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

Expanding Trade through Supply Chain Finance[1]

Content

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

[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

Traditional trade finance involves the use of instruments and mechanisms that have been in existence since at least several hundred years. The Documentary Letter of Credit or L/C is supported by a long-established and globally understood set of rules and practices, including a set of guiding rules called the Uniform Customs and Practice (UCP) for Documentary Credits, first published by the International Chamber of Commerce (ICC) in 1933. The majority of countries on the globe, including the banks in those countries engaged in international trade finance, have agreed to be guided by the UCP in their use and interpretation of documentary letters of credit, which allows these instruments to be commercially effective in almost any commercial, legal and political context in the world.

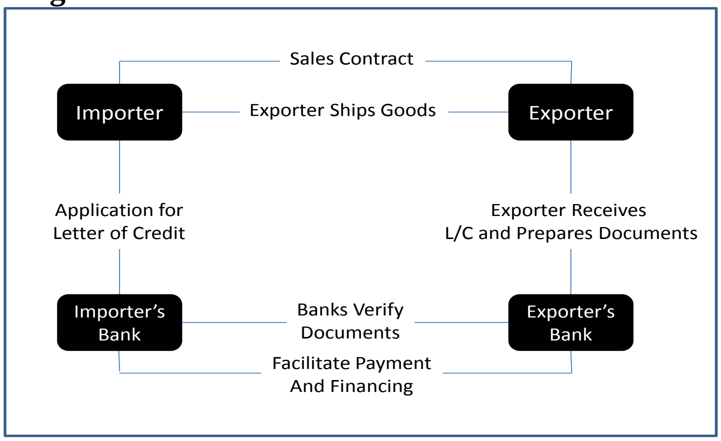
The UCP and a series of related guiding rules are published by the ICC, however, they are “managed” and assisted in their evolution and regular updating, by the national committees of

countries that have agreed to follow the UCP (and its equivalent and complementary sets of rules such as the Uniform Rules for (Documentary) Collections, the Uniform Rules for Demand Guarantees, and the companion International Standard Banking Practice). Given the maturity of these rules, and their application today across a wide range of markets and legal traditions, the major obstacle to adoption by developing markets that have not yet signed on, relates directly to technical competence.

This issue has practical and forward-looking implications, in that a major new innovation in trade finance, the Bank Payment Obligation (discussed in detail later in this paper) is also supported by a set of ICC rules that are similar in character to the other sets of existing rules.

Figure 1 below illustrates a basic transaction flow where importer and exporter agree to trade on the basis of a documentary letter of credit, also referred to simply as a letter of credit, and often abbreviated as L/C.

Figure 1: Basic Letter of Credit Transaction Flow



Source: OPUS Advisory Services International Inc.

The importance and value of an L/C can be appreciated by imaging the complexity and risk of doing business with a company halfway around the world that is perhaps not well known, and where data such as credit reports, commercial reputation and so forth, can be difficult to obtain.

By agreeing to use a letter of credit, importers and exporters achieve a balance in protecting each other's interests. An importer is assured that payment will only be effected, once the exporter demonstrates compliance with all the terms of the letter of credit as they were agreed, and the exporter is assured that if all terms are fully met, the exporter will receive payment, even if the importer happens to go bankrupt, for example, or economic or political tensions in the importer's country impacts the importer's ability to pay.

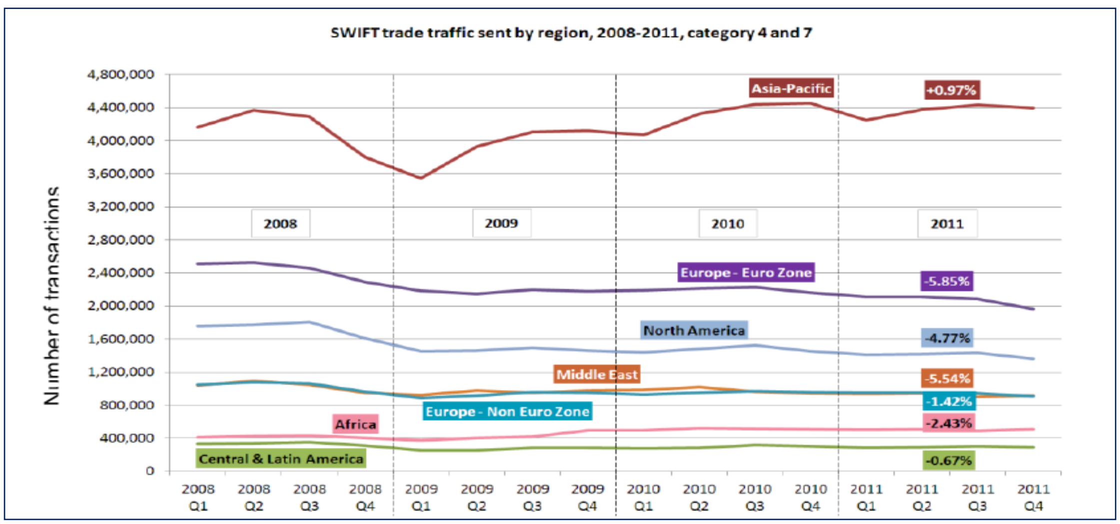
The mutual protection comes from the fact that banks act as intermediaries, with the bank issuing the L/C (typically, the importer's bank) providing a payment promise (the L/C) that has legal standing and on which the exporter can rely, independently of the importer. Banks engaged in trade finance know very well that they must respect accepted practice and legal requirements, as failure to do this will erode the market's confidence in a bank's trustworthiness as a provider of trade finance solutions.

Letters of credit provide additional value based on a variety of features that are available and can be incorporated in the terms and conditions of the letter of credit, such as the option to "Confirm" a letter of credit. This is the scenario where an exporter may be selling into an unfamiliar or high-risk market, where the ability of the issuing bank to make payment, is in doubt, either because the bank is unknown to the exporter, or perhaps because the risk situation in the importing market is considered to be significant. In such cases, the exporter may deem it prudent to ask a bank they trust (their own bank, or a well-known international institution) to add its own separate, standalone payment promise (or Confirmation) to the letter of credit. The exporter will pay for this option, and can then present documents for payment to the Confirming Bank, effectively avoiding any risk related to the importer, the Issuing Bank and even the importer's country.

While traditional instruments and mechanisms remain important, their relative use is in decline and has been for many years. Traditional instruments like the letter of credit are commonly used in higher-risk markets, or in times of crisis, with the majority of trade today conducted on open account terms.

Traditional trade finance instruments like documentary credits and documentary collections are transmitted primarily in the form of structured electronic messages developed by a Belgium-based cooperative called SWIFT. Figure 2 shows message traffic flows from 2008 to 2011, covering 7-series messages (L/C's) and 4-series messages (documentary collections), clearly illustrating that transaction volumes are flat and trending down.

Figure 2: Documentary Credit and Documentary Collection Volumes by Region



Source: SWIFT, 2012

Traditional trade finance is provided largely by major international banks, with some estimates suggesting that the top five to ten providers control as much as 70-80% of the global market share in this area.

As noted earlier, traditional trade instruments are typically used when trade involves markets that are perceived to be high-risk, though historically, they were also meant to be used in the context of new trading relationships, where trust between buyer and seller has not yet been established.

Traditional trade mechanisms, particularly letters of credit, involve significant levels of manual intervention, and paper flows that take time and involve transactional expense in executing. Importers and exporters are increasingly dissatisfied with the timeframes and the cost involved, given that shipments often reach their destination before the document verification and dispatch process is completed between the banks and the exporter and importer. While letters of credit are meant to provide balanced protection to buyer and seller, the practical reality is that exporters are not particularly effective at preparing documents that are in compliance with terms specified in letters of credit. Globally, initial presentations of documents (prior to any corrections that are made) are non-compliant in 60-70% of cases, and in the Nordic region, as much as 80% of transactions.

This is also a driver for the shift from traditional mechanisms to open account trade. As noted earlier, trade finance banks have aimed to remain key players in the financing of international commerce, by devising supply chain finance products and programs, with a view to offering such solutions in response to the shift to open account trade.

2.2. Supply Chain Finance

While banks have a significant and profitable role to play in traditional trade finance, they are far less involved in open account transactions, simply sending a payment to the exporter once instructed to do so, and having little basis on which to offer financing or risk mitigation solutions.

As importers and exporters shifted their preferred payment option from traditional instruments to open account terms (which they see as less complex, less expensive and faster), banks developed supply chain finance as a way to remain involved in the financing of international trade.

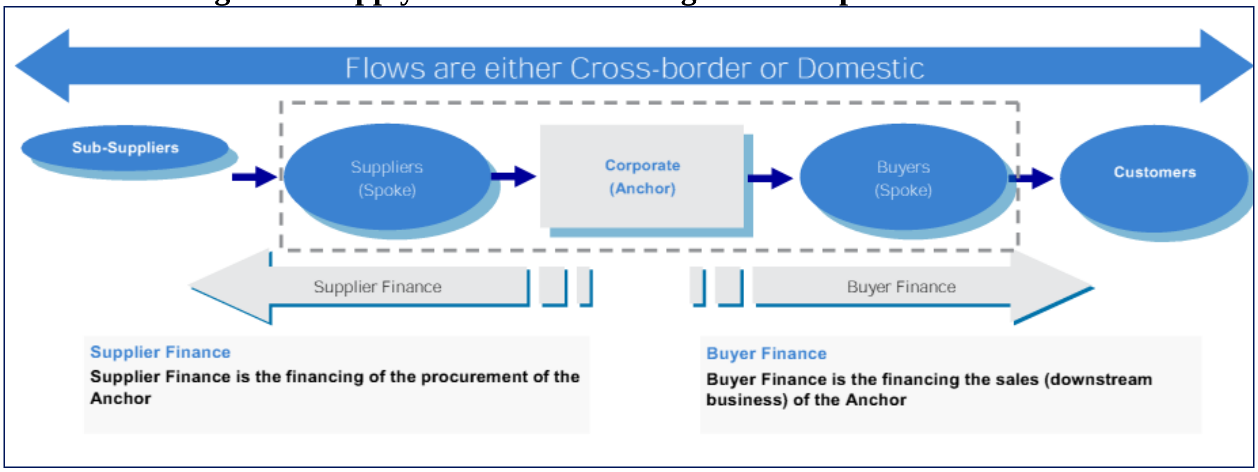
Supply chain finance is still very much in development and evolution, to the extent that even the language used to describe and define this product or solution is not yet consistent across the industry. Some banks refer to supply chain finance to describe a standalone type of product that allows an exporter to accelerate the payments of invoices through a bank, while others use the same expression to describe comprehensive financing programs that can involve dozens or several hundred entities, and various financial structures.

Supply chain finance recognizes the increasing importance and impact of international supply chains on the conduct of international commerce. Trade is increasingly about sourcing from multiple suppliers across multiple markets, even in the production and sale of a single product. The traditional importer/exporter relationship, bilateral in nature, is increasingly giving way to “ecosystems” of trading relationships framed in international supply chains and value chains: a reality to which supply chain finance solutions are very well suited.

Figure 3, illustrates one version of a supply chain finance program, as developed by Standard Chartered Bank. The program available can provide solutions to buyers and suppliers, as well as to other banks perhaps lacking the capacity or expertise to provide such programs to their own

clients. Other providers may choose to extend their offer of financing to sub-suppliers, or to distributors, that is, moving upstream and downstream in the supply chain.

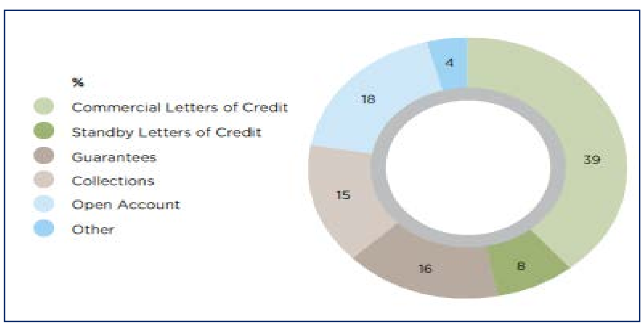
Figure 3: Supply Chain Finance Program – Corporate and Bank



Source: Standard Chartered Bank

Estimates quoted in the ICC Annual Survey, Rethinking Trade Finance 2013, suggest that banks are active in only 5-10% of supply chain finance transactions in the UK, France and Germany, indicating that there is significant opportunity for greater engagement by banks, and that the majority of supply chain solutions appear to be provided by non-bank entities. Figure 4 below illustrates the relative share of import-related products in bank portfolios, showing open account (supply chain-type) transactions to be at about 18% of banks' overall import portfolios.

Figure 4: Distribution of Import Trade Products



Source: International Chamber of Commerce, Rethinking Trade Finance, 2013

Industry specialists, quoted in the ICC's "Rethinking Trade and Finance 2013" convey the view that supply chain finance will be a major source of innovation in the financing of international trade, and note that the needs of corporates, in the context of broader supply chain management practices, will extend, to include comprehensive sets of financial solutions, including financing, hedging and settlement. Such requirements will also include greater attention to risk mitigation solutions in the context of evolving trade and supply chain finance propositions.
The opportunity linked to supply chain finance is such, that UK Prime Minister Cameron invited some members of the FTSE 100 to Number 10 Downing Street, to discuss the ways in which leading British corporates could engage in supply chain finance activity, as one means of

providing financing to the small and medium enterprise segment, deemed crucial to the country's economic recovery. A similar logic can very legitimately apply to leveraging supply chain finance programs to facilitate access to financing for SMEs located in developing and emerging markets.

Table 3 shows some high-level estimates of the different types of trade finance, matched against the 2008 global merchandise trade flows of $15.9 trillion as estimated by the IMF. The Open Account category would, in that timeframe, include a limited amount of what today would be referred to as supply chain finance, whereas the Bank Trade Finance category, and perhaps the Cash in Advance and the ECA-Guaranteed category would encompass traditional trade finance.

Table 3: Trade Financing Arrangements

<table>
<tr>
<td rowspan="2">Cash in Advance

19-22%
$3-3.5 trillion

Exporter may have leverage or provide a unique product</td>
<td rowspan="2">Bank Trade Finance

35-40%
$5.5-6.4 trillion

Includes 'traditional' trade finance such as letters of credit (~ 10%), collections (~2%)</td>
<td colspan="3">Open Account

38-45%
$7.2 trillion

Increasingly common, generally less expensive and less complicated than traditional bank trade finance, requires risk mitigation</td>
</tr>
<tr>
<td>ECA Guaranteed

$1.25-1.5 trillion</td>
<td>Arm's Length Non-Guaranteed</td>
<td>Intra-Firm

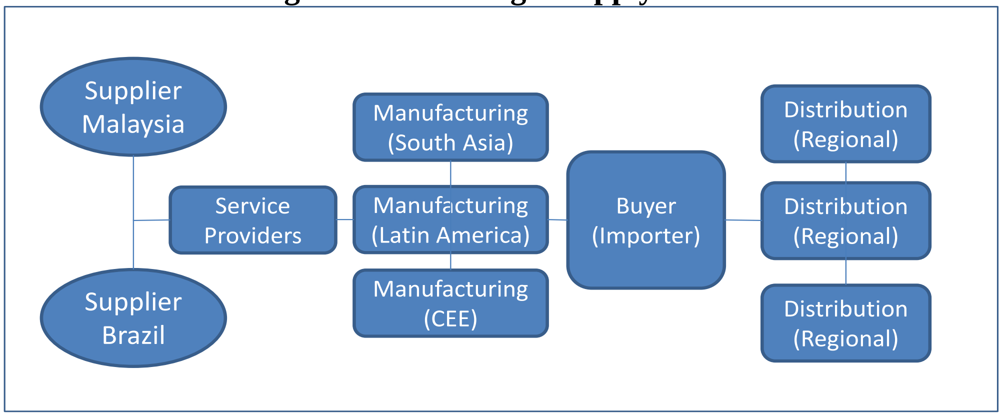
Significant volume among multinationals and their affiliates</td>
</tr>
<tr>
<td colspan="5">Global Merchandise Trade, 2008
$15.9 trillion (IMF Estimate)</td>
</tr>
</table>

Source: OPUS Advisory Services International Inc., Adapted from IMF WP, January 2011

As noted earlier, one of the distinctions between traditional trade finance and supply chain finance is the number and scope of trading relationships impacted, as seen in Figure 5 below. Supply chain finance is by nature multilateral, and can involve and impact hundreds or even thousands of trading relationships, including small suppliers located in developing and emerging markets: a segment historically underserved by traditional trade finance.

One of the more common flavours of supply chain finance is referred to as "Buyer-centric" Supply Chain Finance. In this scenario, a bank will provide financing to members of a buyer's supply chain by mutual agreement. The buyer is typically a large global corporate and an existing client of the bank. The financing (a series of loans) is provided to a group of suppliers based on a guarantee provided by the buyer to the bank, effectively removing the need for the bank to complete detailed credit analysis of each supplier/borrower.

Figure 5: Financing a Supply Chain



Source: OPUS Advisory Services International Inc.

The buyer agrees to do this to ensure steady supply from a financially healthy supply chain; the bank succeeds in supporting an important client, and in providing a series of loans that it would otherwise not be able to do, generating revenue that would otherwise be inaccessible. The suppliers tend to agree to such structures because the financing is generally much less expensive, being based on the capacity and risk of the global buyer. In extreme cases, such a structure might even make available, a financing option to suppliers located in markets where liquidity and financial resources are so constrained as to be unavailable, even at heavily inflated prices. Full-scale supply chain finance programs can include financing solutions to sub-suppliers, to distributors, and even involve a large supplier providing financing to a large number of smaller buyers.

It bears noting that certain financing options are indeed long-established, though they are now also part of the emerging propositions under the umbrella of supply chain financing. Factoring, a particular type of invoice discounting, is an example of such a product. Briefly, this is a process whereby a seller (in international transactions, an exporter) presents and invoice to the buyer and secures approval for that invoice to be paid at an agreed future date. Once the invoice is an "approved payable", the exporter has the option to approach a bank or a "factor", offering to sell that invoice to the bank or factoring company at a discount to the face value. The exporter receives immediate cash, and the financier collects the full value of the invoice, with the difference representing their revenue for the transaction.

Factors' Chain International, an industry body, reports significant growth in cross-border factoring volumes, and this type of relatively straightforward mechanism, properly risk-mitigated, may prove very suitable for use in the context of trade with developing markets. To the extent that such mechanisms can be demonstrated to be effective in developing markets trade finance, local authorities can support their adoption by assuring a receptive but effective legal and regulatory framework and context around such forms of financing.

2.3 Trade, Development & Public/Private Contributions

The private sector plays a fundamental role in the finance of international trade. Top international banks provide the majority of traditional trade finance capacity and solutions today, while numerous other private sector providers are active in the less established domain of open

account trade and supply chain finance. Specialist trade finance boutiques, likewise, play a role in providing financing to selected sectors, or to segments of the market such as small and medium-sized enterprises. Private sector actors, including major commodity traders, have contributed to increasing the capacity to provide trade financing and to attract engage non-bank capital in the financing of commodity trade flows – often from developing markets – through the creation of trade-based investment funds and capital pools. This parallels the importance of private sector engagement in international development.

There is a further parallel between international development and the finance of international trade, in that the role of government and international institutions is indispensable in the context of both. The involvement of public sector entities such as ECAs, together with multilateral institutions such as the ADB, the IFC and others, has always been important in trade finance, but was particularly critical to the maintenance of adequate levels of liquidity and risk management at the peak of the global crisis.

The indispensable role of these entities has been brought to light, particularly in relation to the support of emerging and developing markets trade, where it has been acknowledged, the absence or retreat of banks has been particularly damaging.

Finally, the combined impact of public/private partnerships is notable in its positive impact on trade finance, just as it is an important element of major strategies related to international development activity. In trade finance, this can take the form of transactional collaboration, where a private sector bank will increase its capacity to provide trade finance, by using insurance or guarantee solutions provided by public sector ECAs. There are also strategic partnerships that cross the public/private boundaries, and certain individual organizations, such as Germany's Euler-Hermes, that are, themselves, public/private partnerships mandated to support the financing of international trade.

The established dynamics around public/private partnerships in trade finance may prove helpful in the context of international development, as efforts take shape around enhancing access to trade and supply chain finance, as a means of supporting trade flows and the creation of economic value. The discussion between Prime Minister Cameron and the top UK corporates around supply chain finance, mentioned earlier, provides an illustration of the potential reach of public/private partnerships. A practical and clear illustration of public/private partnership around financing, aimed at the creation of economic value. It is conceivable that a similar approach be devised, with foreign multinationals seeking to operate in developing and emerging markets.

3. Trends and Recent Development in Trade and Supply Chain Finance

3.1 Trade and Supply Chain Finance

The availability of credit and liquidity, globally, has not fully recovered to pre-crisis levels, though Asia was recently described as being "awash" in cash, and trade finance pricing has stabilized to more reasonable levels than were seen at the peak of the crisis. That said, there has been a rationalization of capacity and sources of bank trade finance, as numerous financial institutions retrenched to domestic markets, or retreated from markets where they had been

active; at the same time, trade flows have been reshaped as the two major consumer economies of the globe, the US and Europe, continue to wrestle with post-crisis consequences and with other challenges such as sovereign risk issues, unemployment and spiraling deficits.

The business of trade continues to depend upon various forms of financing, but financing continues to be constrained, due largely now to overall competition for limited financial resources within banks and more broadly in the marketplace.

Global sourcing patterns, likewise, have been reshaped, with exporters now very often also engaged in importing of components or inputs to production, and the classic delineation between trade flows and international investment flows no longer as clear as once was the case. These realities, coupled with activities related to outsourcing, offshoring and the more recent near-shoring practices, have been captured in a view of the world referred to as “Integrative Trade”, which aims to reflect the increasing interdependence of import, export and foreign investment activity, and the increased integration of such activities in the global commercial landscape. The implications of this shift are that financing will need to remain comprehensive, and that supply chain finance is a well-timed proposition as trade flows, patterns and practices evolve.

While supply chains may have become “elongated” in terms of geographic reach and scope, as well as in the number of relationships that can be involved (some reports suggest global corporates may have as many as 150,000+ small suppliers across the world), it is equally true that there is evidence of a transactional acceleration in trade flows: deals are getting done faster, and shipments are arriving faster. Traditional trade finance mechanisms are having difficulty keeping up.

A recurring issue among importers and exporter related to the use of documentary letters of credit, for example, has been the reality that shipments often reach final destination before the “paper shuffle” between banks is complete, and as a consequence, buyers cannot obtain control and possession of the goods upon arrival, but must wait, sometimes days, for the documents of title to reach a local bank where they can finally be picked up.

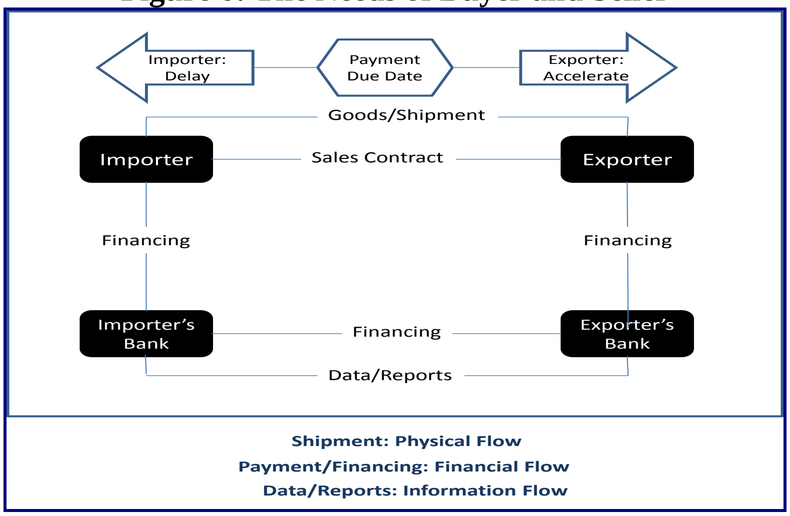
Once again, the growing number of trading relationships in the average supply chain, coupled with the acceleration of commercial practices – and the increased speed of transactions in the physical supply chain (the movement of goods) suggests that a financing solution aimed at international supply chains is timely. This is also specifically accurate in relation to supply chains involving small and medium-sized enterprises based in developing and emerging markets.

Just as there are notable pressures and dynamics at the level of the physical flow of goods between exporter and importer, there is a new urgency at the level of related financial flows: money also needs to flow faster to meet the needs of business.

In the context of constrained liquidity and a world where “cash is king”, buyers and sellers alike are concerned about managing exposures and ensuring adequate levels of working capital, while appreciating that there may need to be a balance between their own needs, and the needs of their business partners. As illustrated in Figure 6 below, exporters seek to collect funds due as soon as feasible, or even before due dates through some form of discounting, while importers will seek to

delay payment as long as possible, even arranging for financing, where a bank will pay the exporter, and collect from the importer at an agreed future date.

Figure 6: The Needs of Buyer and Seller



Source: OPUS Advisory Services International Inc.

While the process and practice of cash flow and working capital management are not "recent developments" *per se*, the urgency around optimization of working capital is recent, and linked directly to the global crisis. This imperative to manage liquidity underpins the effort by trade finance providers to develop propositions that concurrently address the needs of buyer and seller, in the context of international supply chains.

It has been suggested, largely on the basis of empirical evidence that the global crisis generated particularly adverse impact in terms of access to liquidity, including trade finance, for micro and small-medium enterprises and for developing and emerging market economies. To the extent that this view is correct, and it is reasonable to expect so, there would have been direct causal implications for trade flows and therefore, for economic development and poverty reduction.

There has been some debate about whether SMEs and developing markets truly do experience adverse effects and under-servicing, particularly in times of crisis, however, senior bankers and other expert commentators appear to have aligned in the view that, indeed, this is the case. There is now explicit acknowledgement, supported by data and analysis that confirms that SMEs face a daunting challenge in accessing financing, including trade finance specifically. The ICC's "Rethinking Trade Finance 2013" includes selected highlights from a recent ADB survey, indicating that over 25% of the estimated global gap in trade finance is found in developing markets in Asia.

It is worth noting that trade financiers, including banks and others, are working to develop new channels and points of access to facilitate engagement by clients across the globe, including the design and deployment of comprehensive platforms linked to other services and solutions, such as cash management and foreign currency transactions.

Deutsche Bank, in addition to devising a leading position in trade and supply chain finance, is also leading in the development of integrated platforms and in the design of new points of contact and engagement for clients to access trade and supply chain services and solutions.

Deutsche Bank announced the addition of a "Financial Supply Chain Manager" App to their Autobahn App market. The App includes multilingual capability, multicurrency functionality, and integration with corporate client systems as well as electronic data transmission. Deutsche Bank leads the market in the development of App-based banking and trade banking/trade financing functionality and solutions, and illustrates very well, efforts by industry leaders to address key challenges in trade finance.

One question worth exploring in the context of trade and international development may be, what mechanisms or political motivations might be applied to complement the work of international and multilateral development agencies, in facilitating SMEs' access to finance and trade finance?

3.2 Financing Supply Chains: Inclusion in Action?

While traditional trade finance techniques and mechanisms are typically bilateral in nature, involving a transaction (or a series of transactions) between one buyer and one seller, the model of supply chain finance is far more encompassing, holistic and one might argue, inclusive in nature.

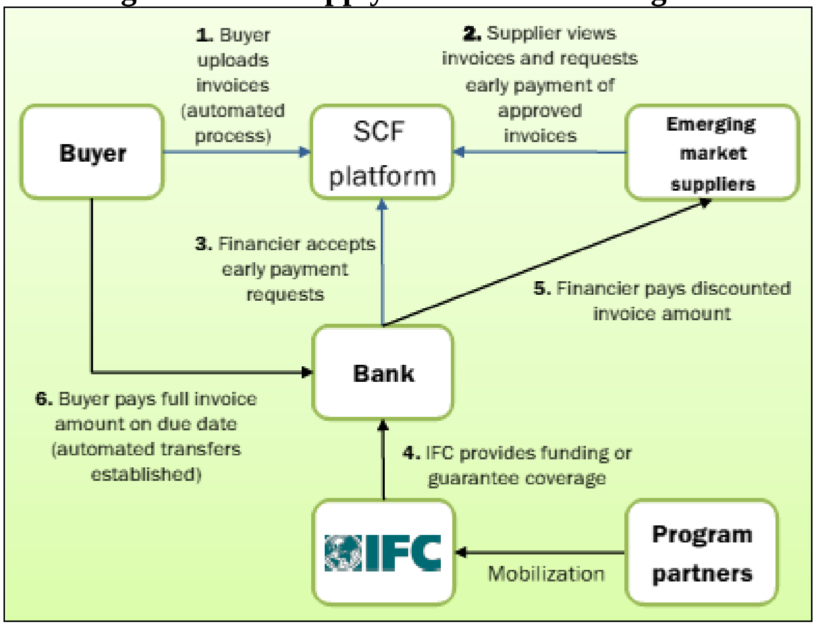
The development of supply chain finance is enabling large global buyers to provide access to financing to (selected/approved) suppliers, on the basis of the much stronger credit standing and borrowing capacity of the buyers. Such programs, referred to as Buyer-Centric Supply Chain Finance, or Reverse Factoring Programs, described earlier, are established when a buyer wishes to ensure the commercial health and sustainability of global supply chains by supporting strategic suppliers in need of affordable liquidity.

While such structures may not be entirely new, there is clearly much greater focus on them in the context of supply chain finance discussions, as noted earlier, as one means of addressing the liquidity needs of SMEs. This also allows the buyer's bank/financier to establish closer linkages to the buyer and its business partners. In the context of international development, such a structure can facilitate access to liquidity on the back of a large corporate sourcing in developing markets, reducing the overall risk profile of a transaction and increasing the likelihood that financing is made available, and at a lower cost than would be accessible to the SMEs on their own merits.

Supply chain finance programs, particularly comprehensive ones, are attractive in that they can facilitate access to affordable trade financing for small suppliers, even those located in relatively higher-risk developing or emerging markets. Such programs take an "ecosystem" view of trading relationships, enabling financing solutions for parties both upstream and downstream from the core buyer/seller trading relationship.

While traditional trade finance also allows for financing of SMEs in developing economies, a significant portion of this must be supported through risk mitigation and guarantee structures and programs, provided by ECAs, or by multilateral institutions such as the Asian Development Bank (ADB), the IFC, as shown in Figure 7 below, and others. Supply chain finance options, such as those based on a buyer-centric program, would allow a bank to finance suppliers in a developing market, on the risk profile and credit standing of a local buyer with which a relationship already exists.

Figure 7: IFC Supply Chain Finance Program



Source: International Finance Corporation, World Bank, Risk Mitigation and Financing for Bank SCF Clients

It has been estimated (McKinsey, 2010) that the use of supply chain finance programs can allow buyers to extend their payment terms, perhaps as much as double, concurrently allowing suppliers to access liquidity at significantly lower rates – and also for longer periods.

Trade finance, irrespective of whether it is effected through traditional mechanisms, or through emerging supply chain-related solutions, most commonly involves some form of financing or lending, and certainly involves some form of settlement, or payment.

The vast majority of traditional trade finance transactions, including the payments that relate to these transactions, are completed through the use of a secure global communications and payment network that is used by the majority of banks, and an increasing number of corporate clients around the world. SWIFT, the Belgium-based Society for Worldwide Interbank Financial Telecommunications is a cooperative to which clients belong, and is the organization that maintains the security and integrity of a network that handles financial traffic from around the globe.

Given the acknowledged importance of mobile technology in reaching unbanked individuals and small businesses in developing economies, it bears considering whether certain established

online settlement solutions might present some potential in terms of facilitating trade-related settlement in the context of a trade finance transaction.

US-based PayPal, now well-established in the business of online payments, and extending its proposition to retail settlement, may offer the basis on which a trade-related solution aimed at developing economies might be designed. The Government of Australia had, several years ago, launched a pilot program aimed at allowing exporters to arrange for payment through PayMate, the locale equivalent of PayPal, for less than AUD $10.00: a model that may be replicated in support of developing markets trade.

Similarly, platform-based and web-enabled models which incorporate settlement in their processes may be applicable in certain markets where the technology infrastructure is sufficiently advanced to support them.

3.3 Regulation and Compliance

In addition to ongoing challenges in providing appropriate/needed levels of trade finance, the industry faces significant pressure, as a result of the banking and financial sector crisis, due to significantly increased requirements around compliance, regulation and capital adequacy (the amount of capital that must be maintained by a bank as a reserve against loans/financing issued by the bank).

Limited bank capital is at a premium in many markets, and the internal competition for this resource within financial institutions has increased materially by all reports. Trade finance was caught up in sweeping changes related to capital adequacy requirements, partly as a result of failure to advocate effectively with the Basel Committee, a group which proposes and promulgates such requirements. In effect, it has become more expensive for banks to offer trade finance, than was the case prior to these changes, because higher levels of capital must now be held in reserve against trade finance loans/instruments. In some cases, the increase means a bank must hold 2 to 5 times more reserve against trade transactions than was required before the latest changes.

Table 4 below illustrates the negligible loss rates experienced by banks in trade finance: import letters of credit evidence transaction-level loss rates of 0.008%; this compares, for example, with portfolio-level loss rates in the credit card business that can exceed 10% and have been reported as high as 18%, and mortgage loss rates likewise in the 7-9% range.

Regulation is appropriate and necessary; the issue for trade finance is that the regulation has become heavy-handed, and does not account for the excellent credit quality and very low loan losses in the financing of trade flows. The lower the losses, the lower the amount of reserve capital (and therefore, the less expensive) should be required.

This has the very real and unintended impact of reducing the amount of capital made available by banks to support trade finance, and concurrently contributes to an increase in the cost of trade finance – estimates suggest, by as much as 15-20% - leading directly to a reduction in trade flows and a demonstrable loss of economic value.

Table 4: Trade Finance Product-Level Default and Loss Rates

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: International Chamber of Commerce, Rethinking Trade Finance, 2013

Regulatory and compliance requirements have also expanded as relates to anti-moneylaundering, and due diligence, including Know your Client (KYC) and Know your Client's Client (KYCC) requirements, all of which add complexity and cost to the provision of trade finance, and perhaps more importantly, discourage certain providers from offering such financing in markets where they risk not meeting regulatory requirements.

Traditional trade finance mechanisms such as documentary letters of credit is often used in attempts to illegally transfer or launder money from one location to another, by arranging payment for fictitious shipments, or by presenting invoices for payment, that significantly inflate the value of the underlying shipment. Trade financiers are required to verify transactions carefully for signs of such activity; some aspects of regulatory monitoring, such as preventing the conduct of trade or the transfer of funds to embargoed countries or individuals, can be supported by screening technology.

The KYC and KYCC requirement necessitates that trade financiers conduct and document appropriate levels of due diligence on their own clients, as well as on their clients' counterparties, including suppliers, often based in developing markets. While KYC processes are relatively well-established in many markets, the KYCC element might require a trade banker in Amsterdam to effect due diligence on a supplier in a distant market, where that institution has no local presence, and where reference points like commercial credit reports are non-existent or of questionable value. Information and data gaps can be so significant as to make it impossible for a financier to complete the due diligence required by domestic authorities, in The Netherland or in the EU, for example.

It is notable that regulatory demands are particularly significant on the banking sector, while other providers of trade finance, such as non-bank institutions, hedge funds and others are not subject to these costly and resource-intensive regulatory regimes.

4. Review of Current Status

Trade finance operates in an environment where access to credit is easy and safe. In Asia and the Pacific, most countries and economies perform well in the ranking of 183 countries, in terms of WB getting credit (Table 5). The ranking is based on the scores of countries in 4 indices: strength of legal rights, depth of credit information, public registry coverage and private bureau coverage. Strength of legal rights index (0 – lowest, 10 – highest) measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and, therefore, indicates the degree of facilitating credit. The other 3 criteria pertain to credit information that facilitates lending decisions. Depth of credit information (0 – lowest, 6 – highest) measures rules and practices affecting the coverage, scope and accessibility of credit information available through either a public credit registry or a private credit bureau; higher values indicate the availability of more credit information, facilitating lending decisions. Public (private) registry coverage reports the percentage of adults listed in a public (private) credit registry with information on their borrowing history from the past 5 years.

Based on the ranking in Table 5, getting credit seems, particularly easy in Malaysia, Georgia, Hong Kong, Singapore and Kyrgyz Republic. This ranking indicates to a degree the potential for access to financing such as trade finance in the region.

Table 5. Rank of Asia and the Pacific in Getting Credit (1 as the highest), 2012

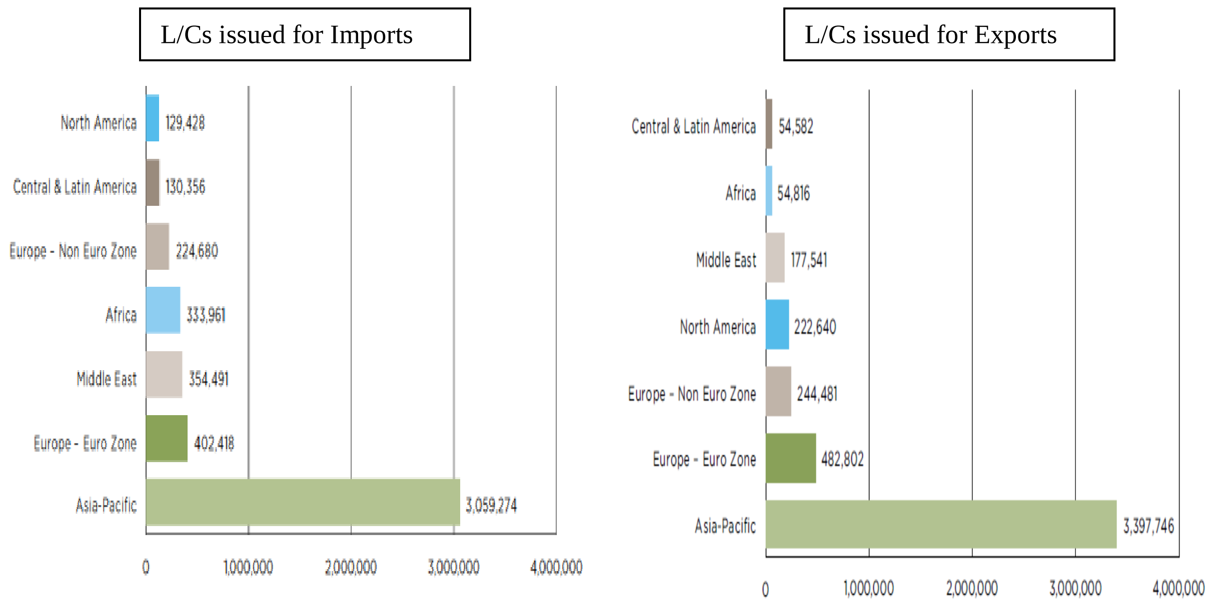
East Asia		Southeast Asia		Central Asia		South Asia		The Pacific	
Hong Kong, China	4	Malaysia	1	Georgia	4	India	23	Fiji	70
Mongolia	53	Singapore	12	Kyrgyz Republic	12	Nepal	70	Marshall Islands	83
China	70	Viet Nam	40	Armenia	40	Sri Lanka	70	Papua New Guinea	83
Taiwan, China	70	Cambodia	53	Azerbaijan	53	Bangladesh	83	Solomon Islands	83
		Thailand	70	Pakistan	70	Bhutan	129	Tonga	83
		Brunei Darussalam	129	Kazakhstan	83			Vanuatu	83
		Indonesia	129	Afghanistan	154			Micronesia, Fed. Sts.	129
		Philippines	129	Uzbekistan	154			Samoa	129
		Lao PDR	167	Tajikistan	180			Kiribati	159
								Timor-Leste	159
								Maldives	167
								Palau	185

Source: WB Getting Credit Data 2012

The ICC reports two indicators of trade finance per region. The volume of L/Cs (in $US) for imports and exports measures the level of trade finance per region. And, the average volume of L/Cs ($US) for imports and exports measures the amount of L/Cs per import/export transaction.

Based on ICC's 2013 report, Asia and the Pacific uses trade finance heavily, amongst all the regions in the world. Asia and the Pacific issues most L/Cs for both imports and exports (Figure 8). This high level of L/Cs reflect the crucial role that traditional trade finance plays in the region.

Figure 8: Trade Finance (Volume of L/Cs in $) Transactions by Region

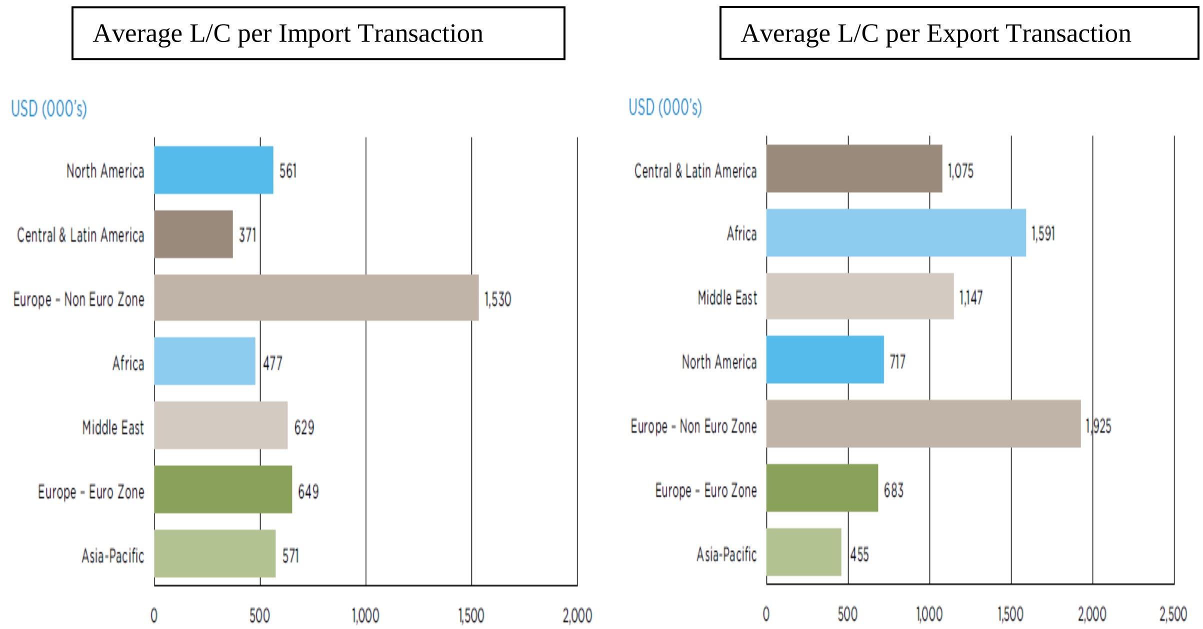


Source: International Chamber of Commerce, Rethinking Trade Finance, 2013

However, according to ICC, since L/Cs were often used in Asia and the Pacific even for small transactions, the average value of L/C for imports and exports issued in the region is smaller than in other regions (Figure 9). This phenomenon in which the volume of L/Cs issued is high (Figure 8) but the average L/C is small (Figure 9) reveals that plenty of transactions heavily rely on traditional trade finance. We see that trade finance is, indeed, important for the facilitation and expansion of trade in Asia and the Pacific.

The good ranking in WB's getting credit (Table 5) reveals the high potential for financing such as trade finance in the region. This is somehow consistent with the ICC report, which says that there is a high level (volume) and degree of reliance on trade finance in the region. However, these data only give us a snapshot of the status of trade finance in the region. Detailed information and case studies will be necessary to design appropriate trade finance policies.

Figure 9: Average Value of L/Cs by Region



Source: International Chamber of Commerce, Rethinking Trade Finance, 2013

5. Challenges

5.1 Industry-Wide Challenges

<u>Challenge 1: Understanding the Gap</u>

Trade and supply chain finance are very poorly understood areas of banking and finance. This is a challenge for the sector in many ways, from helping to set policy priorities to accessing financial and other resources, to the ability of trade financiers to articulate the critical value they bring, to supporting global trade, economic growth and development.

The “veil of mystery” around trade finance, which some suggest is intentionally cultivated, has proven to be a liability over the past several years in particular, as competition for limited bank and financial resources has required trade financiers to articulate their value proposition and demonstrate the value created through trade finance. This gap in understanding, even among senior bank executives, has meant that trade finance has suffered adverse regulatory treatment, and continues to be under-estimated relative to other lines of business in banks, and as a contributor to the creation of economic value. That which is poorly understood cannot be effectively championed.

<u>Challenge 2: Innovation Inertia</u>

The trade finance sector is facing challenges in responding to the changing needs of the market, because innovation is not in the “mindset” of the industry. The long-term relative effectiveness of traditional trade finance instruments, structures and processes have been a success, but at the

same time, have removed any real sense of motivation or urgency around the need to innovate, or even respond proactively to the evolving business practices and requirements of importers and exporters.

Even in cases where serious efforts at innovation were initiated in the late 1990's, such as attempts to leverage technology and enhance transaction and business processes, the up-take of such solutions proved moderate at best in most cases, until relatively recently. That is, even in the cases where there were attempts to innovate, there was some level of inertia among clients, in adopting such innovative programs and solutions, In addition to the inertia among banks, there is also evidence of inertia among corporate clients. The evolution of supply chain finance has been assisted in part by leading banks introducing procurement, operations and finance managers within client organizations, to help advance the development and uptake of supply chain finance programs, for example.

The pace of commerce, even deals and relationships that reach across the globe, has accelerated to the point that innovation is no longer an option, but now a requirement of any business that aims to remain relevant must innovate, and must do so, not in a reactive mode driven by self-preservation, as has been the case with banks in trade finance, but in proactive manner, driven by the need to compete, excel and deliver value.

Technology is now such that long-pursued goals including the dematerialization of documents and the ability to execute payment trigger decisions on the basis of data transmission and an underlying logic are now attainable.

The risk of complacency and lack of innovation is that irrelevance is a predictable outcome.

Challenge 3: Capacity, Concentration and Constraints

The need for trade financing is global, however, there is high concentration of market share among leading trade finance banks; at the same time, there are concerns that the industry does not have enough capacity to respond to expected demand for trade and supply chain finance.

Trade and supply chain finance are provided, globally, by a relatively small number of banks, a group of ECAs and a small number of multilateral institutions, with some boutique firms and a few specialist financiers rounding out the list of providers.

One might argue that the 'global footprint" necessary to the effective provision of trade finance is not within the capabilities of most financial institutions, however, numerous mid-tier and regional institutions have, since the global crisis, discovered both the value and the opportunity in delivering trade and supply chain finance solutions, and are actively looking at partnership models to enable an extension of geographic reach.

The diversity of markets, corporates and small businesses engaged in international trade – increasingly a strategic option at very early stages in the lifecycles of companies – is not well served by concentration in terms of providers of trade and supply chain finance. Notably, several "platform" type providers of finance targeting the SMEs segment have emerged, and are gaining

traction, however, within the global banking industry, concentration levels remain high, with relatively few institutions shaping the course of global trade finance.

The concentration levels in terms of sources of trade-focused liquidity will become increasingly sensitive, as trade in natural resources, agri-food and commodities – almost by definition involving at least one partner in a developing/emerging market – become increasingly central to global trade flows.

In addition to the concentration issue, the industry faces a situation where there is a significant financing gap – the difference between financing requested/required, and financing approved/provided – with some estimates suggesting a global gap in the range of $1.5-2 trillion. At the same time, trade financiers face a situation internally, where competition for bank capital and for risk and lending capacity is extremely intense. Trade finance is seen as a well-managed, adequately risk-mitigated business, with negligible loss levels, but also, as a business that generates good, solid annuity-type revenue, but not a source of spectacular, investment banking type returns.

Supply chain finance programs are already exhibiting issues related to capacity. Such programs can involve facilities in the range of $500 million to $2 billion or more; initially, as these programs were established, companies exhibited an appetite to use about 10% of the facilities set up. More recently, utilization rates have been reported to be in the 80-85% level for the more successful programs and 30-35% for the less successful such programs. The utilization rates have increase by a factor of 300-850% in a period of about three years.

Market concentration is currently a reality, and at the same time, there is already evidence that additional capacity will be required to be able to provide the needed levels of financing, to support trade flows.

In addition to financial capacity constraints and constraints related to industry concentration, the domain of trade finance is facing a global shortage of knowledgeable specialists.

Trade and supply chain finance face a looming shortage of human capital, as senior trade financiers retire and the next generation of trade financiers fails to materialize. The implications of this development are potentially very serious given the nature of the industry and the long cycles of training and development typically associated with attaining expertise in the domain.

Challenge 4: Risk Aversion: SMEs and Developing Markets

Small businesses and developing economies tend to report greater difficulty in accessing trade financing, and when it is available, financing tends to be more expensive. Bankers have historically been less than stellar in serving the small and medium-sized enterprise segment. This reality is common across the globe, and likewise, banks are frequently described by their more internationally-focused clients as being conservative and risk-averse in their market coverage and their willingness to accept various forms of risk associated with international and trade financing.

A systemic challenge in this respect is the reality that banks operate central risk and credit committees that have a great deal, often final, authority relative to the extension of facilities in support of a transaction or trading relationship. The situation is often exacerbated by the fact that such committees are staffed by domestic bankers with limited appreciation for the nature of trade finance.

Actual or perceived risk-conservatism, coupled with underservicing of SMEs link directly to the need to assure adequate levels of trade finance in support of SMEs trade activities involving one or more emerging or developing markets.

The question of inclusion, as far as trade and supply chain finance is concerned, traces directly, at least in part, to this reality of banking. Certain structures in supply chain finance in particular, make it interesting and viable for banks to serve small business, and to serve small suppliers in developing markets.

5.2 Transactional Challenges

Challenge 5: Cost, Complexity of Traditional Trade, Definition of SCF

Trade finance mechanisms are perceived to be too complicated and too expensive, while emerging solutions in supply chain finance are still being defined, such that it is sometimes difficult to understand the options available in financing supply chains.

Traditional trade finance mechanisms, while long-established, remain transactionally complicated and unpopular with companies engaged in international commerce, with the possible exception of businesses in the MENA Region, that have demonstrated an affinity for documentary letters of credit, that is significantly higher than that seen in other markets.

Globally, it has been estimated that 60-80% of documents submitted by exporters for payment, are deemed non-compliant in the first instance. While some discrepancies can be corrected, and importers may be genuinely intending to complete the transaction as agreed, and therefore will be pleased to assist in the process – or will simply accept documents as presented, and authorize the relative payment – there are too many cases where such situations are seen as opportunities for importers to demand discounts or a change to more favourable terms.

In the worst cases, discrepancies/situations of non-compliance can be seen to provide a means of refusing the shipment and therefore avoiding the need to pay: this is seen in commodity trade, for example, where pricing can be volatile, and a price shift (a decrease) may motivate an importer to look for any justification not to complete an agreed transaction. By that time, the shipment has already been effected, and the exporter faces the prospect of selling at a discount or loss, or having to arrange for return shipment. The absence of protection in these circumstances is notable, particularly given the high cost of such instruments relative to typical profit margins.

Supply chain finance, likewise, has its own transactional challenges, not least, that it is aimed at transactions undertaken on open account terms, where there was, historically, limited focus (if at all) on risk mitigation. At the same time, the expression “supply chain finance” currently

encompasses a range of definitions on a continuum, from a single product or structure, to a program of solutions aimed at offering a wide range of financing options for complex supply chain ecosystems that facilitate trade flows in the hundreds of millions of dollars or more, annually.

This disparity of definitions makes it difficult to consistently articulate the value proposition around supply chain finance, and challenges providers to communicate to clients and prospects in a unified manner, so that corporate finance and treasury specialists can assess the applicability of supply chain finance solutions to meet their requirements.

Challenge 6: Position and Role of ECAs and IFIs

There is sometimes inconsistency in the positioning of public sector institutions active in trade finance. These institutions sometimes partner with, sometimes compete with, private sector providers and it is unclear whether competitive postures create net benefit for the market.

The role of public sector or international institutions in supporting and helping to facilitate trade finance is very well established, and despite recent debate, was again reinforced over the course of the crisis. One challenge however, relates to the role, scope and objectives public sector institutions such as ECAs, and to some degree, likewise, the role and scope of the remit of multilateral institutions.

Certain ECAs are guided by a clearly defined, limited mandate, such as export development, or job creation, with a set toolkit of products and solutions that can be offered in the pursuit of that mandate. Other ECAs possess a far more open-ended mandate, such as the creation of economic value, and may seek to execute such a mandate with the broadest possible set of products, services and solutions available, even to the point of taking a competitive posture relative to private sector providers of trade-related financing and risk mitigation.

Where some ECAs are explicitly forbidden by their charters to compete with private sector providers, others are given much wider operating latitude; likewise, the range of business models – fully public sector, hybrid or privatized – under which ECAs operate is another complicating factor for businesses seeking to access or leverage the support of ECAs.

The issue is perhaps amplified, in the context of transactions involving developing or emerging markets, and the possibility of engaging in international development or in poverty reduction initiatives in the context of trade relationships and transactions. Some ECAs may support certain transactions that would otherwise not be justifiable on strict commercial terms, on the basis of "national interest" or "national policy", while others may tend to show a bias toward commercially-oriented transactions; certain jurisdictions may have official development assistance organizations or even development finance institutions to serve as channels for the delivery of development resources and aid.

All this, briefly, illustrates the broad range of business models, priorities and organizational focus of a group of very key institutions involved in supporting international trade and trade

finance, and in some cases, in supporting efforts around international development and poverty reduction.

While certain jurisdictions unabashedly leverage their development assistance as a means to exercise influence, push political agendas and promote a set of values or a view of the world, others prefer to clearly separate development assistance from any sort of political "quid pro quo".

The extent to which such factors influence the availability of support around trade and supply chain finance, and by extension, around international trade, when a developing or emerging economy is involved, is an issue worth considering. Is an ECA or IFI a partner or a competitor to other providers of trade finance? Will the institution focus primarily on supporting development efforts, or will it seek to link development-related contributions to some form of "direction" to be followed in exchange by the receiving jurisdiction?

The choice of institutions and organizations with which to engage in trade and trade-related development activity is of fundamental importance and undeniable influence relative to the outcome.

Challenge 7: Technology and Multibanking

Technology presents both significant opportunity, and an obstacle, to the evolution of trade and supply chain finance. It is an obstacle to the extent that legacy technologies prevent transformational innovation, and to the degree that adoption rates can be slow.

In addition to the issue of innovation considered earlier, there are challenges and bottlenecks around trade finance, related specifically to technology – adoption rates, evolution rates and the need for even the most promising technology to account for limitations in pervasive legacy systems in key jurisdictions such as the United States and Europe among others.

While certain developing and emerging markets have been able to "leapfrog" legacy technologies – having never deployed them, there is no related constraint, and it is possible to quickly adopt and deploy leading edge solutions – others must content with the reality that such technologies are difficult and expensive to decommission, and often so customized as to be difficult to replace with existing solutions.

Additionally, one recurring technology-related issue in trade and trade finance relates to the difficulty for large global corporates to attain a global view of their business. Such companies may maintain a dozen or more key banking relationships, and are hard-pressed to be able to aggregate their business across those institutions to create an integrated view of transactions, trading relationships, risk exposure, or payables and receivables.

There has been notable progress in devising multi-bank solutions in support of trade finance, and it is worth considering the opportunity in mobile channels, particularly given the increasingly central role of mobile telephones in "banking the un-banked" in developing markets.

Challenge 8: Financing Commodity Trade

It is possible, and worth assessing, whether high trade finance pricing in developing markets might be contributing to already (speculation-based) inflated commodity prices, to the detriment of efforts in international development.

Natural resources and commodities remain important – often core – areas of economic value-creation in developing and emerging markets, though there are certainly ongoing considerations about the risks associated with resource-based economies.

International agencies have been arguing for some time that commodity prices and the prices of certain resources are artificially inflated by speculation, and that those inflated prices generate several adverse consequences for developing economies, including keeping such economies from investing in other sectors in order to diversify or reach higher levels of the global value chain, and creating situations where the providers of commodities can scarcely afford those commodities for their own citizens and jurisdictions.

It is unclear, but worth considering, whether trade finance related pricing in the commodities space may be adding to the alleged inflation of commodity prices globally, and if so, whether such contribution is sufficiently material, to require some form of countermeasure or balancing initiative from public sector or international institutions.

6. Overcoming Challenges: Case Studies and Illustrations

It is worth noting that while there are numerous initiatives and industry practices that address some core challenges in the business of trade finance, several of these potential solutions are relatively new, and the sense of momentum, innovation and strategic thinking around trade finance, likewise, is relatively recent.

The current profile around international trade, and the global acknowledgement of the importance of trade finance, provides an excellent opportunity to build on these positive steps and to further champion and invest in the development of trade finance for the twenty-first century.

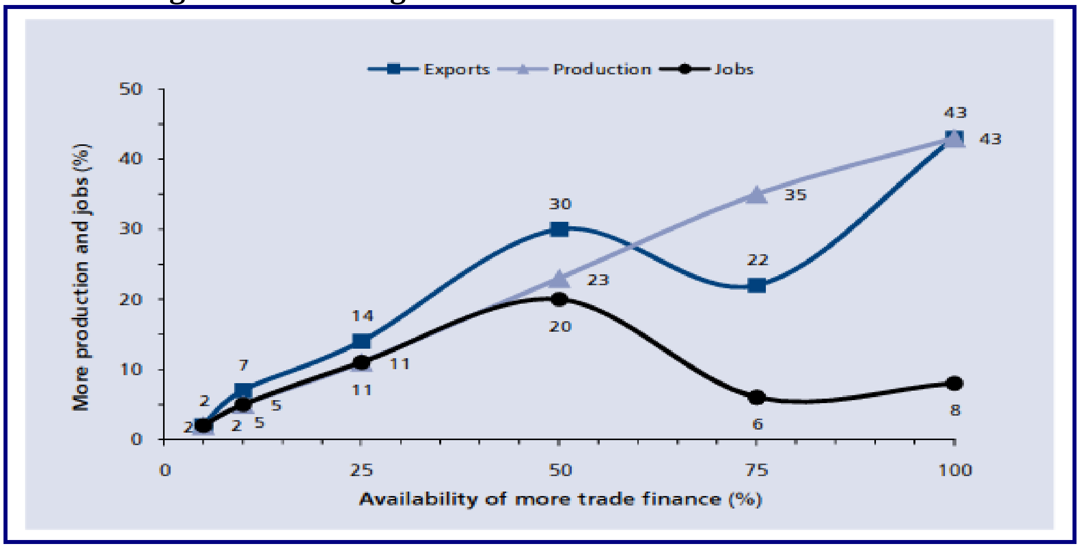
ICC and ADB: The Case of the Trade Finance Surveys: Address Challenge 1

The global crisis, together with the increased regulatory pressure on trade finance, and the need to attract additional capital and capacity to the sector, have combined to motivate industry leaders to better explain the business of financing trade, and to do so on the basis of increasingly robust and informative research and analysis.

The Banking Commission of the ICC has now published several editions of its annual "Rethinking Trade and Finance" report, which provides increasingly comprehensive analysis and increasingly robust data points.

The ADB, likewise, continues to lead in developing high-value analysis and research into the business of trade and supply chain finance. A recent analysis by the ADB has drawn important linkages between availability of trade finance and the translation of that availability into economic value, such as export activity and job creation, as shown in Figure 10.

Figure 10: Relating Trade Finance to Production and Jobs



Source: Asian Development Bank Trade Finance Survey, 2013

Export trade has long been linked to economic growth; as noted above, the vast majority of trade flows, including exports, require some form of financing in order to take place, and the industry is taking significant steps to increase global understanding of that reality.

The ADB Survey brings to life, the direct linkages between trade and economic value, growth, and takes the additional important step of linking levels and availability of trade financing to these higher-level issues and themes.

Respondents to the ADB Survey (ADB, 2013) indicated that a 5% increase in trade finance support could translate into business growth in the range of 2%, and a related increase in demand for staff, of also 2%. The logic appears to apply also at higher rates, where a 10% increase in available trade finance is expected to lead to growth rates of 5% in business activity and in staffing requirements. The clear conclusion is that an increase in availability of trade finance leads directly to the creation of economic value, with such value being traceable to the additional commercial activity enabled through access to trade finance.

<u>ADB/ICC: The Case of the Trade Finance Default Register Addresses Challenges 1 and 4</u>

Objective data about the very favourable risk profile of traditional trade finance assists in addressing regulatory treatment, informing risk assessments and could eventually assist in enhancing access for SMEs and developing markets.

Trade financiers are aware of the characteristics of their business, particularly of the recurring challenges and bottlenecks that can be attributed directly to the financing of international

commerce. Several of the issues noted above are long-standing, and have simply been acknowledged, without motivation to take concrete measures to address them, until an external driver applied sufficient pressure to the industry to engender some form of response.

Recent market conditions, particularly in banking and financial services, have been encouraging trade finance executives to better articulate the value proposition and the value-creation capabilities of trade finance, as a direct result of pressures to compete for limited capital resources, and to respond in part to pressures from regulatory and political authorities, to assert a need for tighter controls around trade finance (in the context of broader financial regulation).

The development of the Trade Finance Default Register, an initiative of the ADB, is a strikingly successful example of an industry initiative conceived to respond to the current economic, financial sector and regulatory/political landscape. While trade finance has historically been very poorly understood, it is equally true that it has long been a challenge to obtain meaningful objective data about the business of financing trade.

The ADB Default Register is now a critical source of both aggregated and granular, product-level data around default rates and loss experiences, among other data and indicators, that is assisting industry leaders in demonstrating – with academic rigour and objectivity – that trade finance is, as has long been claimed – an extremely secure type of business that exhibits negligible losses despite high transaction volumes and despite the facilitation of many high-value and high risk trade relationships and transactions.

The Register has been instrumental in enabling a partial reversal of regulatory requirements related to capital reserves and adequacy, that would have made trade finance business much less capital-efficient for banks: that is, more expensive, and far less attractive. In the end, current regulatory requirements remain unnecessarily severe, however, that can now be demonstrated by providing a portfolio-level view of the trade finance business of leading banks across the globe, with an increasing number of banks contributing data to the Register every year.

The Register is now "operational" and is managed under the auspices of the ICC in Paris, and is now one of several trade-related data gathering, survey and benchmarking efforts undertaken by various stakeholders across the trade and supply chain industry.

Trade Finance Programs of ECAs and IFIs: The Case of ADB and IFC Programs Addresses Challenges 3, 5 and 7

The critical contributions of ECAs and IFIs have been clearly demonstrated by the global crisis, and the engagement of these entities in industry-wide initiatives and industry leadership has increased demonstrably. The role and programs of ECAs and IFIs have been shown to be critical to robust trade flows.

The resurgence (or raised awareness) of ECAs and the indisputably central role of international institutions in supporting trade and supply chain finance, is an important element of the industry's efforts to address the issues around availability of timely and equitably-priced trade finance. IFI programs are listed in Table 6 below.

Table 6: IFI Trade Finance Programs

	EBRD	IFC	IDB	ADB
Program Title	TFP	GTFP	TFFP	TFP
Number of Countries of Operation	20	94	21	18 (soon to be 19 with expansion to Myanmar)
Program Commencement	1999	2005	2005	2004
Number of Transactions since Commencement (year end 31 Dec 2012)	13,504	25,000	1,079	6,295
Value of Transactions since Commencement	EUR8.8 bn	USD21.8 bn	USD2.62 bn	USD12.6 bn
Number of Confirming Banks	800	1,050	224	120
Claims to Date	2 No losses	0	0	0
Website	ebrd.com/tfp	ifc.org/gtfp	iadb.org	adb.org/tfp

Source: International Chamber of Commerce, Rethinking Trade Finance, 2013

Pre-global crisis, there were serious discussions about whether or not public sector ECAs had become anachronisms and should simply be phased out; similarly, the role of international institutions was not particularly visible or necessarily acknowledged as it should have been.

Both these situations have now been decisively reversed, with ECAs of all flavours having been acknowledged, even by trade bankers, as having played a crucial and irreplaceable role in absorbing part of the shock to the global system, when banks were unable to assure adequate levels of trade finance. The price increases of 400-500% and more that were observed relative to trade finance would have been far worse, absent the support of ECAs and IFIs.

The role of the IFIs, likewise, was shown to be critically important, both in assuring some level of liquidity around trade finance, and in ensuring some level of capacity aimed in support of developing and emerging economies.

Trade-related development and economic value-creation requires the support of a robust ECA and IFI community within the trade and supply chain finance sector, as the non-commercial dimensions of the ECAs and the IFIs mandates simply cannot be supported by financial institutions with profitability objectives and with pressure to demonstrate recovery and to create shareholder value.

ADB’s trade finance program, which includes an element aimed at supply chain finance as well, provides an illustrative case study of the way in which IFIs have sought to contribute to meeting trade financing needs in the markets they support.

The ADB Program, established in 2004, currently operates in 19 countries, and has supported over US $ 12.6 billion in trade, with zero claims or losses attributed to the program despite its contribution to over 6,200 financing transactions.

The ADB Program provides a variety of solutions and forms of support, including the provision of financing and loans in support of specific transactions, for example in the area of pre-export finance, where conventional sources offer limited support, as well as various forms of risk mitigation and guarantee aimed at assisting bankers and other financiers to engage in trade finance activity in the markets served by ADB. Additionally, the program includes technical assistance projects and support aimed at raising the competency levels of bankers in trade and supply chain finance

A common approach among IFIs, and one used also in the context of the ADB Program, is for the IFI to identify and qualify a group of banks in the supported region, that are deemed to possess the competence and financial capability to engage in trade finance, and to, in effect, provide a guarantee to international banks collaborating with participating local institutions that they (the international institutions) will be adequately protected.

One way this is done, can be shown in the context of a traditional letter of credit transaction, where a local bank issues a letter of credit which might, in international markets, be consider relatively high risk due to local market conditions (economic circumstances, political instability…) or due to the relative weakness of the local bank.

An international bank participating in the ADB program proposes (or is asked) to add its own financial and legal undertaking or "promise to pay", to the letter of credit issued by the local institution, thus making the instrument more attractive/acceptable to foreign exporters. While the international institution might normally hesitate – or refuse – such an arrangement due to unacceptable risk, ADB effectively guarantees that the obligation of the local institution to the international bank will be met, and thus provides comfort to that international institution, and supports the completion of trade business (and the creation of economic value) that would otherwise not be feasible.

Examples of the various ways in which ADB supports trade include:

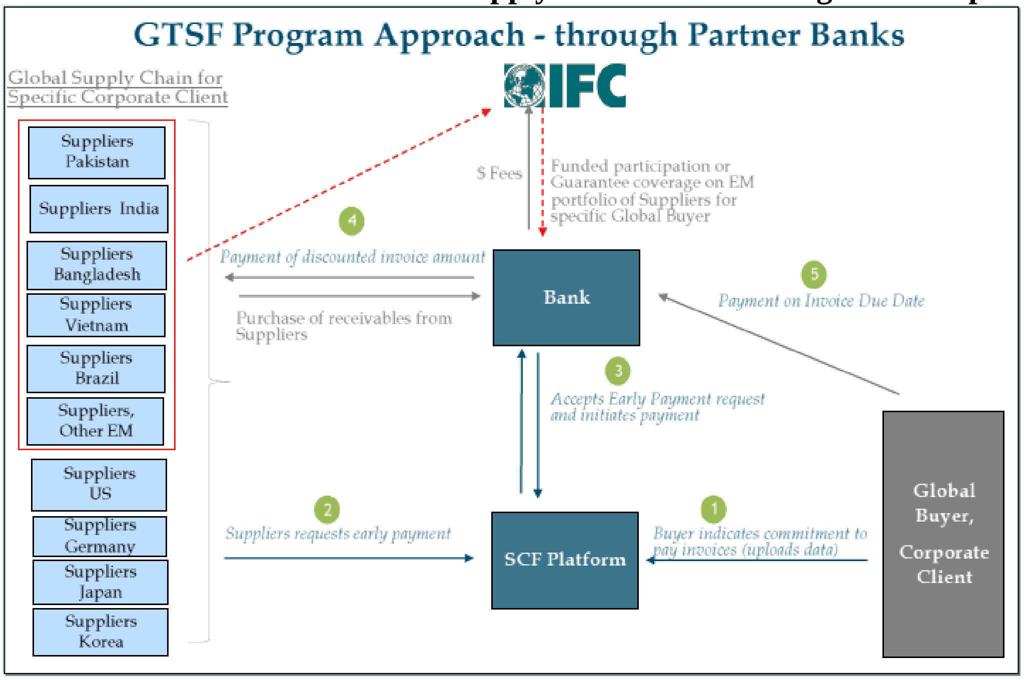
- Provision of a guarantee covering 25% of a trade loan made by a US bank to a financial institution in Vietnam, in support of the acquisition of cellular technology and technical expertise, to enable the installation of a 3G cell network
- A guarantee in support of a German export of capital equipment to Azerbaijan, where the full amount of the required financing was guaranteed by ADB, allowing the German bank and exporter to pursue the transaction on the basis of fully mitigated non-payment risk related to the local bank in the importing market
- Direct lending to a garment manufacturer and exporter in Sri Lanka, aimed at providing liquidity and working capital to the company, to enable production and facilitate exports to Europe, India and the Russian Federation

The scope and variety of products and solutions provided by ADB, and by other international institutions, continues to evolve and grow to meet the needs of businesses and banks in the markets supported by those IFIs.

The World Bank/IFC's Trade Finance Program, a sample transaction of which is shown in Figure 11 below, has also proven to be critical to assuring adequate levels of liquidity in the

global market. It was IFC that was mandated by the G20 to ensure an agreed level of trade-related financing at the peak of the global crisis, and was delegated to manage an infusion funds into the sector on behalf of the G20. IFC has very effectively articulated a value proposition around both traditional trade finance and emerging supply chain finance solutions.

Figure 11: World Bank/IFC Trade & Supply Chain Finance Program: Sample Flow



Source: IFC

ECAs are frequently involved in emerging or developing markets trade, either in a risk mitigation capacity, or in a financing capacity. Given the wide variety of mandates supporting the activities of ECAs, we note here that in the context of developing markets trade and investment, ECAs have taken some steps to mitigate adverse effects linked to ECA and bank financed projects, whether on local environmental conditions, or on indigenous populations displaced by such projects.

ECAs increasingly consider the impact of their financing and risk support decisions, with numerous such entities undertaking detailed environmental impact assessments as part of their deal structuring due diligence. Relatedly, a number of institutions have agreed to abide by a set of international guidelines called the “Equator Principles”, the latest version of which took effect in June of 2013. While the Equator Principles apply primarily to longer-term, project related financing and risk mitigation, it is perhaps worth highlighting this practice in the context of shorter-term trade finance, with the aim of ensuring adequate consideration of similar issues in the application of trade finance to the challenges of trade-based international development.

Private Sector-led Trade Finance Capacity Development: The Case of The London Group Addresses Challenges 3, 4, 5 and 8

Trade financiers have been working to better explain the trade finance asset class, with the objective of attracting new, non-bank capital from sources such as insurance companies, pension and hedge funds and private equity pools, to increase global capacity.

Industry leaders and top-tier trade banks are taking steps to attract new capital and new investors to the trade finance asset class, in response to the challenge described earlier, which discussed insufficient capacity in the global markets, to assure adequate levels of trade finance. The banks, as primary providers, are not able to sufficiently increase their activities in trade finance, and are therefore working with other stakeholders to attract new capacity/capital to the market.

BAFT-IFSA, a leading, Washington-based industry group of senior international and trade bankers, have created the "London Group", a working group mandated specifically to look at the issues and opportunities around attraction of new capital to support the financing of international trade. The work of the London Group was made the subject of a specific panel at the last BAFT-IFSA Global Annual Meeting – Americas.

As demand for trade finance grows, and rates of usage of supply chain finance programs increase, the recognition of bank limits in capacity are such that there have been specific efforts aimed at creating additional financing capacity by bringing new capital into the industry.

Part of this effort has involved the need for industry-level advocacy and explanations about trade finance, and about the attractiveness of trade-based transactions as an investment asset class.

The London Group, a bank and private sector-led initiative aimed at resolving capacity issues in trade and supply chain finance, by encouraging collaboration among banks and by beginning the process of attracting new, non-bank investors into the trade finance market. The latter element means educating and attracting decisionmakers from cash-rich insurance companies, pension funds and private equity pools. The education and attraction process on its own implies significant effort in describing the business of trade finance, articulating its characteristics and risk profile, and demonstrating the potential for attractive and steady returns.

The London Group is also looking at ways in which the trade asset class can be rated by analysts. Insurance companies and pension funds are restricted by law and regulation, in terms of the assets in which they can invest (to ensure that capital is not recklessly invested), and such restrictions include minimum credit ratings. Trade finance assets will have to demonstrate acceptable risk profile – in part through independent credit rating processes – in order to be deemed eligible for investment by pension funds and insurance company investment pools.

The London Group is taking a central role in undertaking research and analysis aimed at understanding the needs of non-bank investors, to encourage the attraction of new capital to the business of trade finance. These initial results from these initiatives can be seen in the relatively recent development of trade-based investment funds, and in the analysis around industry capacity related to supply chain finance programs. Specialty firms such as commodity trading firm

Trafigura, has also recognized a market need and an opportunity around the provision/attraction of new capital in support of trade and commodity finance.

Leading commodity traders, such as Trafigura, have likewise recognized the need for additional capacity in the support of trade flows, and have devised various funds aimed at creating such additional capacity. This initiative also aims to attract sovereign wealth funds as additional investors. The company aims to diversify its own sources of funding from a relatively limited group of banks active in and able to provide financing levels required by the high-value commodity trade deals pursued by Trafigura.

The practical realities are illustrated by the fact that about ten years ago, a tanker of crude oil could be financed for about $40 million. That same shipment today would require six times that amount of financing, as banks have been constrained in their ability to increase trade financing activity.

In addition to the development of capacity through attraction of new capital, further capacity is being added to the trade finance market through the programs of IFIs like the Asian Development Bank, as such programs raise awareness and ability of banks in developing markets to participate effectively in the financing of trade to and from their home markets. Such programs, including the ADB's program, enable the creation of additional capacity through effective risk mitigation (allowing banks to undertake additional risk and therefore support greater volumes of trade finance).

Training and Development: The Case of IFI Training, CDCS and Other Industry Programs Addresses Challenges 1, 2, 3, 4 and 8

IFIs have long contributed to the development of a global talent pool of trade financiers, through various Technical Assistance programs and the development and delivery of trade finance training. The issue is now far broader, and the implications more far-reaching, in that, even centres of domain expertise and excellence in trade finance are exhibiting a shortage of next-generation entrants to the industry.

Trade bankers continue to be convinced, in many cases that the best form of training is to "learn by doing"; however, relatively few such specialists concede that a great deal of time and efficiency are lost through such an approach. In contrast, it is worth noting that industry bodies are promoting structured training and professional designations such as the CDCS (Certified Documentary Credit Specialist) which provides practical transactional training relative to one of the core instruments of traditional trade finance.

While development agencies continue, necessarily, to focus on finance and banking training for small businesses in developing economies, there is an emerging and increasingly urgent need to assure adequate levels of resourcing – and competency – in the next generation of trade financiers.

The technical assistance and capacity development efforts of IFIs, including the ADB, are making an important contribution in raising the competency of bankers in the area of trade

finance, as are the efforts of leading trade banks that often provide some level of support and training to their financial institution partners and clients.

In addition to training efforts by IFIs and other international institutions, private industry has recognized the need for formal development, recognition and maintenance of professional competencies relative to both the operational/transactional aspects of trade finance, and the credit/risk and lending aspects of the business.

Professional designations such as the CDCS, (Certified Documentary Credit Specialist), along with CITF, (Certificate in International Trade and Finance) from the Institute of Financial Services, have contributed to progress in formalizing the reflection of professional competency in these domains.

The various programs provide training in numerous areas, from general trade context to specific trade finance transactional processes and practices, industry regulations and product overviews. The CDCS is aimed specifically at transactional/operational experts – individuals who specialize in processing of transactions.

More recently, the University of Malta has partnered with FIM Bank and the International Factors Group, to devise and launch the COFIT program – the Certificate of Finance in International Trade. The COFIT program covers a range of topics, delivered by industry specialists and practitioners, ranging from EU policy around trade, to Islamic Finance in developing markets.

At the highest level, these initiatives aimed at increasing overall competency in trade finance, are a reflection of the state of the industry, and a direct response to the critical need for additional expertise in the financing of international commerce. IFI capacity development programs in the trade finance space are long-established; private sector, formalized training programs are somewhat more recent, but both categories of activity combine to contribute to what is now recognized as a global need across the industry, including in developing and emerging markets.

It should be noted explicitly that these programs are open to the public, and numerous managers and executives with accountability for trade financing within a corporation, can be found to have obtained the CDCS Designation, either from prior roles in banks, or as part of their professional development within their existing corporate roles.

The International Trade Centre in Geneva published "How to Access Trade Finance: A Guide for Exporting SMEs" in 2009, and rightly placed significant emphasis on the importance of adequate knowledge and training among trade finance clients. This is important particularly in developing markets, in that applicants for financing must understand the ways in which banks and financiers assess risk and evaluate financing applications, including requests for trade financing.

In addition, end-users of trade finance products and solutions must understand the mechanics and the transactional nuances of such structures, in order to maximize the likelihood of an efficient and successful transaction. Global corporates, mid-market clients as well as SMEs located in

developing markets will benefit from appropriate training and education related to accessing and use of trade finance.

Perhaps equally importantly, the efforts of the WTO, the multilateral development banks, the G-20 and others, aimed at raising awareness about the existence of trade financing solutions, resources and programs must continue. Emerging and developing markets may not have the benefit of active/skilled local trade financiers, or the ability to leverage a public sector entity like an export credit agency, and may therefore benefit from specific local initiatives aimed at awareness-raising.

ICC/SWIFT: The Case of the Bank Payment Obligation: Addresses Challenges 2, 4, 5 and 7

The Bank Payment Obligation is a new instrument of trade finance, positioned precisely between a traditional documentary letter of credit and an open account transaction. The Bank Payment Obligation (or BPO) has the advantage of being endorsed by the ICC, and of being subject to a widely agreed and unanimously adopted set of ICC rule called the Uniform Rules for Bank Payment Obligations, or URBPO.

The BPO illustrates or brings to life in one solution, several categories of activities identified earlier, as ways in which trade financiers seek to address current challenges and bottlenecks.

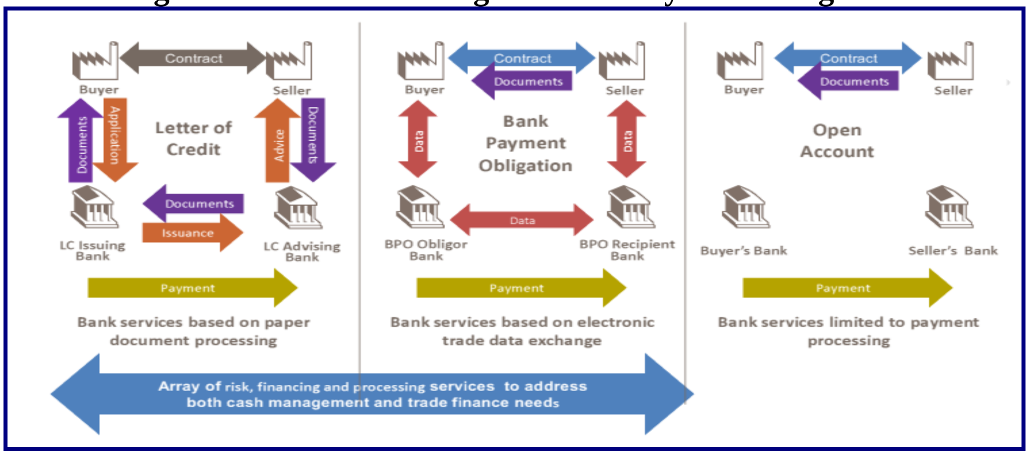
The BPO is a significant innovation at the product and solution level; it represents successful leveraging of leading-edge technology and involves a significant level of industry education and of promotion of the new solution to end-clients and other interested parties. The BPO aims to accelerate and automate transaction processing, and to advance trade financing in significant ways.

As shown in Figure 12 below, a BPO, in contrast to a documentary letter of credit, operates on the basis of an exchange and comparison of data elements, instead of a comparison of physical documents against the terms and conditions stipulated in the documentary credit. An objective, technology-driven process of data-matching which triggers an agreed payment, is not subject to misunderstanding or differing interpretation, and in the normal course, should be significantly faster than a manual document verification process.

In the end, the BPO represents a serious and viable attempt to innovate in the trade finance space, targeting a proposition that combines attractive features of both documentary letters of credit, and open account transactions.

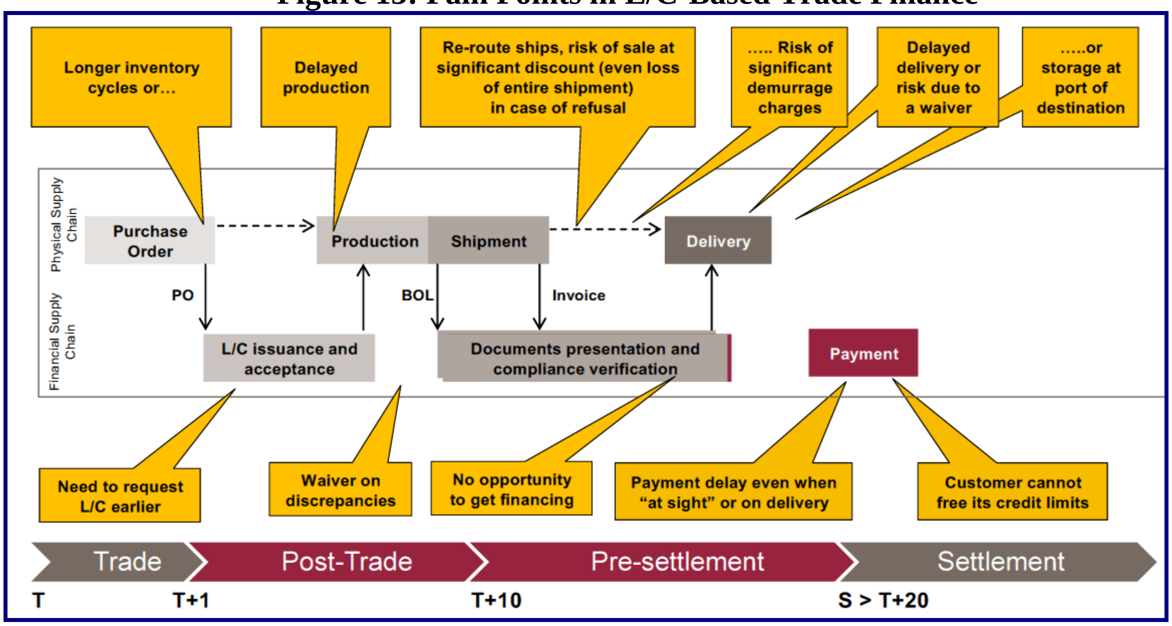
Detailed process flows can be reviewed, and there are several case studies that illustrate a variety of objectives and benefits targeted by corporates in adopting the BPO as an instrument of trade and trade finance. Figure 13 provides some examples. The degree to which the BPO can serve as an effective instrument of trade finance in transactions involving developing market economies, and SMEs located in such markets, is to be determined, but on first view, appears promising.

Figure 12: The Positioning the Bank Payment Obligation



Source: SWIFT/ICC Industry Education Group on the BPO

Figure 13: Pain Points in L/C-Based Trade Finance



Source: ICC/SWIFT Bank Payment Obligation Webinar, Challenges with L/C's

The Bank Payment Obligation is, currently, a bank-to-bank instrument, and as such, the risk related to a BPO is bank risk – the basis on which numerous trade support programs are currently devised, particularly among IFIs. The BPO is still in very early stages of development and deployment – since the first live transaction in 2010, the volume is limited, numbering in the dozens per year, however, bank adoption is advancing, and is expected to accelerate following the recent adoption of the ICC Rules for Bank Payment Obligations, paralleling the long-established Uniform Customs and Practice for Documentary Credits.

The BPO leverages technology and automation, increases options related to trade and supply chain financing, allowing importers and exporters to improve their respective working capital positions, as well as enhancing processes and efficiencies, improving inventory management and

addressing other commercial objectives related to trade activities and trade and supply chain finance.

At last count, over forty banks internationally had signed on in principle to be providers of BPO solutions. There remain numerous issues and transactional details to be ironed out as relates to the BPO, including pricing, accounting and regulatory treatment, and eventual extension of the BPO proposition, to directly allow for engagement of corporate end-user clients. That said, the BPO exemplifies numerous elements of the industry's attempt to advance the evolution of trade and supply chain finance. Interest and adoption levels related to the BPO are rising, and many of the world's top trade banks have already signed on to the program.

The applicability of the BPO to development-related trade is a notion that merits careful consideration.

Given that the BPO can operate with a single bank acting in support of a transaction, developing markets may, through simple awareness-raising, be able to propose a BPO-based settlement option to a large international buyer, for example, whose bank has signed on to the BPO, has the necessary technology in place, and is prepared to help execute a transaction based upon the BPO.

In the medium-term, developing markets could conceivably designate a local institution to lead the adoption of the BPO, with development funding and technical assistance support aimed at enabling the deployment of the necessary technology and the understanding of the product and its related transaction flows. Developing economies can also quickly adopt the Uniform Rules for Bank Payment Obligations (URBPO), the rules akin to the UCP, that aim to guide the use of BPO instruments globally.

Given the electronic and data-driven nature of this instrument, developing markets can take steps to ensure that local legal and regulatory frameworks allow for the use of an instrument such as the BPO.

In the shorter term, it may be feasible for an IFI to act as a provider of BPO-based solutions, collaborating with international banks to enable access to BPO by stakeholders in emerging and developing markets. It is instructive to note that the first commercial, "live" transaction completed using the BPO involved a transaction between China and Canada, facilitated through the Bank of China and Bank of Montreal.

7. Questions for Discussion

7.1 What solutions might be identified and developed based on a detailed transactional review of the needs of emerging-market SMEs?

Might there be an opportunity to develop financing solutions and structures based on a detailed review of trade deals and trade and supply chain finance transactions?

While there is significant focus on the provision of post-shipment finance, there is suggestion that the market would benefit from additional options in pre-shipment finance. Is it

worthwhile to engage in analysis aimed at validating this requirement, and determining, even at a high level, whether such additional liquidity would in fact translate into addition trade flows?

7.2 What additional industry education programs might benefit businesses in developing and emerging markets, in terms of raising awareness about and competency relative to, trade and supply chain finance options?

International institutions such as the multilateral development banks have devised effective training programs aimed at local banks in particular, relative to trade finance and the functioning of trade finance facilitation and support programs.

Is there an opportunity to extend such training and development efforts to target local, in-market businesses of all sizes, to raise their awareness of trade and supply chain financing options?

7.3 Is there an opportunity to tailor – or even simply leverage – an emerging solution such as the Bank Payment Obligation, as an efficient, affordable channel through which trade finance may be accessed in developing markets?

Does the commercial and technology model around the Bank Payment Obligation lend itself well to adaptation for use in developing and emerging markets? To what extent does the transaction flow, and the technology platform, prove effective in enabling access to trade finance? Is there some degree of customization to the model or the technology that should be funded and developed specifically with a view to targeting the needs of companies and banks based in developing and emerging markets?

7.4 What institutions at the national level might be mandated to support access to trade finance as part of a development assistance program and policy?

Is there an opportunity to complement the work of IFIs with contributions from national ECAs, or development finance institutions?

What analysis needs to be completed to determine whether such additional capacity at the national level is required and valuable?

7.5 Is it timely to explore the extension of trade facilitation, promotion and development efforts, to include a component focused on trade and supply chain finance?

Trade promotion and development activities have tended to concentrate on areas such as feasibility analysis, market entry, development of local partnerships and related areas, with (generally) limited focus on the financing and liquidity dimension of international commerce. Is there an opportunity to put greater focus on financing in the context of trade development and promotion activities, and if so, in what form might this be most effectively accomplished?

Best-practice trade development and promotion programs, as shown in Figure 16 below, do include a degree of focus on the financing dimension; the question is, whether such a component ought to become a more common element of trade development and promotion programs.

7.6 Is there an opportunity to learn from the positive and successful lessons of microfinance, to devise similar programs aimed at supporting engagement in international markets, perhaps a form of micro-trade finance?

The levels of trade financing likely needed to support trade flows, particularly export activity, from developing economies, will vary based on the nature of the relative trade flows. Large commodity flows, such as the annual flow of cocoa from certain source markets in Africa, for example, are large even by global standards, and as such, are well met by existing providers.

Smaller flows, related to community-level and small business level initiatives, may benefit greatly from even limited trade financing capacity.

Relatedly, might it be worth assessing the opportunity in financing “fair” trade flows? Financial institutions across Europe and the US in particular, are seeking ways to rehabilitate their images and brands with an increasingly skeptical public, and with an impatient political leadership. Part of the rebuilding of brands and credibility revolves around a return to fundamentals and “real economy” activity in banking, where trade finance figures prominently. The timing may be particularly appropriate to engage traditional providers of trade finance in a discussion around the merits of supporting fair trade flows.

8. Recommendations

The foregoing analysis aims to provide a view on the current state of international trade and supply chain finance, and to illustrate direct linkages between this form of financing, and trade-related international development, and the creation of economic value and growth.

There is an opportunity to take advantage of an unprecedented global focus on trade finance, to secure resources necessary to ensure adequate financing is available in support of global trade flows, including those to and from developing economies as they become larger relative to total trade.

Trade and supply chain finance are in a phase of evolution and development, in response to the needs of importers and exporters throughout the world, and are linked directly to international development, and to the theme of the APTFF 2013 around inclusive supply chains.

At the highest level, a core recommendation of this paper is that trade and supply chain finance be made core elements of trade facilitation programs and strategies. The current focus on trade financing ought to be leveraged to assure that additional resources are directed to trade finance-related training and capacity development, and that additional solutions are developed in the area of financing for SMEs and developing markets.

It is recommended that participants to the APTFF be asked to take ownership of specific agreed actions in support of the foregoing, and that one outcome of the APTFF becomes the initiation of a regional dialogue around trade and supply chain finance, as an additional tool in the disciplines of trade facilitation, promotion and development.

In support of the above higher-level recommendations, it is further recommended that the APTFF contribute as follows:

- 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/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 and 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 to the field of trade finance

One outcome of the APTFF could be the development of a roadmap of actions across the various streams of discussion, identifying any linkages, dependencies and opportunities to leverage work or analysis across streams. In the event the scope of activities is too broad, or there is some doubt as to wide applicability of certain recommendations or solutions, it may be prudent to translate certain recommendations into proofs of concept, with agreed timelines associated to the development and completion of each – with assessment reports flowing from each proof of concept, back to an agreed “owner group” drawn from among participants to the APTFF 2013.

9. Conclusion

Trade finance is fundamentally important to the conduct of international commerce, and by extension, fundamentally important to any development effort or initiative that relies on cross-border commerce.

While trade finance has historically made its contribution “in the background”, and has operated under a veil of perceived complexity, the reality is that trade finance can be defined in terms of basic principles: payment facilitation, financing, mitigation of risk and information flow. These elements have been undeniably shown to be critically important to the enablement of trade, and thus, trade finance now enjoys a level of profile and attention at the highest levels of business, political leadership and international organizations.

The explicit linkages now drawn between trade finance and the creation of economic growth provide an unprecedented opportunity to better champion trade and supply chain finance and to more compellingly attract and negotiate for resources that will ensure increased levels of liquidity in support of international commerce.

Estimates suggesting the existence of a financing gap in the range of $2 trillion help illustrate the potential for significant additional economic growth and value-creation on the basis of appropriate levels of trade financing. Emerging and developing market trade grows in value and significance, and the importance of small businesses – in fact, micro, small and medium-sized enterprises (MSMEs) – to national economies is increasingly recognized, yet these two client segments, MSMEs and emerging markets, are reported to face the greatest challenges in accessing trade finance.

The linkage between trade finance and trade is well established; the connection between trade and international development, likewise, is well acknowledged. The opportunity now is to strengthen the understanding and perception of global stakeholders, about the linkages between trade finance and international development, and to make trade finance a more integral component of trade promotion/development and trade-based international development activity.

The ADB, through its own Trade Finance Program, has contributed importantly to the advancement and maturation of the value proposition around trade and supply chain finance, and the APTFF provides an excellent context within which to explore – and take action on – additional opportunities in assuring appropriate levels of financing support in the Asia Pacific Region, and globally.

A reality of trade and supply chain finance is that this business is poorly understood, and while technical assistance and training programs have been, and continue to be important, there is a need for enhanced communication of the value of trade finance, and a need for more effective championing and advocacy of trade and supply chain finance, including – but not exclusively – in the context of international development. The global circumstances continue to be favourable to such advocacy and to the investment of further resources in support of trade finance, as political and business leaders, and senior leaders in international institutions continue to look to trade as a major driver of global recovery and growth.

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