating agencies, or line of business data, such as credit card loan losses which might amount to 10-15% of a portfolio, or domestic mortgage losses which could reach 5% of a portfolio, as against losses related to Confirmed Export Letters of Credit, row two in the table, at 0.011%.

The regulatory standard is proposed by the Basel Committee on Banking Supervision in Switzerland,

however, interpretation and implementation is the responsibility of regional and/or national regulatory authorities, and the implementation of these standards, staggered across geographic markets, creates variance and the issue of 'regulatory arbitrage' – a reality that has commercial implications for the conduct of international commerce. The scope of data collection and analysis, as well as of related advocacy efforts with regulatory authorities will necessarily increase, as will the robustness and sophistication of the methodology applied to the conduct of this research.

The policy opportunity here is to ensure that the execution of Basel requirements around capital adequacy are implemented in a manner that achieves the intended regulatory objectives while enabling access to adequate levels of trade-enabling financing. This policy-related activity should involve a degree of education about the nature and impact of trade finance, and its role in enabling trade and the creation of economic value.

5. Due Diligence: KYC and AML

In addition to capital adequacy, financial institutions, especially banks, are facing increasing pressure to participate in enforcement activity in support of local and international policing. Banks are required to engage in significant levels of due diligence related to their own clients, as well as on their client counterparties, under "Know Your Client" (KYC) and "Know Your Client's Client" (KYCC), along with anti-money laundering and anti-terrorism monitoring and reporting requirements.

The paper ["Regulatory Issues Affecting Trade and Supply Chain Finance, 2014] notes the adjustments to Basel 3 regulations on account of the low risk profile of trade financing but cautions about the potential adverse impact of regulatory arbitrage on competitiveness due to uneven implementation of Basel rules across economies. Other major challenges to trade and supply chain financing pertain to difficulties of onboarding suppliers in the supply chain finance platform due to stringent Know-Your-Customer (KYC) and CDD rules. At a minimum, the paper suggests a central database in each economy where KYC-relevant company information are stored and accessed by financial institutions to ease the burden of executing KYC/CDD.

Source: Regulatory Issues Affecting Trade and Supply Chain Finance. APEC Policy Support Unit, Issues Paper No.8, 2014

KYC and AML demands placed upon financial institutions, though certainly understandable and clearly helpful in various dimensions of investigative and enforcement activity, do place significant staffing,

预览已结束，完整报告链接和二维码如下：
https://www.yunbaogao.cn/report/index/report?reportId=5_4209