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KEY POINTS

- Fundamental changes in global trade flows, driven by geopolitical and economic shifts, have generated a fulsome response from the Asian Development Bank (ADB) and its Trade Finance Program (TFP), in terms of the products and services offered to ensure that local banks in developing Asia benefit from those changes.
- Through the TFP and in collaboration with its trade finance partners, ADB intends to bridge gaps in trade finance and provide a level playing field for small and medium-sized enterprises by promoting job creation and sustained economic growth in the 21 countries where the TFP operates.
- Much attention is now focused on the trade enhancement potential of various technological advances. This brief looks at early developments, the issues that still need to be addressed, and the implications for banks around the world.

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The Trade Finance Program and Its Role in Lifting Impediments to Trade

Data from the International Chamber of Commerce (ICC) show that all the multilateral development banks increased their lending limits and resources in 2015 while the Trade Finance Program (TFP) of the Asian Development Bank (ADB) continues to extend its range of products and initiatives to sustain trade flows. The TFP is a nimble crisis response vehicle, able to mobilize resources when disasters hit the more vulnerable countries. Most recently, ADB established an emergency trade facility for banks in Nepal to increase their capacity for aid and reconstruction following the earthquakes of 2015. ADB is also aware of the region's continuing need for more knowledge and expertise. Committed to filling this need in trade finance, the TFP sponsors training seminars and workshops in a variety of trade finance and related topics for individual banks, countries, and subregions, to improve expertise and help mitigate risk. ADB also provides advice and expertise to local banks in four countries in formulating gender-inclusive policies.

MORE FUNDED SUPPORT FOR TRADE

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

THE SUPPLY CHAIN FINANCE PROGRAM

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

50 YEARS ADB

THE TRADE FINANCE REGISTER

In 2009, ADB partnered with the ICC to create the ICC Trade Finance Register, which showed Basel III regulators that trade finance carries an extremely low risk of default, at around 0.02%–0.05% each year worldwide. This information was critical to banks engaged in trade finance. It helped persuade the regulators to change the capital requirements for their business, such as reducing the leverage ratio for letters of credit to 20%.

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

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

Capital rules are becoming so stringent that resources go to the biggest clients in the most familiar markets, squeezing out ADB's developing member partners.

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

Reasons for the impediments to trade finance fell into two main categories; regulatory (including anti-money laundering/know-your-client [AML/KYC] at 90% and Basel III at 77%) and risk (including the credit rating of the country, for 82% of respondents, and that of the issuing bank, for 85%). Among the client companies surveyed, rejection was ascribed mainly to the inability to meet standard bank requirements, including collateral (47%), documentation (37%), and valid company records (34%).

DERISKING

Global banks appear to have completed their withdrawal from operations in parts of the world where tighter regulations rendered the risk–return ratio untenable, but the ramifications are still emerging. Developing countries and emerging markets have been disproportionately affected, and there is a real risk that some markets are close to being completely cut off from the global payments network. The so-called derisking phenomenon is already a problem for local banks in countries like Myanmar and the Pacific Islands, which are unable to clear some payments in hard currency through the international banking system. Appetite for trade credit from banks is dampened, especially among smaller companies in difficult markets, for which the cost of compliance with AML/KYC regulations does not match the value of business banks can immediately generate. The aspirations of SMEs in developing countries, faced with the greater challenge of providing financial information and collateral, consequently remain unmet, directly affecting economic growth and job creation.

THE ANTI–MONEY LAUNDERING/KNOW-YOUR-CLIENT INITIATIVE

Another unintended consequence of derisking is the creation of unregulated financial space, increasing the risk of illicit financial flows outside the system. To reengage with and integrate into the global financial system, the countries affected must make a robust and meaningful effort to implement international AML/KYC standards. To this end, in 2017, ADB announced an investment of $2 million in technical assistance to its developing member countries to counter money laundering and the financing of terrorism; to maintain tax integrity; to tackle tax secrecy, evasion, and aggressive tax planning; and to promote domestic resource mobilization.

ADB is also bringing together a few private sector banks to pool data on AML/KYC infractions to better understand trends or patterns. The aim is to create an early warning system. Such information would help banks understand better the risks associated with the client onboarding process and can contribute to a more substantive

discussion with regulators on AML/KYC requirements. Financial technology (fintech), too, can support a more sustainable AML/KYC regulatory framework, making it more efficient and affordable, and allowing the pooling of information worldwide.

THE SWIFT KYC REGISTRY

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

FINTECH AND THE POTENTIAL OF LEDGER TECHNOLOGY IN TRADE FINANCE

The movement of physical goods around the world and the storage of trade documentation is an intensive and time-consuming process. Advances in digital trade generate excitement because they offer solutions to a cumbersome activity that has remained largely unchanged for centuries. Digitization, ledger technology, and blockchains may conjure up a dystopian vision of the future for some, and particularly among those unfamiliar with digital finance—including 70% of firms covered by ADB's 2016 trade finance survey. Digital trade is not a new phenomenon, although so far it has developed bilaterally or on online platforms while paper verification remains common especially within the banking sector and among shipping companies and freight forwarders. But the pace of technological change has been gathering momentum over the past year. Banks are beginning to respond to growing client interest in digital methods of doing business, while remaining mindful of the initial cost of investment and the increasing complexity of the legal ramifications.

Benefits of Ledger Technology

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

Such bespoke technology lends itself well to the process of trade and its financing, since it can be operated and managed by the many necessary entities along the chain of supply often across several jurisdictions: buyer and seller, their bankers, shipping company, freight forwarder, inspection agency, insurer, and so on. Proponents of this technology say it will speed up trade by facilitating the exchange of contracts, the issuance of letters of credit, and the issuance of certifications and other paper-based authorizations needed to move goods around the world. The information generated and stored can demonstrate the existence and origin of a shipment, allow the transfer of title to, and the physical movement of, goods, and facilitate payment once certain conditions are satisfied. The traceability and accumulated performance and payment data provided can assist credit assessment. The technology also offers the opportunity to enhance the proper registration of collateral and to establish transparency in the priority of rights. It not only reduces the operational costs of trade by simplifying the workflow and improving accuracy, but also minimizes the risk of documentary disputes that can sometimes arise.

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Creating a platform for so many parties located across several jurisdictions for any one transaction will not happen overnight. The process must demonstrate that it can overcome the operational differences in the conduct of trade across companies and geographies. This is an area of concern for the TFP, since the investment in technology in developing Asia lags behind other parts of the world. The 21 countries where the TFP operates still rely heavily on paper-based processes to execute contracts, obtain licenses, and clear customs.

Clearly, it is essential that users agree in advance how they should treat all types of information and manage the ledger. The rights and responsibilities of all parties associated with a distributable ledger must be clearly defined and accepted by all if the new technology is to gain their trust and confidence. Already, more searching questions are being asked about developments in fintech and whether individual projects can or should be integrated systematically worldwide. How far should ledgers be verifiable and searchable to meet compliance and audit requirements? Who will assume oversight responsibility? Will information be transferable between platforms? What is being done to guard against cyberattack?

Mitigation of Disintermediation Risk

Such a vast and not yet fully comprehended prospect will require global engagement to evolve properly. Banks in the United States and Europe, as well as in the PRC and India, and the monetary authorities of Hong Kong, China and Singapore, are at the vanguard of such developments. But many more banks worldwide need to develop in-house digital capabilities or to partner with fintech companies if they are to retain their trade finance business capacity. In fact, it will need the sustained effort of information technology companies, lawyers, auditors, central banks, regulators and governments to devise not just the technology but also equitable commercial solutions and the laws and regulations that realize such a vision. A system on which the process of trade depends must guarantee authenticity to avoid driving trade and the benefits of technological gain into the shadow economy. The legal framework that supports the digitization of trade will be crucial. Law and regulation has yet to keep up with the pace of technological advances and it is now becoming imperative to ensure the risk of forgery and fraud is minimized. However, a balance must be struck. Industry standardization will ease acceptance of the process but at the same time, excessive governance could defeat the potential for operational and cost efficiencies that promise growth in global trade.

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It is therefore easy to understand why such far-reaching technological advances and their yet-unknown impact on global trade might be perceived as disruptive to the banking sector. But the process, in some form, seems irreversible. The need to close the trade finance gap is now well documented, so banks still have a key role to play in shaping the meaningful digitization, and perhaps even the global harmonization, of trade while still meeting the high standards of compliance and security required of them. KYC compliance could cost considerably less, if the technology and its associated agreements prove reliable. In fact, greater efficiencies and cost savings will benefit all participants, given the potential for economies of scale. Further, the technology could mark a return to more transaction-based lending, providing both transparency and creditworthiness to trade finance and reinforcing the value of such low-risk lending for the purposes of bank regulation and capital adequacy efficiency. Yet, it is also an ambitious endeavor that will need cooperation, debate, and eventual cohesion if it is to benefit trade and, by extension, economic advancement, on a genuinely global scale. ADB intends to show leadership in realizing such potential and in ensuring that developing Asia remains part of the process by working with its partner banks and information technology companies, sharing knowledge and understanding with industry bodies and regulators, and collaborating with multilateral partners. The link between the provision of trade finance and fintech, on the one hand, and economic growth and job creation, on the other, would gain credence.

Global Legal Identifier Foundation

The establishment of a Legal Entity Identifier (LEI) will help confirm the integrity of digital functions within the trade finance sector. The Global Legal Identifier Foundation (GLEIF) is a not-for-profit organization created by the Financial Stability Board in 2014, following a mandate from the Group of Twenty, the international forum for the world's leading industrialized and emerging economies, to implement a globally harmonized digital identifier for all companies including financial institutions. The GLEIF is overseen by a committee whose members are drawn from regulatory authorities and central banks around the world. The system would verify three things: who is who, who owns whom, and who owns what, with the aim of assisting the flow of trade and other

cross-border transactions, and simplifying KYC and other forms of due diligence and reducing their cost. It would complement the growing number of shared information sources, such as the SWIFT KYC Registry, making risk assessment more transparent and credible, and trade finance more accessible especially for SMEs and developing countries. A truly global system will would enable government to improve its tax collection capability.

Companies would pay a nominal fee to establish and maintain an LEI, a 20-digit alphanumeric code based on International Organization for Standardization standards. There are now around 500,000 companies with identifiers, including ADB, but most are based in the United States and Europe. ADB is working with the ICC and the World Trade Board to promote global adoption via legislation agreed on by the Group of Twenty countries. The LEI Index is freely accessible online, providing open, standardized, and high-quality due diligence data. It therefore reduces the costs of conducting due diligence and facilitates lending to SMEs, which often struggle to maintain full business records that would give them access to finance. More widespread use of the LEI Index could soon lead to a verified set of transactions that track credit history, payment performance, and commercial dispute data. It is vital that emerging markets become involved in this system since it will promote a more open, transparent, and inclusive form of finance.

Banks still have a role to play in shaping the meaningful digitization, and perhaps even the global harmonization, of trade while still meeting the high standards of compliance and security required of them.

What Lies Ahead

Despite the fall in commodity prices, the number of transactions handled by the TFP each year, across a wide range of sectors and industries, has remained relatively steady since 2012—a testament to Asian dynamism. There is much future potential for trade support to feed ever-growing infrastructure projects and ongoing economic diversification in the region. Asia must also compete more effectively in global export markets and become more integrated into supply chains. TFP clients are hungry for knowledge and the TFP strives to enhance the knowledge and skill sets of banking and regulatory staff in countries where the TFP operates.

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

The TFP, backed by ADB's AAA credit rating, provides guarantees and loans to over 200 partner banks to support trade, thus enabling more companies throughout Asia to engage in import and export activities. With dedicated trade finance specialists and a 24-hour response time, the program has established itself as a key partner of the international trade community, providing fast, reliable, and responsive support to fill gaps in the region's most challenging markets. The TFP complements its financial support with a regular series of workshops and seminars to increase knowledge and expertise in trade finance products and operations, risk management, and fraud prevention. Since 2009, the TFP has supported more than 9,200 small and medium businesses across developing Asia, through over 13,000 transactions valued at through over $25.5 billion, in sectors ranging from commodities and capital goods, to medical supplies and consumer goods. The TFP website (http://www.adb.org/tfp) provides more information.

About the Asian Development Bank
ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to a large share of the world's poor. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

ADB Briefs are based on papers or notes prepared by ADB staff and their resource persons. The series is designed to provide concise, nontechnical accounts of policy issues of topical interest, with a view to facilitating informed debate. The Department of External Relations administers the series.

The views expressed in this publication are those of the authors and do not necessarily reflect the views and policies of ADB or its Board of Governors or the governments they represent.

Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
Tel +63 2 632 4444
Fax +63 2 636 2444

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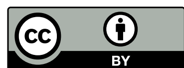
ADB Briefs aim to highlight achievements of ADB projects that support social protection initiatives in developing member countries.



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