Asia Pacific Trade Facilitation Forum: Background Paper for Session 2 (Trade Finance)

Expanding Trade through Supply Chain Finance[1]

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Executive Summary

This background paper provides an overview of trade and supply chain finance as an essential enabler of global trade. Trade finance has been brought sharply into focus by the global financial and economic crisis. While trade finance is a somewhat esoteric subset of finance, it has benefitted from unprecedented profile, professional and political support over the past five years, in particular.

The profile of trade and supply chain finance has enabled the industry to better convey its value and better advocate for resources, innovation and broader engagement of key decisionmakers on a global scale, with the ultimate aim of assuring adequate levels of liquidity in support of international commerce. Trade finance has a long and successful track record of enabling trade, perhaps 80-90% of which requires some form of liquidity or risk mitigation support through trade finance mechanisms.

The paper provides an overview of both traditional and emerging mechanisms of trade and supply chain finance and endeavors to demonstrate a direct link between such instruments and reveal their ability of developing economies and their businesses, including small and medium enterprises (SMEs) to engage in and benefit from inclusive, trade-based development.

The paper provides an overview of the trade and supply chain finance sector, exploring the role of banks as well as public or quasi-public sector export credit agencies (ECAs) and various

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[1] This paper is prepared by Alexander R. Malaket for the Asia Pacific Trade Facilitation Forum. The author appreciates comments from staff/consultants of Asian Development Bank (ADB) and United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP). The views expressed in this paper are those of the author and do not necessarily reflect the views and policies of ADB and UNESCAP.

International Financial Institutions (IFIs) whose support to trade through financing and risk mitigation solutions has proved critically important to developing markets.

The paper identifies several recurring, global challenges related to the financing of trade and international supply chains:

- Understanding the Gap: The sector is not well understood
- Innovation Inertia: Innovations, historically, have been relatively rare and ineffective
- Capacity, Concentration and Constraints: The sector exhibits insufficient capacity, with a limited number of providers and significant constraints arising from regulatory requirements
- Risk Aversion: SMEs and developing markets are underserved
- Cost, Complexity of Traditional Trade, Definition of SCF: Traditional instruments are unpopular, complex and costly, while new mechanisms are still being defined and developed
- Position and Role of ECAs and IFIs: The role of these institutions is increasingly important, though in some instances, the collaborative/competitive posture of ECAs and IFIs relative to banks and other providers can be inconsistent
- Technology and Multibanking: Development and adoption of technology is central to the needs of importers and exporters, but can be slowed by the existence of legal systems and practices
- Financing Commodity Trade: Commodity prices are alleged to be significantly inflated by speculation; it is a question whether higher trade financing costs are contributing to this systemic issue

Trade and supply chain finance and the challenges surrounding it have direct implications for trade and its benefits in developing markets.

An overarching message from this paper is that there is an unparalleled opportunity to contribute to the evolution of trade and supply chain finance. The breadth of stakeholders and issues suggests that an event like the Asia Pacific Trade Facilitation Forum (APTFF) is well-placed to generate substantive ideas and recommendations, including enhanced integration of financing into the disciplines of trade development and promotion.

The paper proposes several questions for consideration and discussion, and concludes by offering several preliminary recommendations:

- Devise and execute a targeted and customized advocacy program aimed at articulating the value and potential of trade and supply chain finance as an element of an overall trade facilitation, development and promotion program
- Support the completion of a study aimed at identifying transaction-level opportunities to provide additional trade financing mechanisms and capacity in support of flows to and from developing economies in the Asia-Pacific Region
- Mandate an executing agency to assess the potential of the SWIFT/International Chamber of Commerce (ICC) Bank Payment Obligation as an effective mechanism for trade and supply chain finance, specifically considering whether the model requires modification, or complementary mechanisms such as guarantee schemes to make it viable in the context of development-related trade

- Request the development of trade and supply chain finance training programs aimed at businesses of all sizes in local markets, including delivery through web-based or mobile channels as feasible
- Create an Asia Pacific Centre of Excellence in trade and supply chain finance, mandated to serve as a source of expertise, professional development and knowledge repository around trade finance, and empowered to design programs to attract a next generation of specialists in the field of trade finance

The approach taken in this paper has been aimed at providing foundational information, a consideration of selected, illustrative issues, and initial suggestions linked to trade and development, globally and in Asia and the Pacific. The paper is intended to provide a basis for further discussion at the APTFF and beyond, ideally, leading to concrete progress in leveraging trade and supply chain finance as an effective enabler of inclusive, trade-based development.

1. Introduction: The Significance and Scope of Trade Finance

Trade finance is a specialised type of financing, focused entirely on the financing of international trade, both import and export. Trade finance is often perceived to be complex, even by seasoned bankers and finance experts. It involves four fundamental elements that are combined and emphasized to different degrees, based on the needs of a particular trading relationship or transaction.

Trade cannot take place without financing, and thus, the importance of trade finance can be appreciated, by noting that global trade flows have been in the range of $15-17 trillion annually, and that such flows contribute directly to economic value-creation and growth, and is a significant portion of gross domestic product (GDP) for many economies. 80-90% of trade flows globally are supported by some form of financing. Without adequate levels of financing and liquidity, the vast majority of global trade flows could not take place.
Practitioners are aware of this reality. The peak of the global crisis brought this reality sharply into focus, when trade finance suddenly became tightly constrained and expensive, and trade flows from Asia to Europe and the Americas dropped by 40%, with direct impact on the economies involved.

Trade finance supports and enables the vast majority of global trade, particularly transactions involving merchandise and manufactured goods, commodities and many other "real economy" related trade flows. The peak of the global crisis demonstrated the critical importance of maintaining adequate levels of liquidity in trade and supply chain finance, in that the implosion of the bank-to-bank lending market at that time, resulted in a shortage of trade finance, and an immediate drop in trade flows from Asia to Europe and the Americas, as noted earlier.

The increasing role of emerging economies in shaping global trade flows will further reinforce the linkage between trade finance and international development. As the link between international development, poverty reduction and trade flows continues to be championed, the timing is opportune, and appropriate to actively promote and incorporate the linkages to trade and supply chain finance, doing so in the context of public/private partnerships, but also with reference to the emerging patterns of trade and international investment, and the technology-driven commercial models that shape the global landscape today.

The financing of international trade typically involves some combination of four things, as follows:

- Secure and timely payment across borders or across the globe
- Financing of one or more of the parties (importer, exporter or bank) engaged in trade
- Effective mitigation of a variety of risks, including country, political, bank and commercial risks, among others
- Information about the status of a physical shipment and related financial flows

As with other forms of financing, trade finance can be provided over various terms or durations, ranging from a few days to considerably longer. The expression "trade finance" refers to the short-term category of transactions, covering terms up to 18 to 24 months in duration, with deal structures varying from relatively straightforward to complex. That is, a trade finance transaction

might involve a loan that is provided, and repayable, over a two-year period. More typical terms are 30, 60 or 90 days.

Trade finance helps companies to trade more securely, by transferring risk and by enabling financing and payment across borders. An exporter could do business directly with a foreign-based buyer, simply arranging payment by an agreed means, and accepting the risks associated with that buyer and their market. Likewise, the importer could agree to transact on similar terms, taking the risk that the shipment is not sent, or that the goods are not as agreed, whether from a quality point of view, or a specifications perspective.

Buyers, in general, will seek to delay payment if commercially feasible to keep as much liquidity and cash available to run and grow their business. At the same time, sellers will seek to accelerate the collection of outstanding invoices – get paid quickly – to ensure that their own cashflow needs are well met. Trade finance solutions can allow an exporter to accelerate collection of fees due, while also enabling an importer to delay payment. This is done by having one or more banks (or trade financiers) provide financing to the exporter, the importer or both: paying the exporter before the due date of an outstanding invoice, and allowing the importer to pay later than would otherwise be expected.

Trade finance instruments such as documentary letters of credit allow importers and exporters to involve banks as intermediaries in a trade transaction, providing greater security for both buyer and seller, and enabling access to financing for one or both trading partners. Supply chain finance solutions also assist in meeting the needs of both importer and exporter, even when those needs might seem to be in conflict; for example, an exporter seeking to accelerate payment, and an importer hoping to delay payment if possible. Trade finance today is discussed in terms of two broad categories: traditional trade finance, and supply chain finance.

The so-called traditional trade finance refers to long-established instruments and practices such as documentary letters of credit, generally involving an importer and an exporter (with, perhaps, a broker or middleman). As businesses have shifted away from such instruments due to the expense and perceived complexity of such transactions, the preference has been to conduct trade on the basis that the importer will send payment once the shipment has been sent. This is referred to as trade on "open account" terms. In response to this shift away from traditional trade instruments, the banks (and other providers) worked to develop new trade financing options and mechanisms, largely on the basis of the needs of international supply chains.

Supply chain finance is the term used to refer to these "new" solutions, which can involve some banks, one or two very specific products, and for others, comprehensive programs covering, say one large buyer and dozens of suppliers. Supply chain finance is particularly promising in terms of assuring adequate levels of trade finance to SMEs, including those located in developing and emerging markets, thus potentially well suited to providing financing solutions in support of international development.

2. Description of the Sector

Trade finance, as noted earlier, is fundamentally about four things, illustrated in Table 1 below. Although these elements can be found in varying degrees in most transactions, trade finance is a branch of finance that is currently in flux, encompassing a set of familiar and long-established instruments and practices, as well as a more recent proposition referred to as supply chain finance. Some will argue that supply chain finance is a repackaging of long-familiar finance and banking solutions, however, the distinctive and notable development relates to the way that supply chain finance has been positioned by leading providers – as a comprehensive program aimed at supporting global supply chains, and not merely as a set of individual financing products under a new name.

Table 1. Four Elements of Trade Finance

Payment	Financing	Risk Mitigation	Information
▪ Secure ▪ Timely & Prompt ▪ Global ▪ Low-cost ▪ All leading currencies	▪ Available to importer or exporter ▪ Several stages in the transaction ▪ No impact in Operating Line for exporters	▪ Risk Transfer ▪ Country, Bank and Commercial Risk ▪ Transport Insurance ▪ Export Credit Insurance	▪ Financial flows ▪ Shipment Status ▪ Quality of Shipment ▪ L/C systems include web & desktop solutions

Source: OPUS Advisory Services International Inc.

For some financial institutions, trade finance refers to both the traditional form, and the supply chain component, where others have opted to position traditional trade finance as a subset of supply chain finance. For others yet, both the traditional trade and the supply chain elements are part of an even broader category of solutions referred to as Working Capital Management.

For the purposes of this document, we suggest that trade finance refer to the broad category of activities, and that this category be divided into traditional trade finance and supply chain finance.

Since the eruption of the global crisis, the importance of financing and liquidity, including trade financing, has become a core element of the value proposition of international financial and development finance institutions. While entities such as public sector export credit agencies (ECAs) originated in post-World War II Europe, there has been some evidence of interest in such entities among developing and emerging markets.

The source of trade financing in response to the needs of developing markets need not be provided by banks, whose activities represent the majority of global market share, certainly in traditional trade finance. In fact, trade finance aimed at developing economies is, perhaps, better provided as a matter of public policy or as part of external development support, not even necessarily on commercial terms. This suggestion stems from the view that the risk profiles of developing economies are often considered to be unfavourable, with commensurately expensive mitigation solutions. The challenge is exacerbated for companies located in developing markets wherein those seeking trade finance are often SMEs with limited experience about which due diligence information is difficult to access.

ECAs are, originally, public sector entities mandated to support the “national interest” of their home jurisdictions through the development and support of export opportunities for businesses of all sizes, including SMEs. In some cases, an ECA might support a transaction on the basis of creating benefit from the national economy, even if such a transaction were commercially unviable, whether the private market might deem it unprofitable, or unacceptably risky.

The mandates and sophistication of ECAs have evolved significantly over the last several decades, and there is a wide spectrum of types of mandates and organizational structures around ECAs globally. From public sector entities focused on a policy-based mandate, to semi-privatized or fully privatized organizations, some operating on terms that approach commercial terms, there is no shortage of models that can be analyzed and adapted for use in the Asia and the Pacific Region.

Certain ECAs, such as the Export-Import Bank of the United States, operate on the basis of non-competition with the private sector, while others take both a collaborative and a competitive posture relative to private sector sources of liquidity or risk mitigation. While some ECAs focus strictly on risk mitigation through insurance and guarantee products, along with some level of financing support, others extend their activities to include equity investment in companies (even those based outside the home country) on the expectation of eventual generation of economic benefit.

While there was serious discussion pre-crisis about whether ECAs ought to be phased out as redundant, the crisis demonstrated beyond debate that the private sector could not assure adequate liquidity in times of crisis, and the work of ECAs together with International Financial Institutions (IFIs) proved to be critically important to the revitalization of global trade flows.

The recognition of potential synergies in the work of ECAs and IFIs is well illustrated by a recent announcement (May 2013) indicating that the Berne Union, an industry group representing member ECAs around the world, and the IFC, have agreed to “scale up” collaboration in support of trade and investment.

Developing and emerging markets have invested in the development of ECAs, and in the context of the APTFF, it is worth noting that there may be value in considering the development of a regional ECA-type entity mandated to support development-related trade, with particular, policy-driven focus on SMEs. There have been discussions in the past, about the viability of a pan-European Union ECA; while the degree of regional integration is significantly different, the notion of an organization empowered to support Asia and the Pacific trade flows involving SMEs appears well-linked to the themes of the APTFF.

It is instructive to note that the top ten countries accounting for Berne Union members’ short term credit insurance exposure are overwhelmingly “developed” economies Table 2.

Table 2. Berne Union Members’ Short Term Credit Insurance Exposure

Credit Exposure by Country (Top Ten)	Claims Paid by Country (Top Ten)
The United States	Italy
The United Kingdom	The United States
Germany	Iran

Italy	The United Kingdom
France	Spain
China	Germany
Spain	Mexico
The Netherlands	Greece
Brazil	Brazil
Switzerland	France

Source: Berne Union Statistics

Aside from the increasingly significant efforts of international institutions, it is difficult to find concerted focus on trade finance requirements and issues linked to international development. Pre-crisis, there was significant interest among a small number of hedge funds, in facilitating access to trade finance in support of trade flows to and from Africa, ostensibly due to attractive margins arising from perceived risk.

Stakeholders focused on international development, and the need for trade financing in this context, have several opportunities:

- The emergence of supply chain finance presents opportunities for SMEs suppliers in developing economies to access liquidity at reduced cost
- The public dialogue around trade finance and its high profile as an enabler of trade and economic value-creation is now mature, and can be extended to international development
- The roles of IFIs and ECAs have increased as a result of private sector banks retreating from the business or from certain markets, with the resultant gaps needing to be addressed through IFIs and ECAs, and there is an opportunity to link development-related trade finance to the expanded mandates of such institutions
- Governments in developing economies can increase their collaborations with IFIs in supporting the training of their bankers as well as their importers and exporters in trade finance, and can support, from a legislative and regulatory perspective, the use of emerging financing structures as well as new, technology-based models for the conduct and settlement of trade transactions. One such solution, the Bank Payment Obligation, is discussed in a subsequent section of this paper.

2.1. Traditional trade finance

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