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KEY POINTS

- The global trade finance gap is estimated at $1.5 trillion.
- 40% of the gap originates in Asia and the Pacific.
- 74% of rejected trade finance transactions come from SMEs and midcap firms.
- Female-owned firms report higher rejection rates, and are less likely to find alternatives in the formal financial sector.
- At least 36% of rejected trade finance may be fundable by other financial institutions.
- A 10% increase in trade finance could boost employment by 1%.
- 80% of banks report digitization will cut costs, yet no evidence that savings translate to additional trade finance capacity.

2017 TRADE FINANCE GAPS, GROWTH, AND JOBS SURVEY

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INTRODUCTION

Over the last year, the trade finance ecosystem continued to adapt to new technologies and regulatory conditions. Notably, both banks and firms in the trade finance space are increasingly implementing digital solutions. But even as change progresses, trade finance gaps persist for emerging economies and small and medium-sized enterprises (SMEs).

This has happened during a transitional year for trade. Global trade growth remained slow at only 1.3%, the Trans-Pacific Partnership failed to be ratified, and anti-globalization sentiment spread. But there were positive developments as well. SME finance is increasingly on the trade finance agenda. The first letter of credit transaction was conducted on the blockchain. And fintech investment grew with more than $13 billion of venture capital invested in 2016.

Using new questions, the 2017 ADB Trade Finance Gaps, Growth, and Jobs Survey deepens our understanding of both the quality of rejected transactions and the amount of foregone trade that results when firms cannot access sufficient trade finance. The survey, now in its fifth year, also explores the associations between shortfalls of trade finance and jobs as well as the behavior of woman-owned firms.

In addition, this year's survey introduces suggestive evidence about whether fintech and digitization made inroads into the trade finance shortfalls that continue to characterize emerging economies. Using complementary surveys of both banks and firms, we explore digitization, inclusion, and the regulatory environment to understand the landscape of global trade finance shortfalls.

The 2017 survey results were obtained through the participation of 515 banks from 100 countries and 1,336 firms from 103 countries.[1]

The ADB 2017 Trade Finance Gaps, Growth, and Jobs Survey is a joint product of the Private Sector Operations Department, ADB Institute, and the Regional Cooperation and Integration Division.

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TRADE FINANCE GAPS IMPACT EMERGING MARKETS

Even as technology is introducing new ways to assess and manage risk, the fundamental causes of unmet demand for trade finance remain unaddressed. Using bank-reported rejection rates for trade finance transactions, we find that the global trade finance gap remained relatively stable at $1.5 trillion, compared with the previous year at $1.6 trillion.

Emerging economies continue to face the greatest shortfalls. And as in previous years, Asia and the Pacific is the largest source of both proposals (i.e. requests by firms to banks for trade finance support) and rejections (Figure 1). Banks report that 46% of global proposals came from Asia and the Pacific, a third of which originated from developing Asia including the People's Republic of China (PRC) and India. Around 40% of total rejections are from Asia and the Pacific. Within Asia and the Pacific, developing Asia—including the PRC and India—consistently accounts for the largest proportion of rejections even despite compositional variations due to different samples in each year's survey.

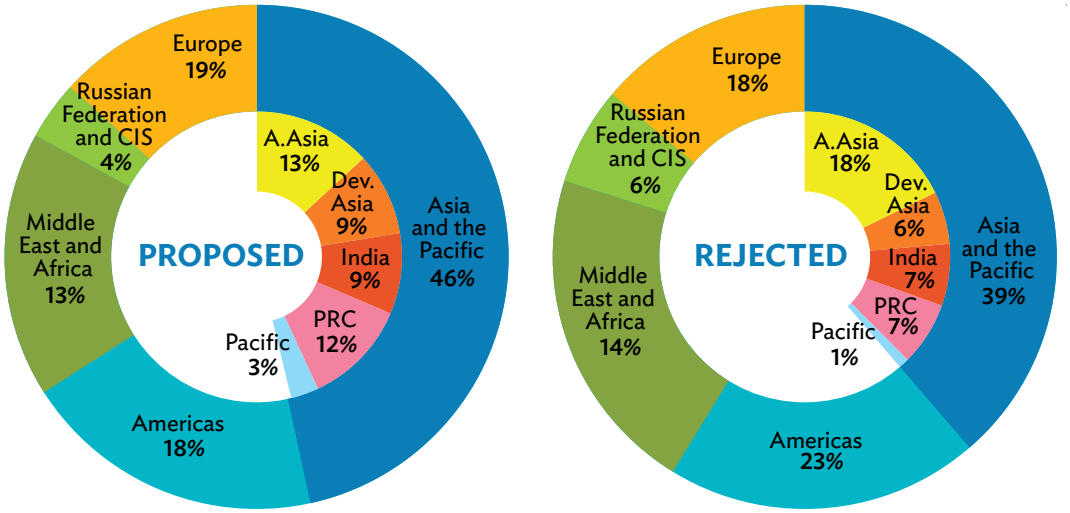
The persistent shortfalls in Asia and the Pacific may reflect the anchoring of manufacturing supply chains in the region. This is particularly relevant for inclusion policy given significant market interest in accessing preshipment financing in support of SME suppliers in emerging markets. The PRC's large role in regional gaps may reflect a combination of export-related trade financing needs, together with growth in import financing, the latter linked directly to the PRC's growing wealth and consumer activity.

MSMEs REMAIN UNDERSERVED, TRADE FOREGONE

Micro, small, and medium-sized enterprises (MSMEs) continue to face more difficulty accessing trade finance than large firms. This has been consistent throughout the years of the survey. Banks report that 74% of rejections come from MSMEs and midcap firms (Figure 2). The difference in magnitude from previous years partly reflects a definitional change in the survey's firm-size categories.

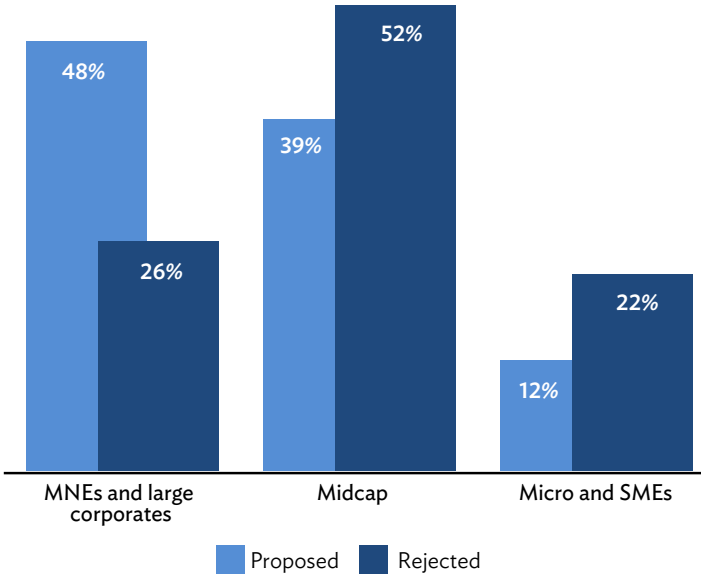
One key impact of high rejection rates is foregone trade. Firms were asked what happened to the trade transaction after rejection. About 60% of responding firms reported that they failed to execute the transaction when their application for trade finance was rejected. This reflects one of the negative impacts of trade finance shortfalls: in the aggregate it will be a drag on overall economic growth. The remaining 40% of firms were able to complete the sale without bank-intermediated trade finance.

Figure 1: Proposed and Rejected Trade Finance Transactions (by region)



A.Asia= Advanced Asia (Hong Kong, China; Japan; the Republic of Korea; and Singapore); CIS= Commonwealth of Independent States; Dev. Asia= Developing Asia excluding the PRC and India; PRC= People's Republic of China.
Source: ADB. 2017 Trade Finance Gaps, Growth, and Jobs Survey.

Figure 2: Proposed and Rejected Trade Finance Transactions (by firm size)



MNEs = multinational enterprises, SMEs = small and medium-sized enterprises.
Source: ADB. 2017 Trade Finance Gaps, Growth, and Jobs Survey.

Taking a different approach to the question of what happens after a transaction is rejected, more than half (53%) of surveyed firms didn't look for any alternative sources of financing when a transaction was rejected. Among those respondents that found an alternative (both formal and informal solutions), only half of the firms used it— the other half found it too expensive. Respondent firms in Africa and South America resorted to informal financial providers more than firms from other regions.

Woman-owned firms face more frequent rejection for their trade finance proposals. They were 2.5 times more likely to have 100% of their proposals rejected by banks than male-owned firms. It doesn't help that woman-owned firms are smaller, and thus less likely to have strong financials. Once rejected, they are more likely to seek out alternatives than the general population (46% vs 36%). Overall, however, they are less likely to find alternatives in the formal financial sector (12% vs 22%).

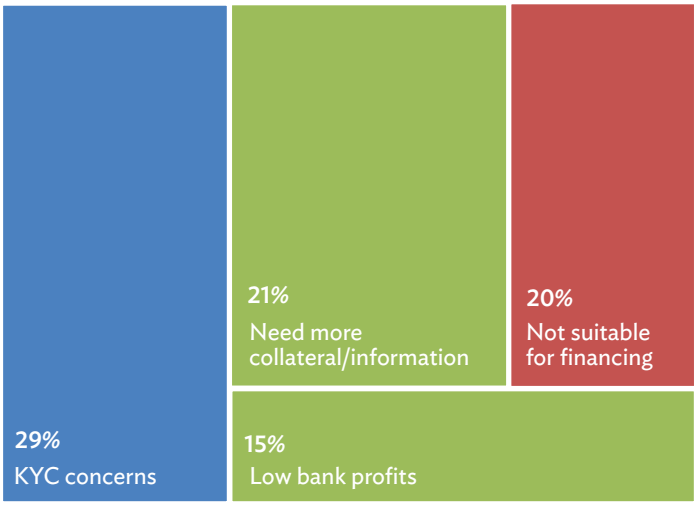
HOW MUCH OF THE GAP COULD HAVE BEEN FUNDED?

A critical policy question is how much of the reported global gap in trade finance can be addressed. Because the global gap number is calculated using all reported rejections, it captures both low and high risk transactions, as well as proposed transactions that are arguably not suitable for financing. A compositional breakdown sheds some light on identifying potential policy options to address the gap by mitigating the risks.

About 36% of rejected trade finance transactions were considered viable (Figure 3). The reason for rejection in these cases was either low profitability (15%) or the need for additional client information or collateral (21%). These types of rejections, however, may be fundable by other financial institutions such as fintech firms which have different requirements.

Another 29% of rejected transactions—those due to Know Your Customer (KYC) concerns—fall into a more ambiguous category. In some cases, banks may be concerned that potential clients are unlikely to meet anti-financial crimes requirements. But anecdotal evidence suggests in most cases banks were not willing to expend the cost and effort to conduct KYC, particularly for potential SME clients that would not generate much profit. For SMEs, this second category is a particular problem because of the low profitability of requested transactions and the difficulty of evaluating firms which lack clear financial and other records (this particular impediment was mentioned by over 50% of banks).

Figure 3: Reasons Banks Reject Trade Finance Applications (% of rejections)



Source: ADB. 2017 Trade Finance Gaps, Growth, and Jobs Survey.

The reluctance of banks to undertake KYC for low-value transactions has been a persistent problem in the trade finance sector since the global financial crisis. It is a function of the expansion of regulations and capital requirements in the sector. The cost of regulatory compliance can lead banks to

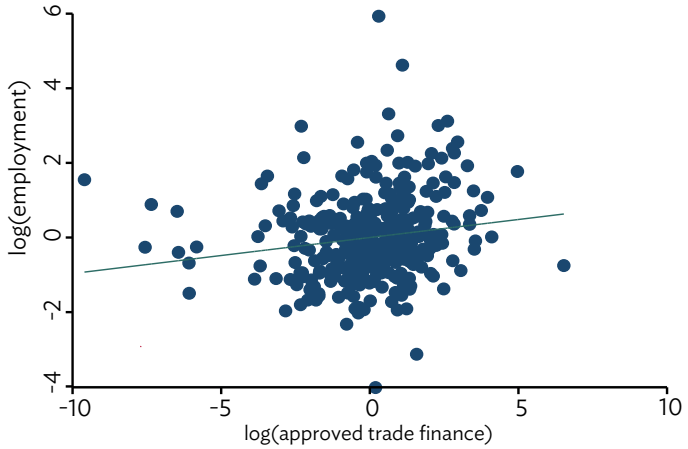
exit client relationships (40% in the 2016 survey and 45% in the 2015 survey), including the withdrawal of correspondent relationships. Forfaiters also report regulatory requirements as a major risk for business. This is particularly pronounced in some regions such as the Pacific where in some cases entire countries risk having no ability to manage remittances and conduct trade finance in the absence of any correspondent relationship. This has resulted in an increasing number of global efforts to establish and promote KYC utilities and digital identities.

JOB CREATION IMPACTS

It is tricky to distill the real economic impact of trade finance gaps. However, firms (86% in the 2017 survey) have consistently reported that additional trade finance would enable their businesses to grow and generate more employment. This perception is level across regions, with the strongest results among African and South American firms (90% of firms report that additional trade finance would enable them to create jobs).

To empirically assess whether this perception is borne out in the data, we conducted a regression analysis using the responding firms' data from the 2016 and 2017 surveys. After controlling for firms' characteristics that affect their demand for trade finance, the analysis suggests that firms which receive more trade finance are likely to employ more workers. Specifically, a 10% increase in trade finance is associated with a 1% increase in the number of workers employed (Figure 4).

Figure 4: Impact of Trade Finance on Employment



coefficient = 0.097, (robust) standard error = 0.037, t = 2.630

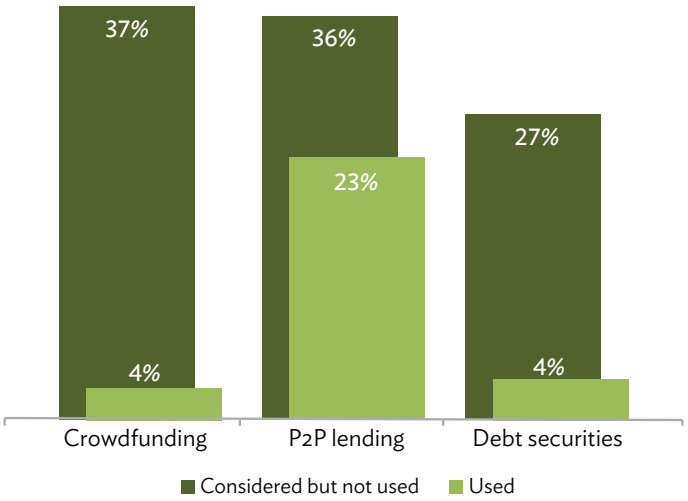
Note: A partial regression plot where the slope represents the percentage change in employment when amount of trade received increases by 1%, given other things equal. More details on the model are available at https://aric.adb.org/2017TFSappendix
Source: ADB caclulations using data from the 2016 and 2017 Trade Finance Gaps, Growth, and Jobs Survey.

FIRMS USING FINTECH FOR TRANSACTIONS

Fintech and digitization have attracted a lot of attention as a potential solution to SME financing needs for timely and affordable finance. However, data continue to show that few firms are familiar with fintech solutions to finance, and digitization of trade finance processes in banks are not reducing rejection rates for SMEs. The potential for both remains great, but the build phase continues.

Only around 20% of all reporting firms have used digital finance platforms. Among those firms, peer-to-peer (P2P) lending continues to be the type of fintech that was most used (Figure 5). This is in line with global trends. Though fintech credit is growing rapidly, low usage likely reflects the small size of fintech markets outside of the United States, the United Kingdom, and the PRC. P2P targets small business, and has expanded quickly from concentration in North America and Europe to a broader range of developing countries, with the PRC expanding particularly quickly even following recent regulations.

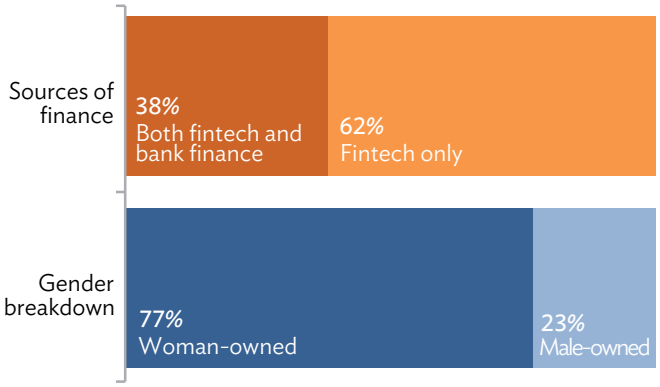
Figure 5: Use of Digital Finance Platforms
(by type, % of respondents)



P2P = peer-to-peer.
Source: ADB. 2017 Trade Finance Gaps, Growth, and Jobs Survey.

Respondents indicate that fintech is being used in two ways. Around 38% of firms that used fintech solutions also received bank finance, suggesting that in these cases, fintech is being used to diversify firms financing (Figure 6). In the other 62% of firms, only fintech was used. An interesting feature of fintech, and in particular P2P, is that woman-led firms are more likely to use it than the general population.

Figure 6: Profile of Fintech Users
(% of respondents)



Note: Fintech defined as crowdfunding, peer-to-peer lending, and debt-based securities.
Source: ADB. 2017 Trade Finance Gaps, Growth, and Jobs Survey.

DIGITIZATION NOT YET IMPACTING GAPS

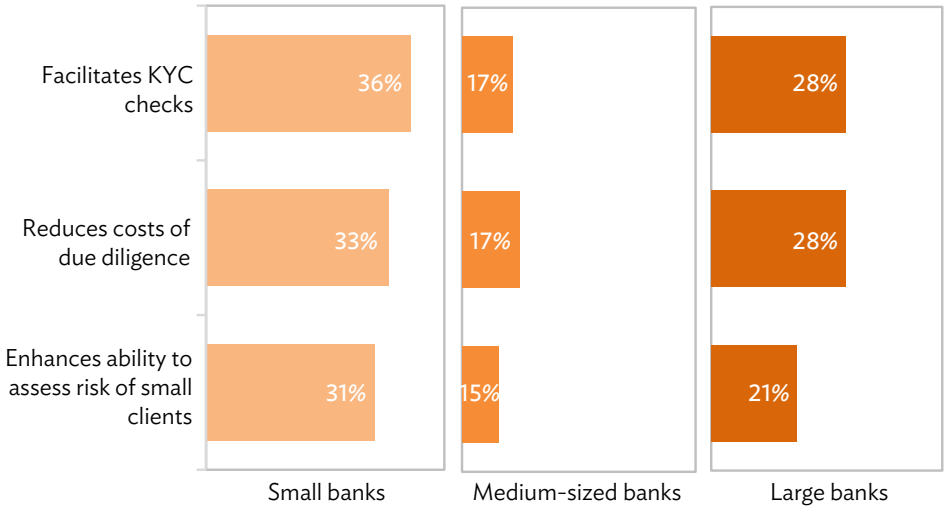
Turning to the supply side, among banks, digitization continues to make progress. The 2017 survey introduced additional questions to understand the impacts of these changes. In previous surveys, we showed that while digitization is spreading globally, it remains low among banks located in emerging and developing economies, including those in Asia and the Pacific.

This year, a greater proportion of banks report implementing digitization in banking operations. The objective is concentrated on cost reduction. When asked to define the areas in which digitization could potentially affect trade finance, 80% of responding banks expect that this will reduce the cost of complying with regulatory requirements and due diligence (Figure 7). A similar result was found for factoring companies, although they were more likely to positively evaluate the impact of digitization on credit assessment methods. This highlights the potential benefits, but for this potential to be realized, additional measures, and a more holistic perspective by banks beyond cost-cutting, are needed.

While digitization may lead to more inclusion, its potential impact on the gap is not yet realized. Last year's survey showed that the degree of digitization in banks was not correlated with their rejection rates of trade finance. In 2017, 66% of responding institutions reported that digitization is expected to enhance their ability to assess SME risk, a result which is stronger among smaller banks. Yet rejection rates of SMEs remain elevated.

This survey result is not meant to understate the financial community's enthusiasm for digitization and fintech to reduce the cost of administering trade (and other) finance. Around 70% of firms report that they expect technology platforms to reduce trade finance gaps, for example. But the data challenge assumptions that cost reductions alone will automatically reduce market gaps, particularly for SMEs. Indeed, there is no evidence to suggest this is happening. To promote this result, digitization and fintech must be used to make due diligence on credit risk, performance risk and KYC more efficient, cost effective, and reliable.

Figure 7: Section of Banking Business Expected to be Impacted by Digitization (by bank asset size)



KYC = Know Your Customer.
Note: Values refer to agree and strongly agree responses as percentage of total responses. Large banks are those whose assets in 2016 are higher than $50 billion, medium-sized between $10 billion and $50 billion, and small less than $10 billion.
Source: ADB. 2017 Trade Finance Gaps, Growth, and Jobs Survey.

FOUR POLICIES TO ADDRESS SHORTFALLS

This year's trade finance survey results suggest the following policy recommendations:

- First, implement identity solutions to address challenges in KYC due diligence. The Legal Entity Identifier (LEI) is a reliable harmonized global identification system that could address the issue at a global level. LEI will verify who's who, who owns whom, and who owns what. This would serve to simplify the challenges financial institutions face in conducting key portions of KYC due diligence.

- Second, scale up new methods of credit risk assessment. Supply chain finance (SCF), for example, enables a different approach to risk assessment. Unlike traditional methods that focus on financials and collateral—where SMEs tend to be weak—SCF assesses performance history and the 'stickiness' of relationships in a supply chain. Multilateral development banks are keen to support the growth of SCF and ADB has recently conducted its first set of SCF supported transactions.

- Third, harmonize digital standards in the financial and trade sectors. Even as digitalization has opened up new ways to administer the financing of trade, the lack of interoperability limits the ability to scale solutions. Regulators, banks, customs, shipping, logistics and fintech companies need to work together to inform new regulatory, legal and technical standards. This would enable all actors to generate and use new sources of credit and risk data to inform the due diligence that could help reduce gaps for SMEs.

- Fourth, continue to collect data with a view to creating a consolidated data architecture for the global trade finance market. A powerful way to promote good policy on trade finance is through detailed data analysis, benchmarking, trend analytics and advocacy. This work will enable us to better understand the real economic impacts of trade finance shortfalls.

Notes: Bank respondents came from both the International Chamber of Commerce Banking Commission as well as banks participating in ADB's trade finance program. The trade finance gap is estimated using the rejected value of proposed trade finance transactions as reported by responding banks. A regional trade finance gap is derived from the sampled rejected amount adjusted to reflect the degree to which the responding bank assets represent the total bank assets in the region. The global gap is calculated as the total of regional gaps. The results reported here are indicative of the current survey only and not comparable across years. Each wave of the survey has a unique population with different characteristics.

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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.

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