



Advisory Services
International Inc.

Financing International Trade:

Concepts, Challenges and Global Trends

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Standing Committee
for Economic and Commercial Cooperation
of the Organization of Islamic Cooperation

Key Messages

- Concepts and overview of trade finance

Selected observations on challenges and trends:

- Trade finance is essential to the conduct of trade
- A specialized form of financing, poorly understood, but at its core, relatively straightforward
- Trade finance involves long-standing practices, but significant, even transformational recent innovations
- Direct link to economic value-creation and international development
- Current level of attention around trade and supply chain finance is an important opportunity
- Many of the issues and challenges, including SME access, are shared within OIC Member States and beyond

CONCEPTS

Basics of Trade Finance

“Short-term credit/trade finance has been associated with the expansion of international trade in the past century, and has in general been considered as a routine operation, providing fluidity and security to the movement of goods and services. Short-term finance is the true life-line of international trade.”

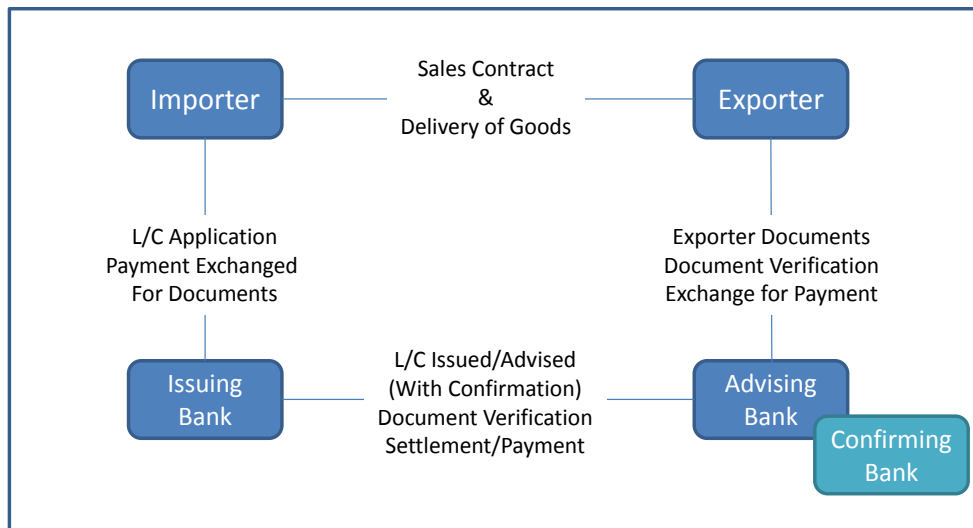
Source: Improving the Availability of Trade Finance during Financial Crises, WTO Publications, 2003

Trade Finance Is:

- Short-term in nature
- Linked directly to an underlying flow of goods or services, “real economy” activity
- Self-liquidating as a liability or financial obligation
- Very secure, exhibiting negligible default and loss rates over years and across large portfolios of transactions

Basics of Trade Finance

Payment <ul style="list-style-type: none">■ Secure■ Timely & Prompt■ Global■ Low-cost■ All leading currencies	Financing <ul style="list-style-type: none">■ Available to importer or exporter■ Several stages in the transaction■ No impact in Operating Line for exporters	Risk Mitigation <ul style="list-style-type: none">■ Risk Transfer■ Country, Bank and Commercial Risk■ Transport Insurance■ Export Credit Insurance	Information <ul style="list-style-type: none">■ Financial flows■ Shipment Status■ Quality of Shipment■ L/C systems include web & desktop solutions
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- Long-established, familiar instruments supported by global rules and practices (ICC sets of rules, including UCP and others)
- Effective in high-risk and developing markets
- SME's underserved by banks but supported by IFI's and ECA's
- Use of "Traditional Trade" globally is flat and trending down
- Shift is to Open Account trade, evolving solutions in financing global supply chains

The Documentary Letter of Credit

Basics of Trade Finance

Payment

- Secure
- Timely & Prompt
- Global
- Low-cost
- All leading currencies

Financing

**EASILY
Accessed!**

Risk Mitigation

**Quickly
FORGOTTEN!**

Information

- Financial flows
- Shipment Status
- Quality of Shipment
- L/C systems include web & desktop solutions

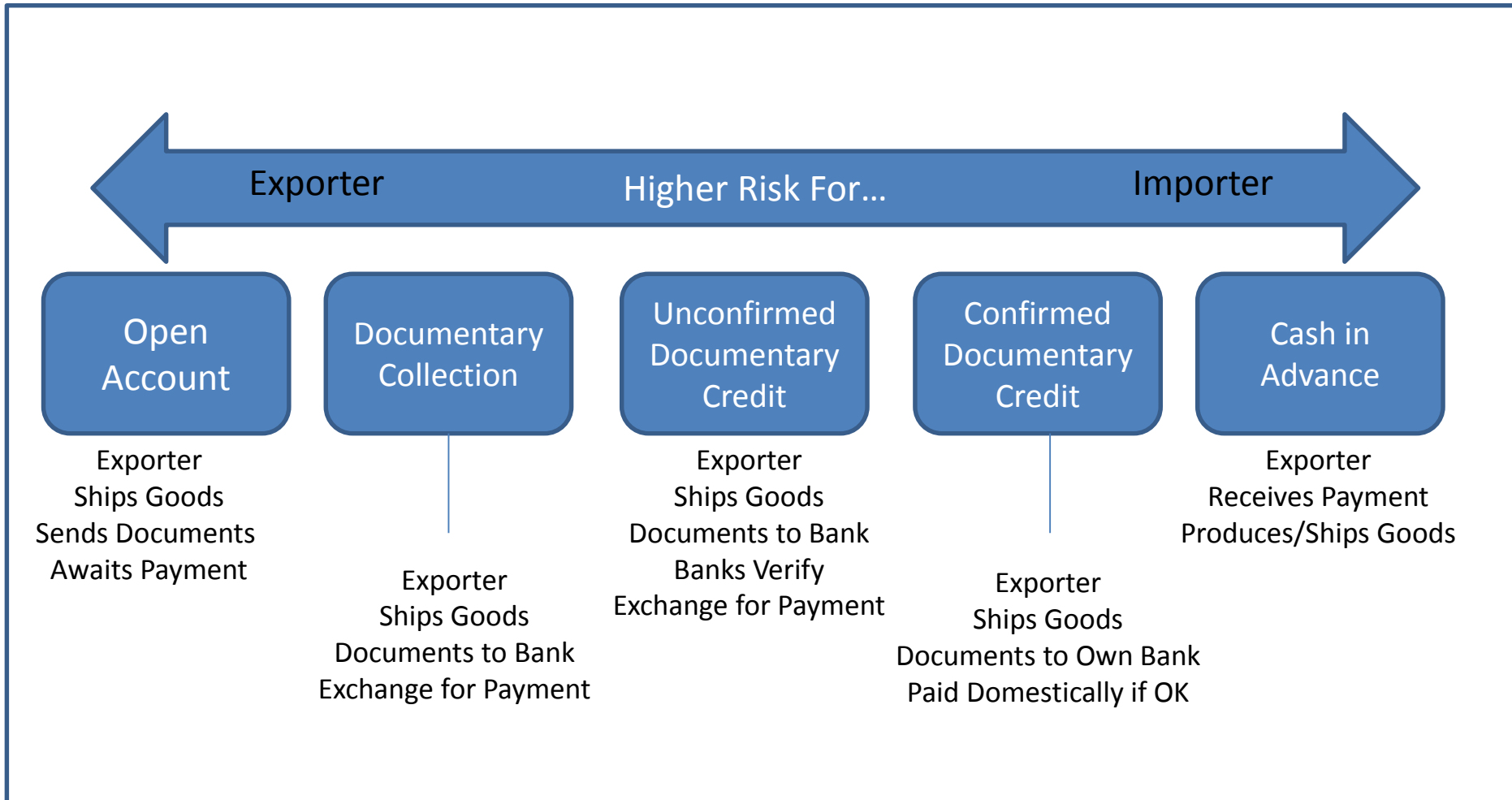
Pre-crisis, importers, exporters and bankers seem to have forgotten about the disciplines of risk assessment and management. High liquidity facilitated easy and low-cost access to finance. Buyers and sellers shifted focus to prompt payment and data flows.

Bank “disintermediation” was eventually recognized as a real threat and a probability!

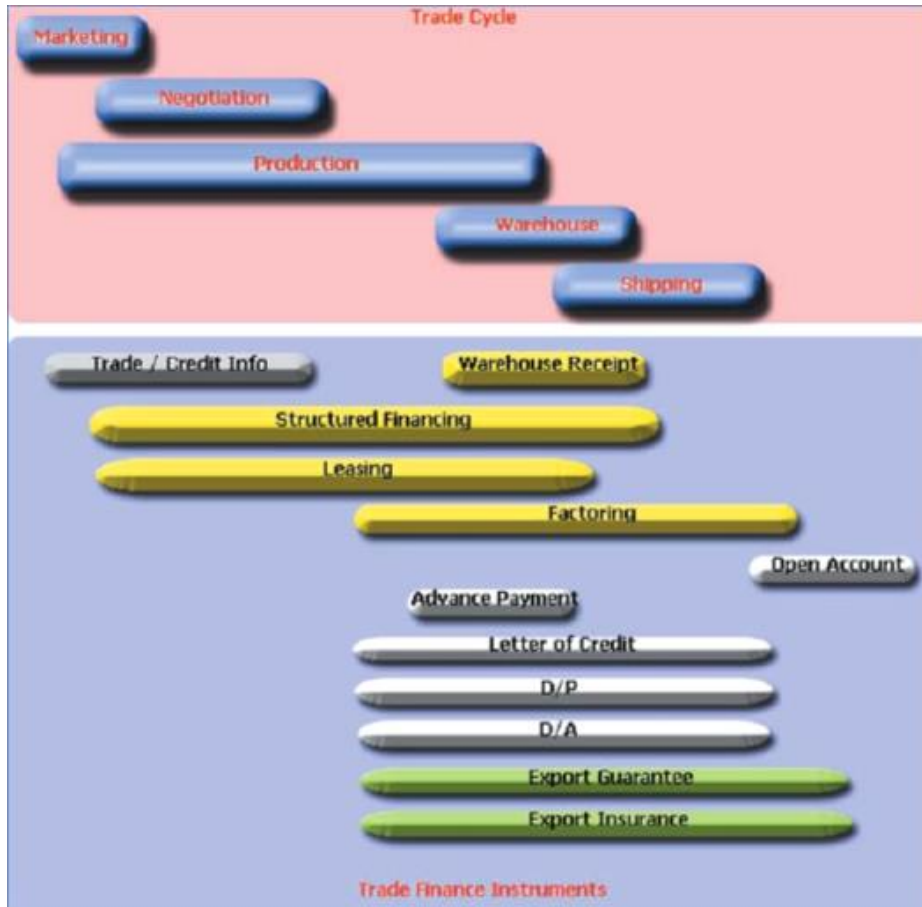
Basics of Trade Finance

- Exporters can require financing to be able to source factors of production and to complete the production and shipment process
- Importers may require financing until they receive the goods purchased, sell them and generate a profit
- Banks, including those in developing and emerging markets, can also periodically require financing from other financial institutions
- Trade finance mechanisms allow for and can facilitate all of these forms of financing
- Financing can occur as early as on issuance of a purchase order, and at several points between the start and end of a transaction: often separated into pre-shipment and post-shipment financing
- Emerging sourcing patterns and trade flows, including flows to and from Asia, and intra-regional flows in Africa and the MENA Region are likewise dependent on financing. Extended global supply chains also require liquidity and risk mitigation solutions available through trade finance

Basics of Trade Finance



Basics of Trade Finance



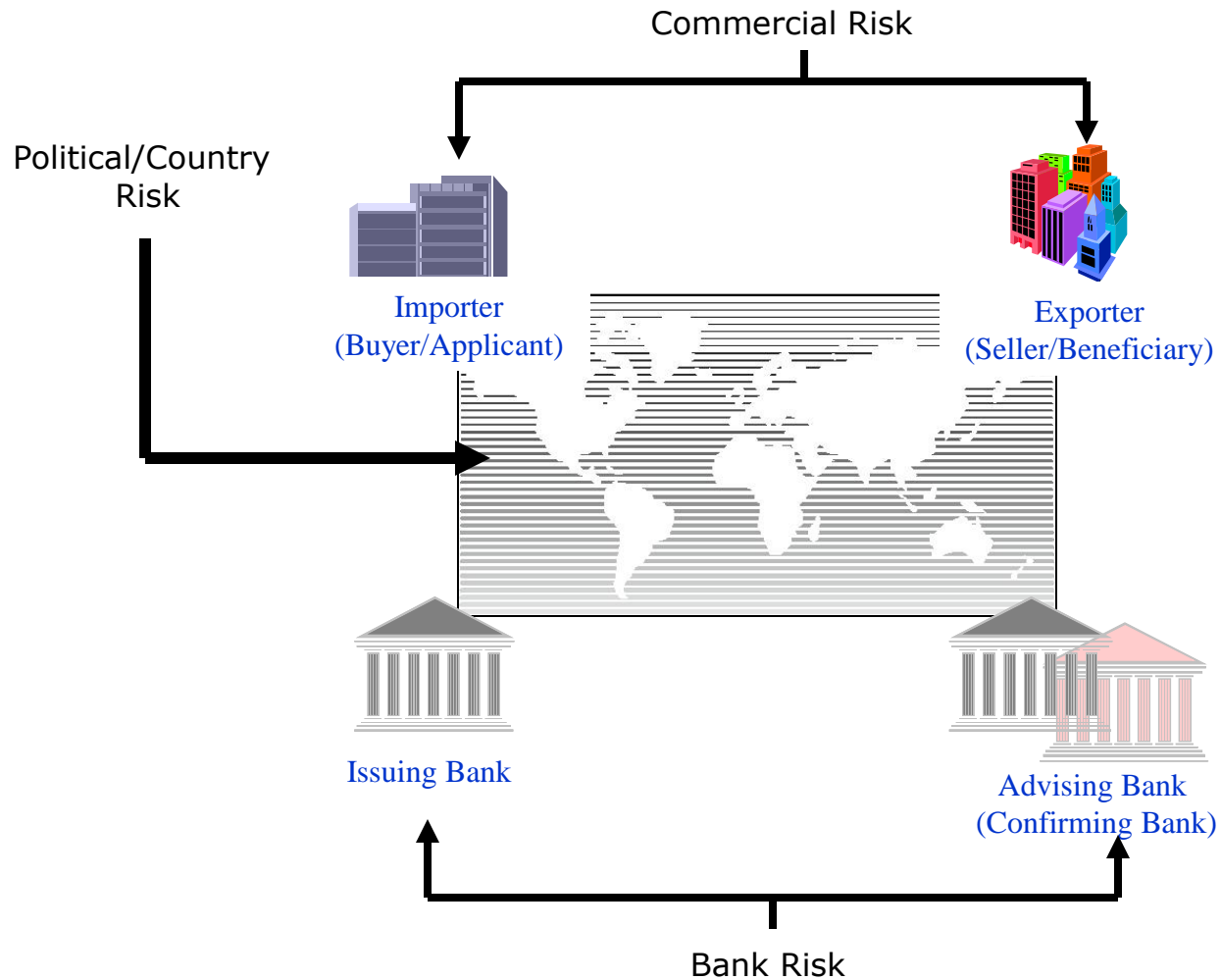
- Documentary letter of credit
- Documentary collection, including documents against payment and documents against acceptance
- Export credit
- Various forms of guarantees, including standby letters of credit
- Warehouse and trust receipt financing
- Importer credit
- Supplier credit
- Forfaiting
- Countertrade
- Export leasing
- Supply chain finance

Basics of Trade Finance

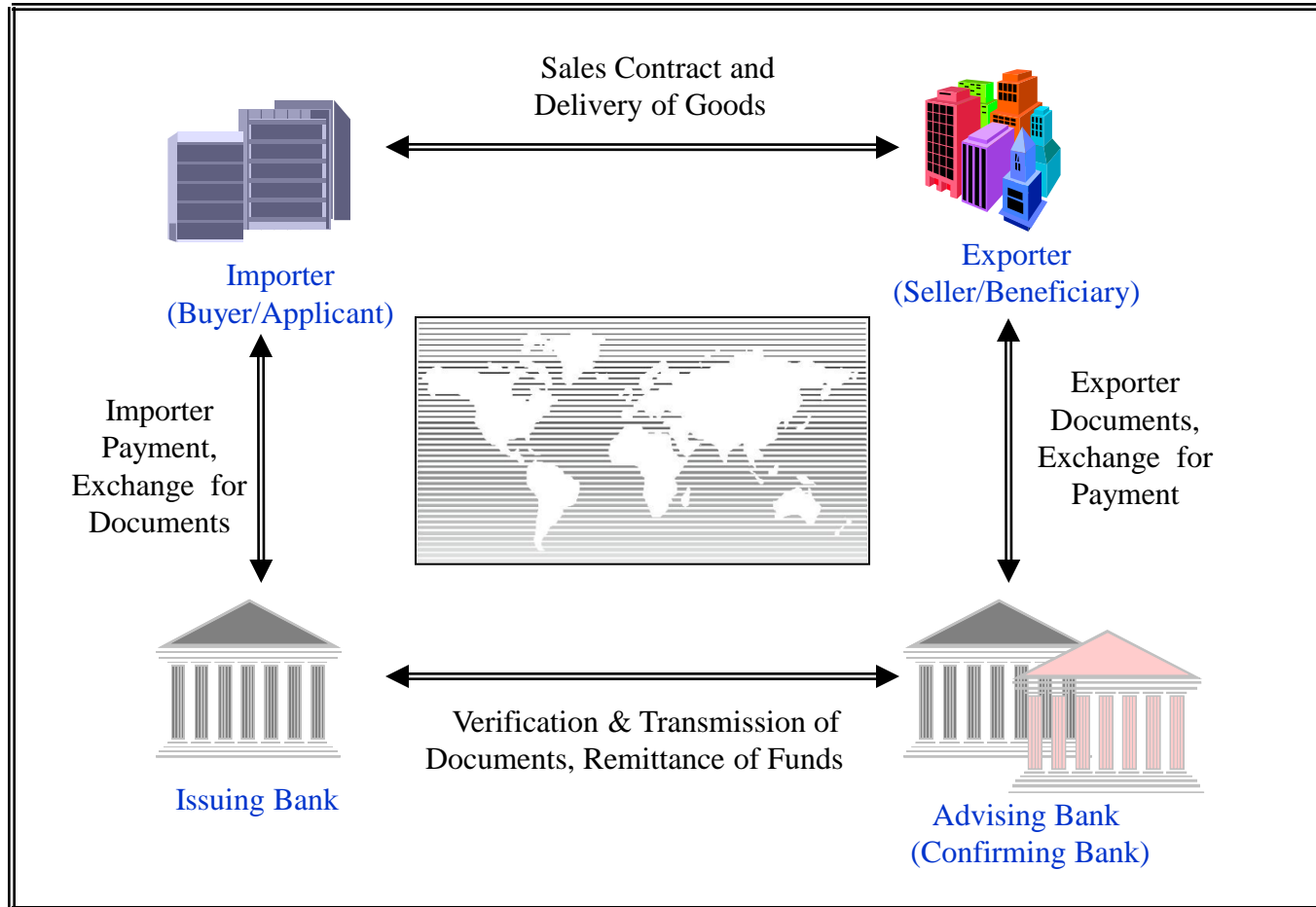
Risk Category	Economic (commercial) risks related to the trading partner	Exchange rate risk	Transportation risk	Political risks		
				Foreign policy	Domestic policy	Economic policy
Examples	Importer is not willing or unable to pay Importer does not accept merchandise Exporter does not deliver on time or products agreed	Floating exchange rates: variations in exchange rates Fixed exchange rates: risk of devaluation	Damaged or loss of goods	War Embargo Restrictions	Revolt Civil War	Prohibition to transfer foreign exchange Currency declared non-convertible
Methods to mitigate risks	Private insurance or public export credit agencies Letter of Credit Bank guarantees	Bank provide hedging facilities; public exchange risk insurance	Private insurance	Export credit agencies or private insurance		

Source: WTO

Basics of Trade Finance



Basics of Trade Finance: Documentary Credits



Documentary Credits

- Documentary Credits (Letters of Credit) are typically used between trading partners wishing to ensure mutual security in a transaction
- They may also be required as the basis for financing; Banks will often discount or advance funds due under a Letter of Credit. In parts of Asia, Documentary Credits are often used as collateral against loans. The need to use L/C's may arise out of financial arrangements independent of the buyer/seller relationship
- Banks have extensive and well-established roles and obligations to ensure that the terms and conditions of these instruments are met
- The Issuing Bank structures and issues the Letter of Credit on behalf of the Applicant, but the Credit, once issued, represents a "promise to pay" by the Issuing Bank

Documentary Credits

- The Advising Bank receives, authenticates and verifies the L/C, then "Advises" or transmits it to the exporter in order to trigger production or shipment of the goods, presentation of shipping Documents
- Documentary Credits may include a separate payment undertaking by a Confirming Bank, which may be sought by the exporter if Issuing Bank's payment promise is not considered satisfactory. This may arise as a result of the Issuing Bank's lack of International standing, or out of external factors such as political instability or exchange controls, for example
- Discrepancies in the Shipping Documents against the L/C terms can cause the transaction to fail, or they may be waived to permit conclusion of the transaction. Banks are charged with identifying discrepancies, though the process typically involves communication between the parties to the transaction. 60-70% of documents tendered by exporters under L/C's have some type of discrepancy
- Governed by the Uniform Customs and Practice for Documentary Credits (UCP 600), International Chamber of Commerce, Paris, and periodic revisions thereto

Basics of Trade Finance:

Trade and Supply Chain Finance

Traditional Trade Finance

- Transactional
- Product-driven
- Typically multiple banks
- Long-established
- Highly effective risk mitigation
- UCP/URDG/ISBP
- Common understanding

Supply Chain Finance

- “System”-based
- Solution-driven
- One or more banks
- “New” but also long-established
- Emerging definitions and practices
- Understanding still evolving

Complementary elements of an overall proposition. Some banks position traditional trade finance under SCF, others see SCF as part of trade finance. Still others position trade and SCF under working capital management

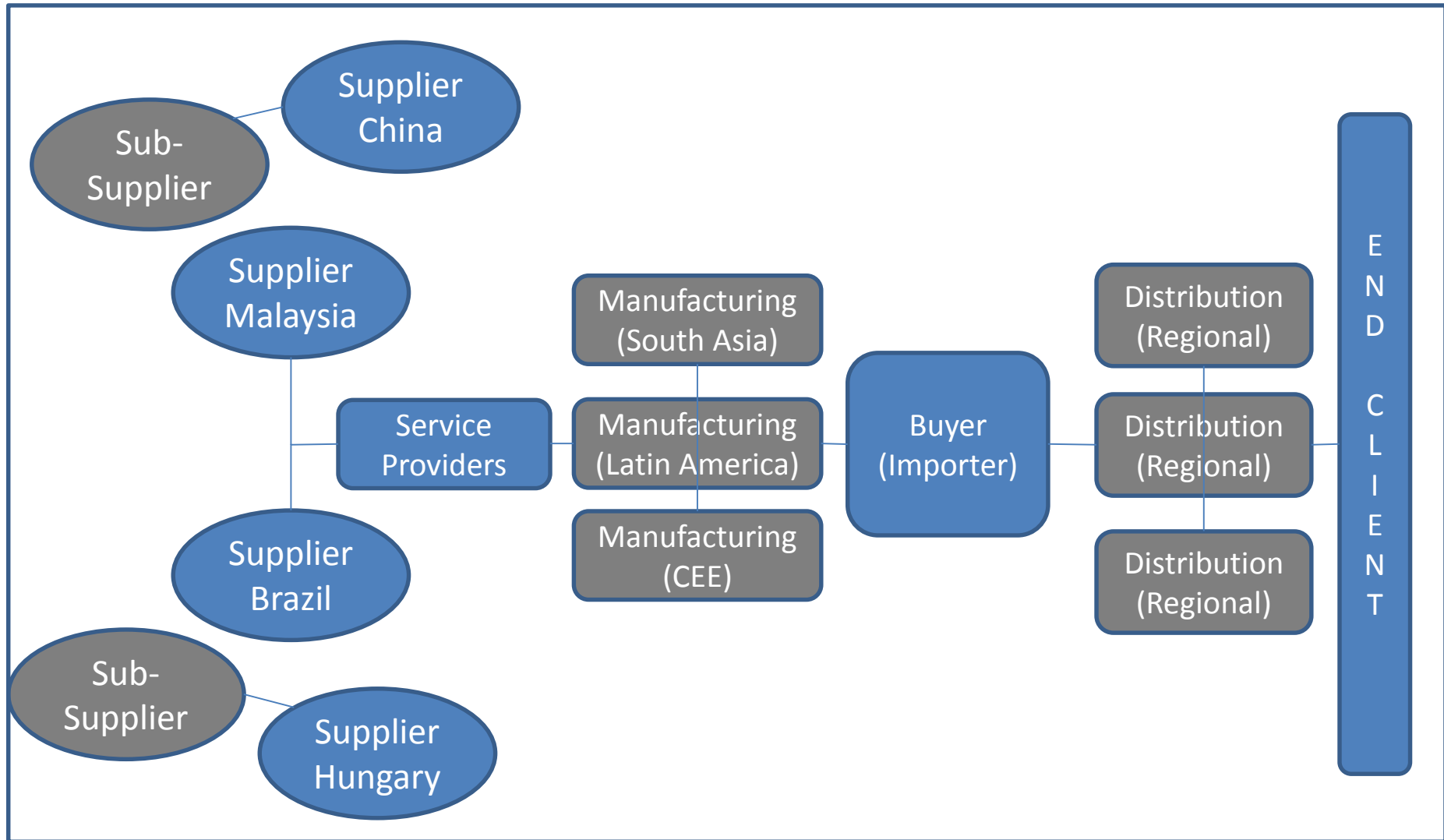
Supply Chain Finance

- Drive from large global retailers to reduce costs and complexity associated with the use of L/C's
- Perception, pre-crisis, that liquidity was easily accessible, and risk negligible
- Demands for trade on open account terms
- Direct threat to the banks' trade finance business
- Vision to provide liquidity to a supply chain based on borrowing capacity (and lower financing cost) of anchor client

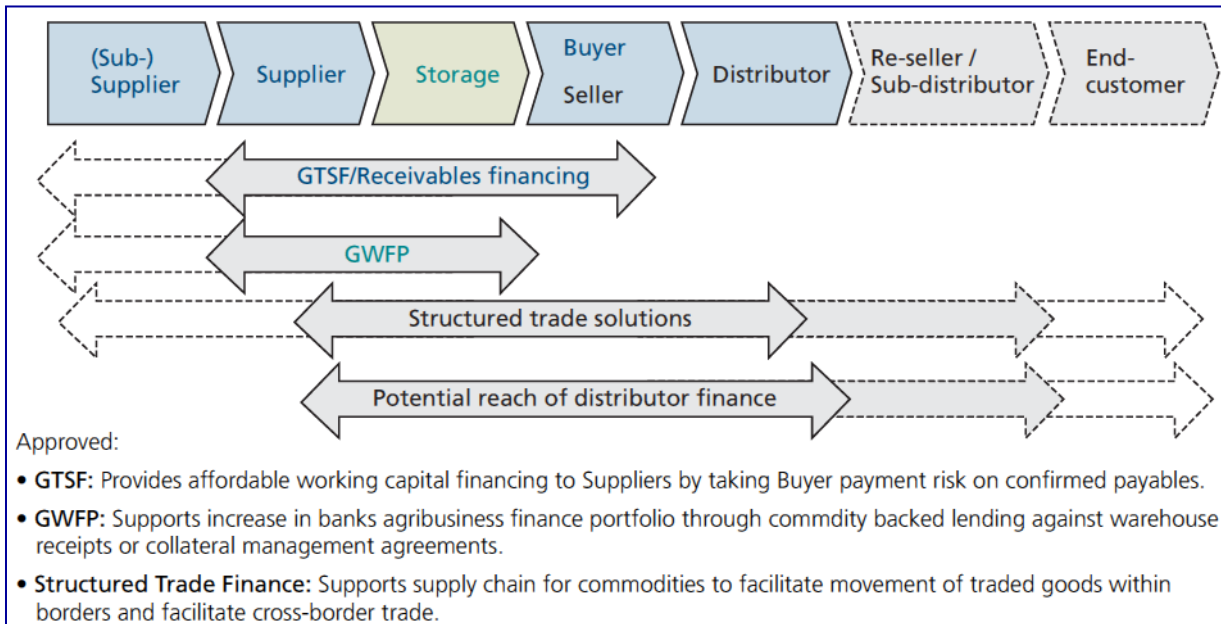
Supply Chain Finance

- Buyer-centric programs leverage the credit standing of large corporates to offer support to supplier network
- Suppliers often in developing/emerging markets, ICT limitations or obstacles related to remoteness
- Reluctance to show financial need or weakness to buyer, fear of giving away leverage
- Banks face significant due diligence and KYC-C challenges

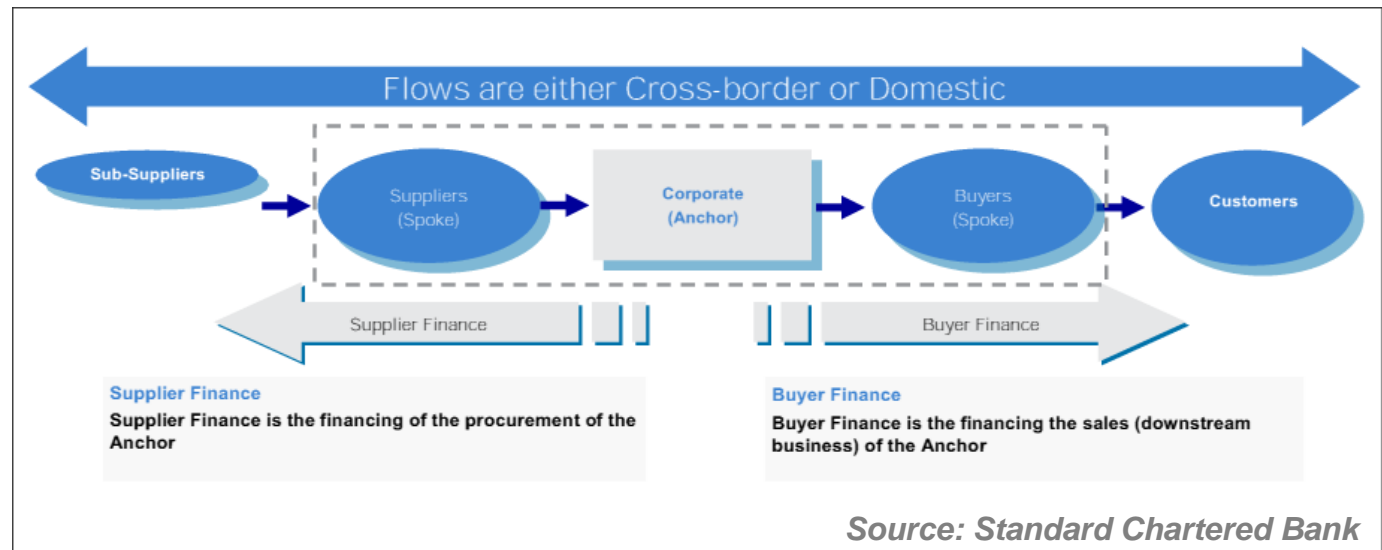
Supply Chain Finance



Supply Chain Finance



Source: IFC Short Term Trade Finance 2011



Islamic Trade Finance

- Significant global momentum
- Growing interest among leading trade finance banks in the Middle East, Asia and internationally
- Based on Islamic Sharia Law
- Key distinction is in not permitting the charging or collection of interest
- Investor/Borrower relationship
- Banks may take ownership of goods, purchasing from supplier, selling to customer on deferred payment terms at agreed profit to generate a 'surplus'
- Murabaha – Mark-up Transaction
- Musharaka – Profit and Loss Sharing Transaction

Islamic Trade Finance

“From a framework perspective, the conclusion must be that there are sufficient similarities at the core of conventional and Islamic Trade Finance that enable consideration of both varieties in the context of broader trade development and collaboration initiatives to be conceived and developed for OIC Member States.

The direct linkage between financing and an identifiable flow of goods, the non-speculative, “back-to-basics” focus of trade practitioners, and the merchant banking parallel where a financier takes ownership of the goods financed, all combine to provide a strong sense of compatibility between conventional and Islamic Trade Finance.”

Source: Improving the SMEs Access to Trade Finance in OIC Member States, 2013

CHALLENGES

Financing Gap

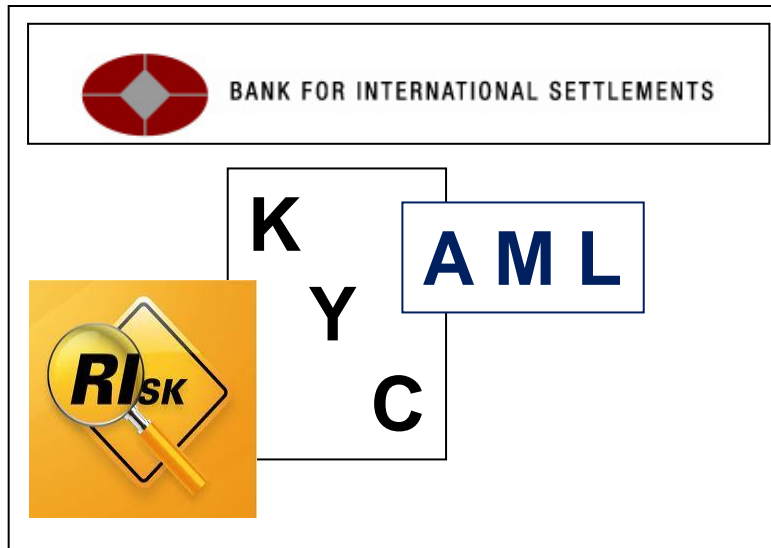
The IFC estimates a financing gap of up to USD 2 Trillion in the MSME segment, approximately USD 1.3 trillion of which is related to short-term trade finance.



SME's at the forefront of political focus and expected recovery, yet remain under-financed.

German "MittelStand" as the global example

Regulatory Pressures



- Regulatory pressures and costs, including KYC, KYCC, AML and more
- Capital adequacy and Basel III
- Banks facing significant disadvantage as a result
- Direct impact on the cost of trade finance
- Ultimate impact on end-clients, including SMEs and developing economies
- National and regional authorities can help to mitigate

Challenges: Trade Finance

- Bank and other provider capacity constraints
- Requirement to risk-share and distribute trade assets, absent a global framework for doing so
- Pricing and margin compression in trade
- Trade process-related challenges that add to urgency in financing:

[The time]...it takes for the typical 20-foot container to reach the most accessible port. In Bangui, Central African Republic, it takes 116 days for such a container to be moved from a factory in the city to the nearest port in the Gulf of Guinea. It takes 71 days to move such container from Ouagadougou, Burkina Faso, to the nearest port. On the contrary it takes 5 days from Copenhagen, 6 days from Berlin and 20 days from Shanghai, Kuala Lumpur and Santiago de Chile. Same studies find that a delay of one day reduces trade by more than 1%.

Source: UNECA Aid for Trade Review 2009

Challenges: Trade Finance, OIC Member States

Just as there are systemic issues in accessing or deploying financial resources in support of trade, globally, there are several observable challenges in doing so within and between OIC Member States. These include:

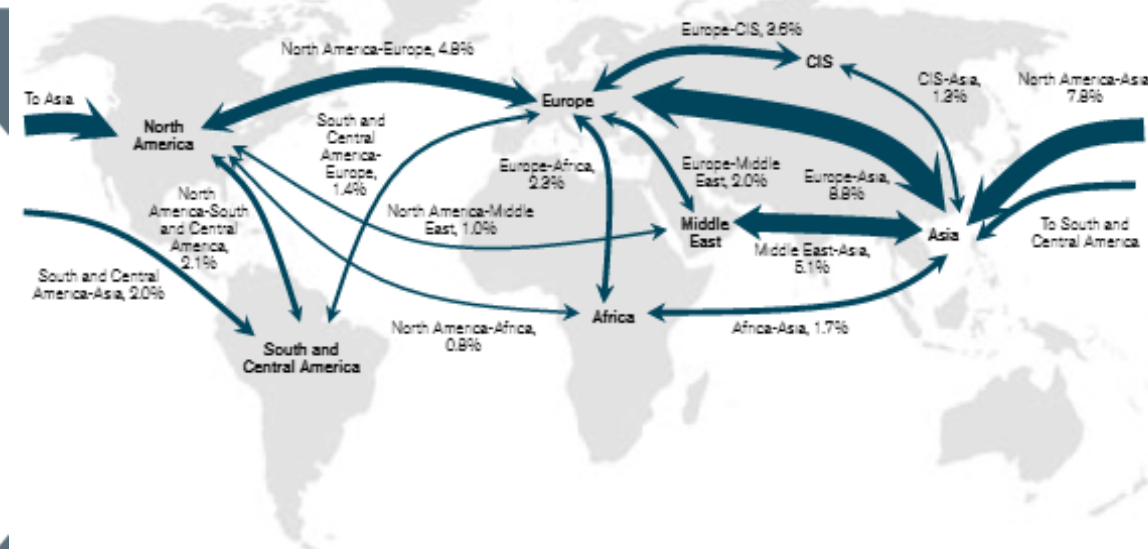
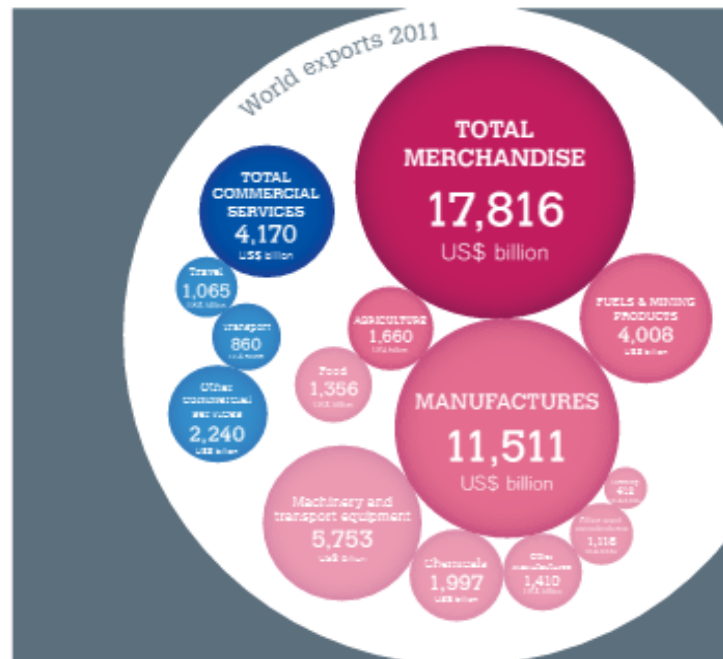
- Limited payment and settlement infrastructure in OIC Member States, forcing the use of (expensive) international centres of finance
- Limited availability and uptake of ECA support and risk insurance
- Limited trade finance product innovation beyond basic structures
- Systemic risk aversion
- Absence of capacity management through syndications and other forms of risk sharing, or development of additional capacity

Challenges: SME Access to Finance

- An entrepreneurial mind-set and related distrust of banks and large institutions
- Hesitancy in providing visibility around business operations, strategic direction and financial status
- Limited technical competence in finance which prevents small businesses from “speaking the language of the lender” and appreciating the critical importance to timely and adequate disclosure
- Opacity relative to the purposes and planned use of borrowed funds, and a related perception of heightened risk
- Inability to prepare credible loan or financing requests
- Limited collateral or other forms of security
- Perceptions of non-bankability especially in developing markets
- Perceived high risk of SME finance and trade finance
- High level of coaching and resource intensive nature of SME relationships
- Internal competition for limited capital, meant to be deployed in support of secure, profitable business
- Lack of technical competence around trade finance among credit and risk analysts

GLOBAL TRENDS

International Trade Statistics 2012



Source: WTO Secretariat estimates.

Note: World trade includes intra-EU trade. Arrow weights based on shares in 2011. Trade within regions and with unspecified destinations represented 54% of world trade in 2011.

- Industry metrics suggest 80-90% of global trade is supported by some form of trade finance. Export Credit Agencies (ECA's) alone support about 10% of global trade
- Emerging sourcing patterns and trade flows, including flows to and from Asia, are likewise dependent on financing. Extended global supply chains and regional trade flows alike require liquidity and risk mitigation solutions available through trade finance
- The link between trade finance and the creation of economic value has only recently been the focus of serious analysis; An Asian Development Bank (ADB) Survey suggests a 10% increase in trade finance can translate to a 5% increase in business activity and demand for human resources

Global Trends



*BAFT-IFSA and ICC
Championing
Trade Finance*



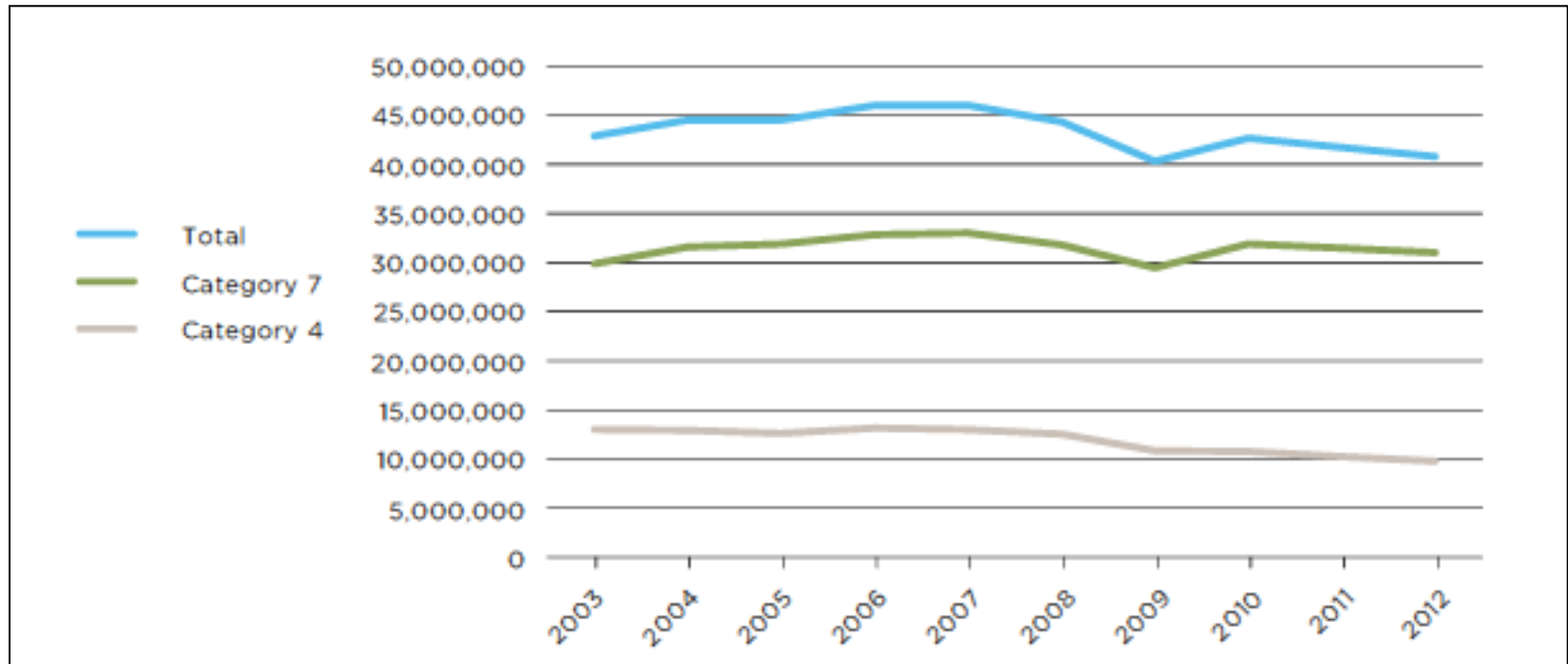
*Promoted at top
Political Levels*



*Unprecedented focus
at G-20 and WTO*



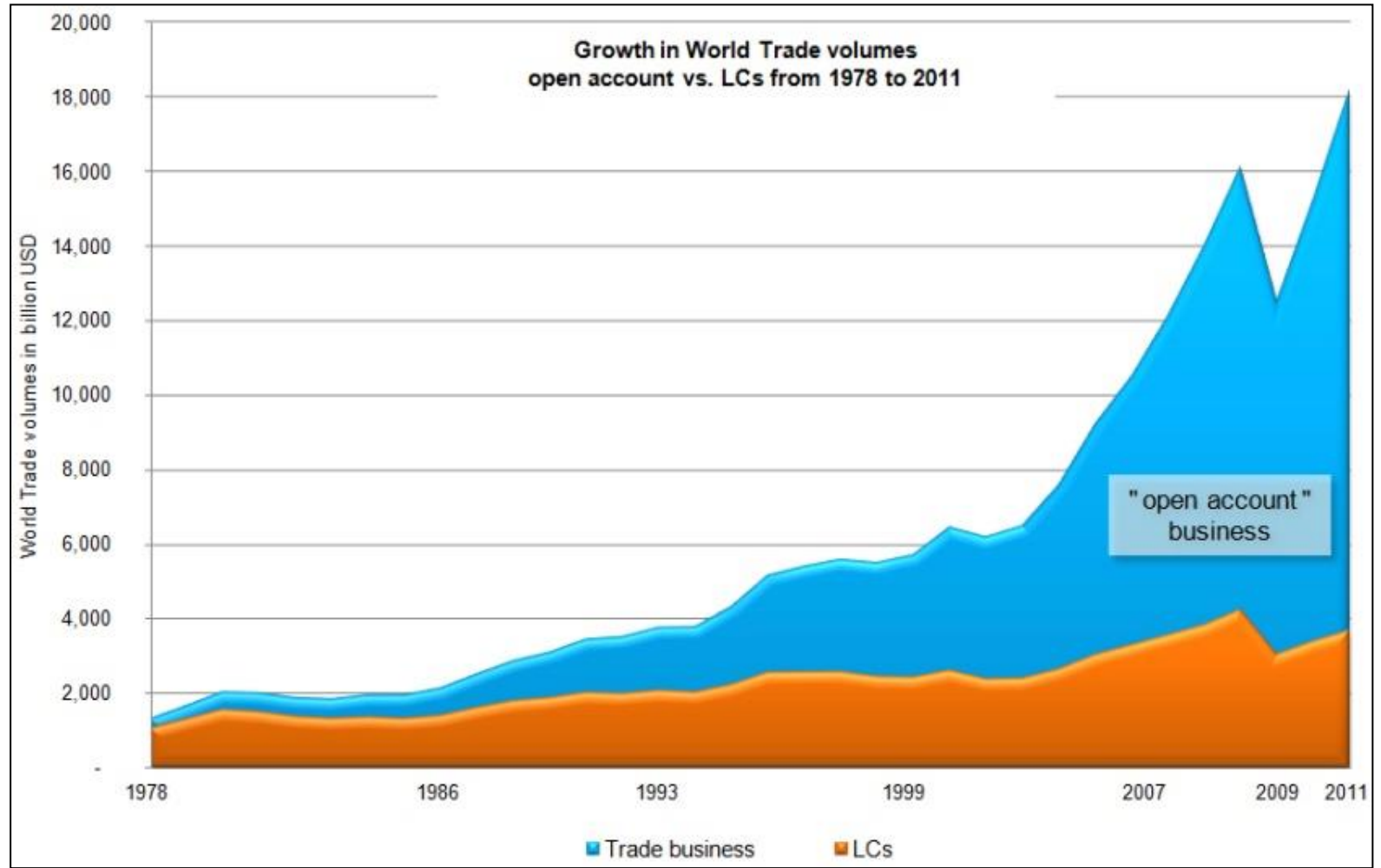
Global Trends



Source: ICC

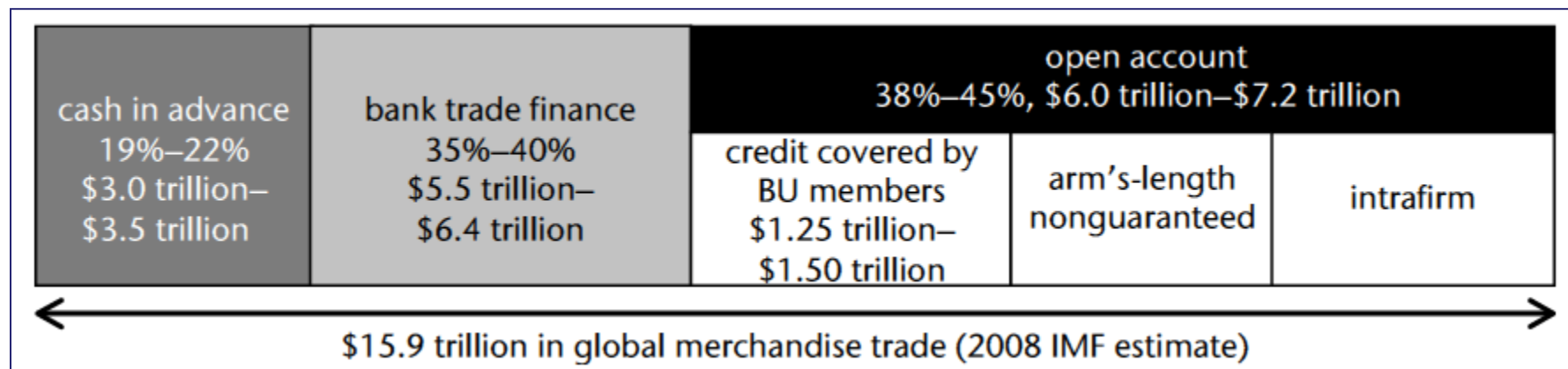
- Companies shifting to Open Account terms almost globally, even in “high-risk” markets
- Supply chain finance solutions evolving among banks and other providers, allow for ecosystem/multilateral view of trade
- Opportunity to service SMEs and to facilitate access to finance in developing markets

Market Evolution

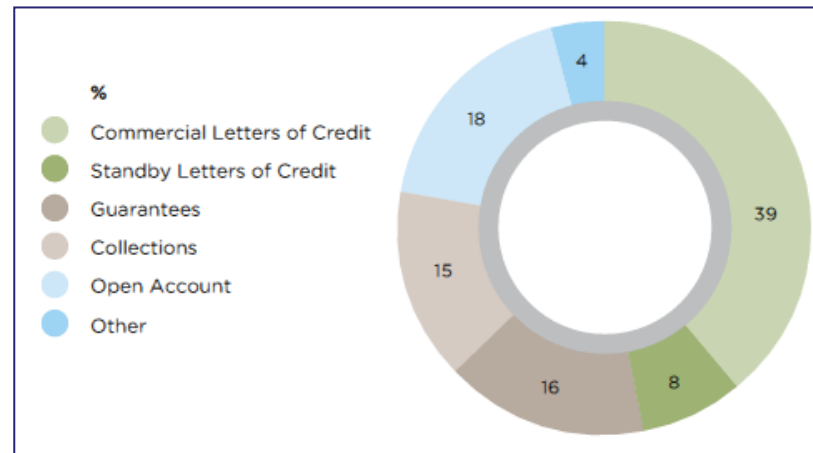
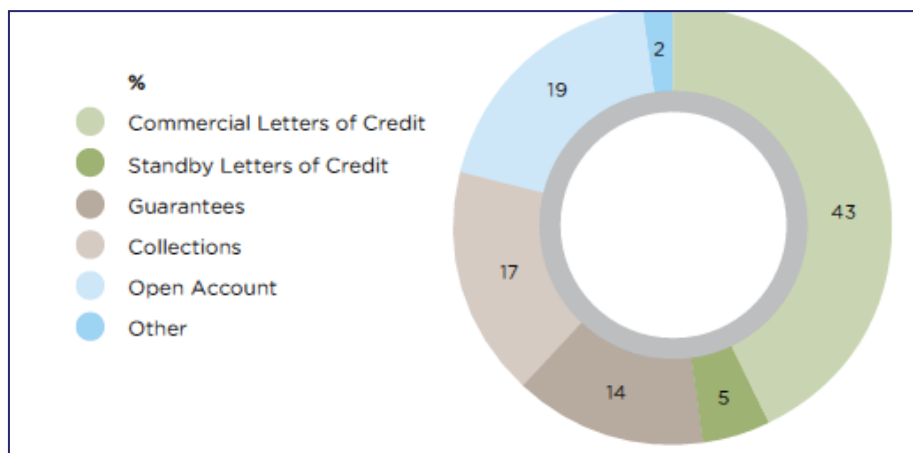


Source: Unicredit

Global Trends

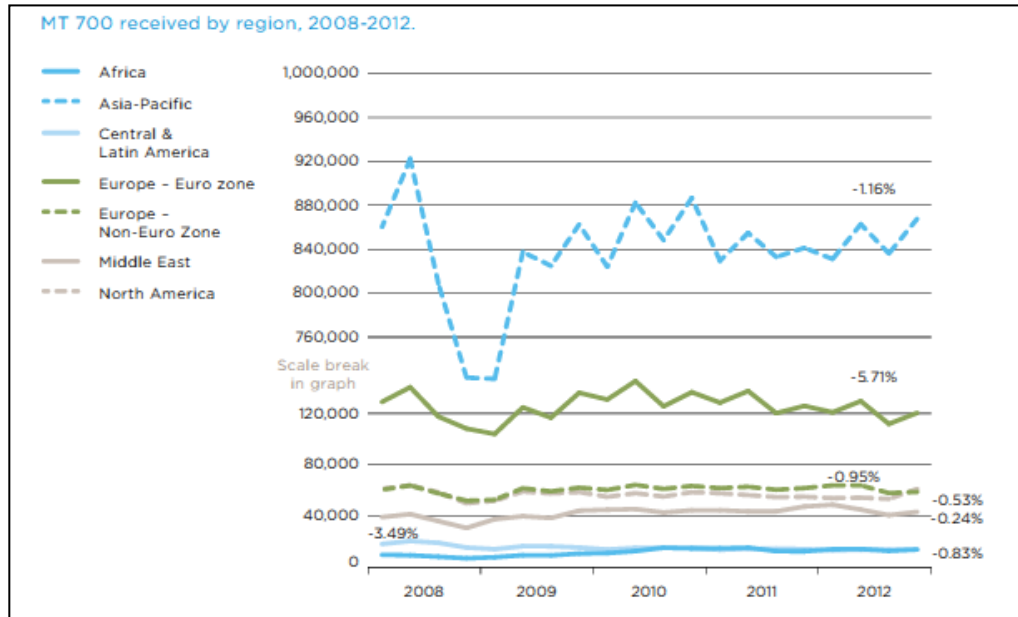


Source: World Bank/IMF

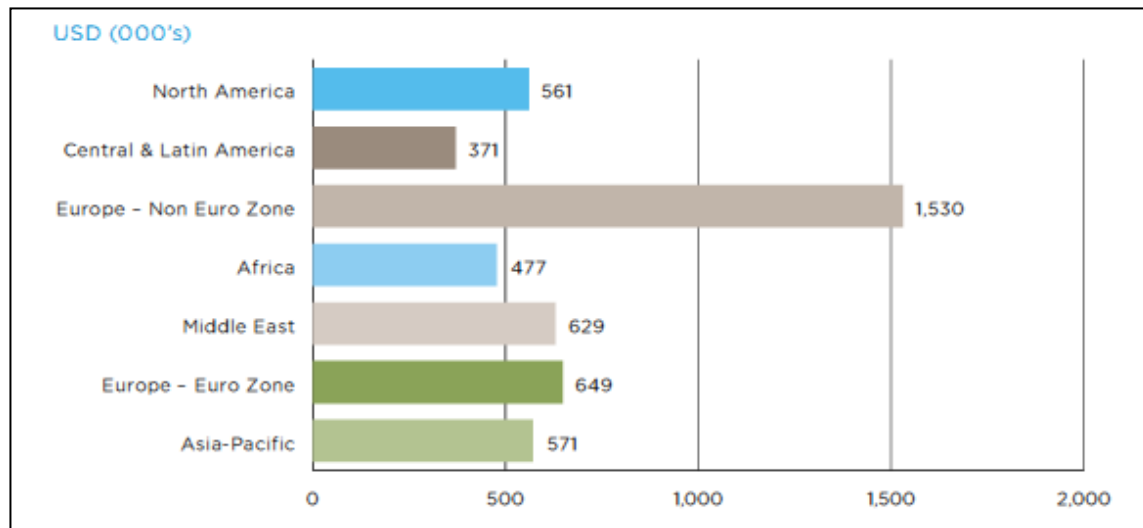


Source: ICC 2013

Global Trends



Source: ICC 2013



Global Trends

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: ICC 2013

- Very effective risk mitigation
- Negligible default and loss rates even in higher-risk markets
- Various insurance and guarantee programs, risk transfer mechanisms
- Handles country, bank and commercial risk, FX risk and others
- Banks, ECAs, IFIs, private insurers all contribute

	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/gtftp	iadb.org	adb.org/tfp

Global Trends



Short Term Credit Insurance Cover, ECAs								
MILLION USD	2005	2006	2007	2008	2009	2010	2011	2012
New business covered	843,719	975,262	1,126,721	1,296,878	1,122,608	1,257,794	1,495,227	1,530,097
Claims paid	702	783	1,007	1,128	2,418	1,508	1,323	2,093

Source: Berne Union

Global Trends



To help banks provide innovative trade and supply chain services that enable their corporate customers to:

- reduce risk
- enhance process efficiency
- improve liquidity management.

More than 9,000 financial institutions in 209 countries.

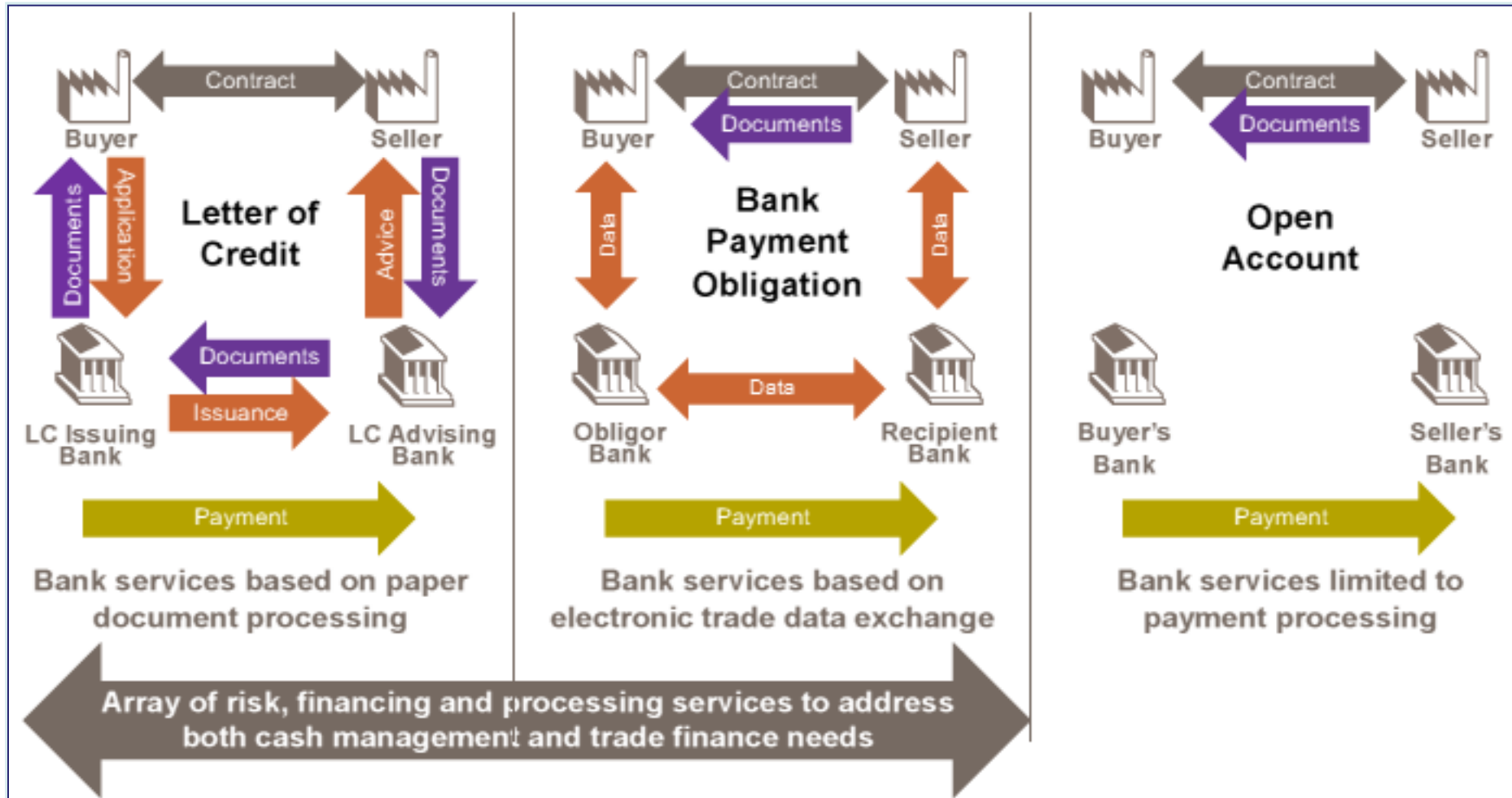


The ICC Banking Commission is a leading global rule-making body for the banking industry, producing universally accepted rules and guidelines for international banking practice, notably letters of credit, demand guarantees and bank-to-bank reimbursement.

Over 500 members in 85 countries.

Uniform Rules for
**Bank Payment
Obligations**

Global Trends



...a viable option to facilitate access to trade finance for SME's in Developing Markets

For Consideration...

For Consideration...

- Better leverage the profile of trade finance today, to advocate in favour of supportive national and regional policy
- Undertake specific analysis around the applicability of the BPO as an instrument of trade finance in developing markets
- Continue training and education efforts linked to trade finance; broaden the audience to end-users and selected stakeholders
- Expand the role and scope of operation of ECA's and IFI's; support non-banks interested in financing developing market trade (PPP)

For Consideration...

- Undertake complementary short and long term initiatives to facilitate SME access to trade finance
- Consider SME access to trade finance with reference to conventional and Islamic Finance, broader trade facilitation activity and related COMCEC work-streams
- Link policy initiatives directly to economic value and to the creation of economic value for OIC Member States individually and as a Group
- Map OIC Members to comparable jurisdictions to identify applicable lessons and mutual challenges
- Undertake an IFI and ECA Best Practices Study
- Design and deploy training and competency development initiatives for providers and end-clients
- Undertake an analysis of the Bank Payment Obligation and its applicability in support of SMEs in OIC Member States
- Take policy measures to help increase trade financing capacity
- Undertake an OIC-specific Best Practices Study



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Thank You.

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