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KEY POINTS

- The global trade finance gap stands at $1.4 trillion, $693 billion of which is in developing Asia (including India and the Peoples Republic of China).
- While availability of trade finance has improved, gaps have become more concentrated
- 45% of banks reported terminating correspondent banking relationships due to the cost or complexity of compliance with regulations designed to stem financial crimes.
- Small and medium sized enterprise proposals for trade finance are rejected 52% of the time, while multinational corporations have 87% of their proposals accepted.
- 46% of firms report that a doubling of trade finance availability would fuel an increase in production and exports.

Keywords: trade finance, Asia, BRICs, due diligence, trade, development, financial crimes compliance, bank regulation, anti-money laundering (AML), know your client (KYC)
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2015 TRADE FINANCE GAPS, GROWTH, AND JOBS SURVEY[1]

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INTRODUCTION

Respondents to the 2015 survey believe the availability of trade finance has improved globally. However, data indicate that gaps are increasingly pronounced in emerging economies. The geographic concentration of trade finance shortfalls appears to be driven by a combination of banks rationalizing existing business away from high-risk markets and weaker trade in some regions.

This year's survey follows from and improves on ADB's previous efforts to understand where and why gaps in global trade finance exist and their impact on growth and jobs. In addition, this year's questions sought more clarity on the unintended consequences associated with regulatory requirements designed to stop financial crimes, which were again raised as a major impediment to the availability of trade finance.

In the 2015 survey, 253 banks from 86 countries responded. This is an increase from the 101 responses in 2014. The reported results are indicative of the responding population only. The larger population for 2015 suggests that this year's survey (of 2014 data) presents a more accurate picture of the global trade finance environment.

The persistence of gaps in some developing economies is troubling. For these economies, trade finance continues to put a brake on trade growth and on trade-based economic value-creation and poverty alleviation, particularly for small and medium sized enterprises (SMEs). Geographically, gaps are proportionately widest in Sub-Saharan Africa, South America, and within developing Asia.

[1] ADB acknowledges the advice, support, and cooperation of our partner organizations. These include the World Trade Organization (WTO), the International Chamber of Commerce (ICC) Banking Commission, the International Trade and Forfaiting Association (ITFA), Factors Chain International (FCI), the Centre for the Promotion of Imports from developing countries (CBI), the International Trade Centre (ITC), the Bankers Association for Finance and Trade (BAFT), the International Credit Insurance & Surety Association (ICISA) and the many banks and companies that took time to complete our surveys.

TRADE FINANCE AVAILABILITY IMPROVED GLOBALLY IN 2014

In this year's survey, both banks and companies were positive about the availability of trade finance globally. In value terms, the projected global trade finance gap for 2014 is estimated at $1.4 trillion. Asia and the Pacific as a region faces a shortfall of trade finance of $1 trillion.

Companies report levels of trade finance sufficiency similar to the level seen before the 2008 Global Financial Crisis. Trade finance quality appears to have also remained strong as the 2014 update to the ICC's Trade Register continues to reflect average default rates below 0.25%.

Companies in Africa (47%) were more likely to report insufficient levels of trade finance than companies in the general sample (29%). The trade landscape in Africa registers difficulty in other areas as well—SWIFT data on trade volumes for example, showed Africa as the region with the highest annual decrease of more than 18%.[2]

More than 80% of banks report maintaining or increasing the number of lines of credit they offer to both financial institutions and corporate clients. While most increases were moderate, about 15% of banks reported increases of 25%-50% for corporate clients. The data further show that bigger banks (often international banks) receive more trade finance proposals and also reject a higher proportion than the average bank.

In forfaiting, 36% of respondents indicated an increase in the value of forfaiting activity. 62% reported that there was no change in the cost to support transactions over the 2014 levels and did not expect costs to change in 2015. Respondents to the factoring survey also indicated that demand had increased, while fees had not changed over 2014.

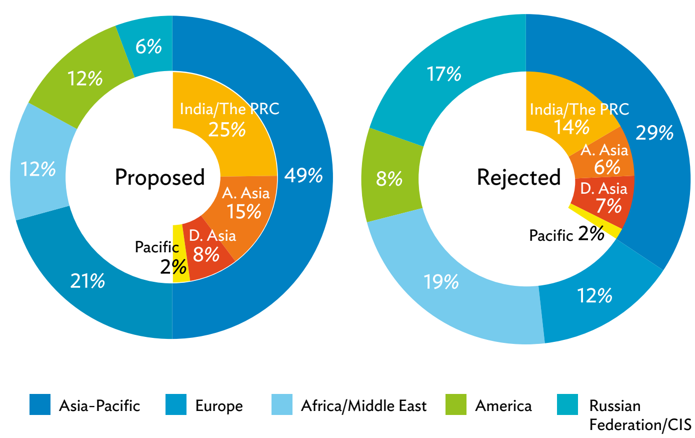
In contrast to other industry sectors, the credit insurance market, including re-insurance, continues to see supply outpace demand. Demand is increasing. The number of policyholders and insured exposure levels have been increasing in recent years with the trend expected to continue in 2015.

BUT GAPS INCREASINGLY FOCUS ON EMERGING ECONOMIES

Emerging economies—specifically the People's Republic of China (PRC), India, and the Russian Federation—faced the highest rejection rates of proposed trade finance transactions according to surveyed banks (Figure 1). This distribution was also reflected in the responses to the forfaiting survey.

The value of proposed trade finance transactions were highest in the PRC and India. This is consistent with previous surveys which found that trade finance requests from Asia were higher than the global average. Surveyed banks reported that in 2014, 25% of requests came from India and the PRC. This compares with 21% from Europe, which is a much more mature market, where the majority of trade activity is pursued on open account terms. Thus higher rejection rates (14% for India and the PRC versus 12% for Europe) are expected.

Figure 1: Distribution of Proposals Received and Rejected Transactions by Region (as a share of total)



The PRC - People's Republic of China
CIS - Commonwealth of Independent States
A. Asia - Advanced Asia
D. Asia - Developing Asia
Note: Advanced Asia is made up of Hong Kong, China, Japan, the Republic of Korea, and Singapore while Developing Asia makes up the rest of Asia, excluding India and the PRC
Source: ADB. 2015 Trade Finance Gaps, Growth, and Jobs Survey.

[2] SWIFT trade volume statistics are only part of the global picture. They provide a good indication of usage trends for the Letters of Credit (L/C) instrument, as SWIFT claims 90% of global L/C transactions go via SWIFT. Globally, SWIFT trade volume decreased by 1.79% in 2014 (which is more than the 2013 decrease of 0.65%).

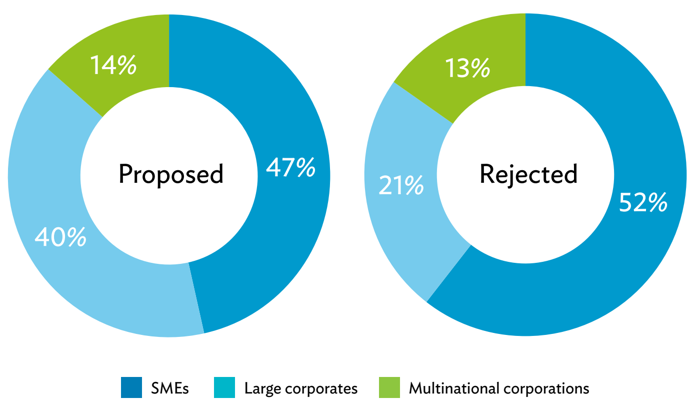
On a regional level, rejection rates are disproportionately large for the Russian Federation/Commonwealth of Independent States (CIS) (6% of proposals and 17% of rejections) and Africa/Middle East (12% of proposals and 19% of rejections). This reflects several different forces. In the Russian Federation/CIS, lower oil prices and sanctions impacted trade finance in 2014. Regulatory compliance concerns are also likely to have contributed as 38% of responding banks reported that the Russian Federation/CIS had been impacted "to a great extent" or more, and 31% of banks report the same for Africa/Middle East.

SMES CONSTRAINED BY COST

Among firm types, SMEs are consistently underserved. This confirms evidence that is well-established elsewhere. Matched responses from banks and companies revealed some dynamics underlying the SME finance gap.

First, SMEs face higher rejection rates than other firm types, globally, for their proposals for trade finance (Figure 2). Banks reported that 47% of proposed transactions are submitted by SMEs. However, in contrast to multinationals which submit only 14% of proposals and have 87% of their transactions accepted, SMEs are rejected 52% of the time.

Figure 2: Distribution of Proposals Received and Rejected Transactions by Business Type (as a share of total)



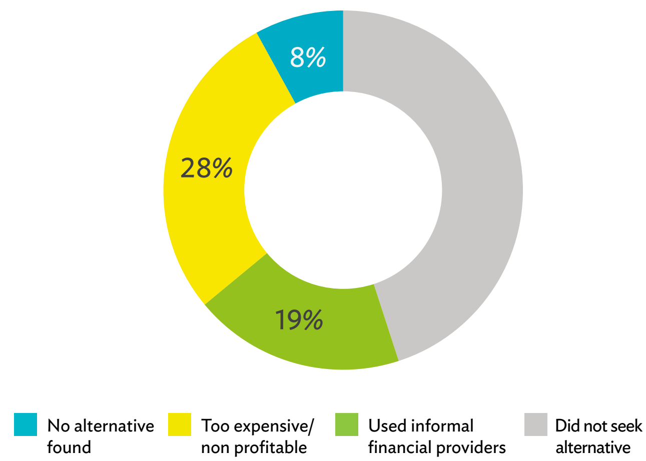
Source: ADB. 2015 Trade Finance Gaps, Growth, and Jobs Survey.

Second, firms globally report rising prices for trade finance that accelerated in the second half of 2014. For the whole year, 28% of companies reported rising prices, while 39% reported increasing prices in the second half of the year.

The role of prices in the SME finance gap is further detailed by the question of what firms do when their applications for finance are rejected (Figure 3). Of those seeking alternative sources of finance, 28% found that other formal providers were willing to finance, but that it was too expensive. This suggests that at least some rejected proposals were profitable for formal financial providers, meaning that they met some standard of submission. However, the cost was too high for SMEs. 19% found the assistance they needed by turning to informal financial providers.

Given that costs are expected to rise in coming years, we can assume that much of the increase will be borne by SMEs. This is cause for concern as this client group is least able to afford it and are, as a rule, most in need of cashflow and financing as a prerequisite to survival and sustainability.

Figure 3: Companies Which Sought Alternative Trade Finance Resources



Source: ADB. 2015 Trade Finance Gaps, Growth, and Jobs Survey.

SMEs—especially in Africa (32%) and Asia (19%) depend on working capital for pre-export financing as their main source of trade finance.

Globally, 16% of SME respondents reported using credit insurance. This is in comparison to only 1% of large corporates. Credit insurance providers also report seeing great potential in the SME market, particularly in Asia.

In forfaiting, 48% of respondents reported an increase in demand for forfaiting in 2014. Two-thirds of respondents reported that the increase in demand for forfaiting was at least partly due to

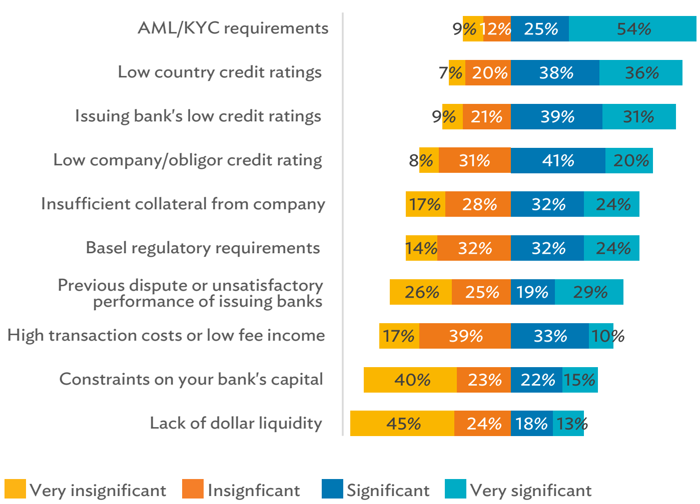
SME requests. This suggests that the sector is expanding to new types of clients. However, familiarity of SMEs with this instrument remains low among responding firms, particularly in Africa (2% are familiar with forfaiting) and Asia (8%).

SME finance shortfalls are well known and there are global efforts, for example by multilateral development banks (MDBs), to encourage banks to lend to this underserved segment.

IMPEDIMENTS TO TRADE FINANCE INCLUDE RISK AND REGULATION

Banks report that the reasons that gaps in trade finance persist are tied largely to risk appetite (Figure 4). Of the top five impediments to trade finance, three were directly related to high risk – low country credit ratings (74%), bank's low credit ratings (70%), and low company credit ratings (61%).

Figure 4: Impediments to the Availability of Trade Finance



Source: ADB. 2015 Trade Finance Gaps, Growth, and Jobs Survey.

As in previous years, a top impediment - cited by 80% of banks – is anti-money laundering (AML) and know your client (KYC) requirements. This refers to the regulatory requirements banks need to put in place to counter money laundering, terrorism finance, and to ensure that sanctioned parties and markets are not supported. Further, the role of banks has shifted in recent years from the need to identify and report to a more active role of avoidance and prevention.

Unlike traditional risk indicators, the channels through which AML/KYC requirements affect access to trade finance are less obvious. Subsequent questions suggest that this impediment is not always directly related to a client or country engaging in illegal activities, but rather the cost of conducting due diligence on transactions against the revenue to be gained, especially for transactions supporting SMEs based in markets where limited infrastructure, lack of trusted data and constraints linked to information and communication technology make the conduct of such investigations expensive and risky.

Anecdotal evidence suggests that the foregoing factors have resulted in a consolidation of banking services to lower-risk countries and (bank as well as corporate) client segments. This is supported by responses to the question about which regions are most affected by increasing cost or complexity of compliance.

Multiple banks reported that lack of staff with experience in trade finance is an additional impediment to their ability to offer more trade finance, and to undertake higher-risk transactions where technical skills are critical to risk management and the avoidance of losses or unintentional breaches of regulation and compliance. Responses cited both the problem of lack of awareness of products and limited ability to handle a transaction as reasons that trade finance products are not offered to the client.[3]

Forfaiters reported a slightly different story. As forfaiting is mainly (but not exclusively) housed within specialized departments of banks, regulatory requirements are a substantial impediment to client service. Both AML (81% of respondents) and Basel regulatory requirements (72%) were cited. But beyond that, limited income from transactions was the secondary impediment. This included high transactions cost/low fee income and insufficient collateral (67%).

INCREASE IN CANCELED CORRESPONDENT RELATIONSHIPS

Correspondent banking networks play a critical role in helping developing economies and their business communities to engage successfully in the international economic system through trade. 70% of bank respondents reported that they declined transactions for reasons related to the cost or complexity of compliance. The survey also reported 45% terminating correspondent relationships for the same reason. The cancelation of relationships may lead to broader negative impacts on the country and customer segments in which this is occurring.

The geography of impact in 2014 is centered on Africa, the Russian Federation/CIS, and North America. In each of these regions, more than 50% of banks feel that the cost or complexity of regulatory compliance has a great or very great impact on the termination of correspondent relationships. By contrast, 64% of

[3] ADB's Trade Finance Program (TFP) seeks to address knowledge gaps such as these through training programs. In 2014, TFP conducted 3 seminars for 19 banks in 2 countries.

responding banks report that there was little or no impact on their correspondent relationships in the PRC and India.

Respondents to both the forfaiting and the factoring survey indicated that most had not canceled correspondent relationships as a result of the cost or complexity of compliance. Consultations suggest that this reflects the enhanced due diligence that factoring and forfeiting have in place, rather than any difference in the standards of regulatory compliance which have increased for all providers.

Banks were also asked about the nature of canceled correspondent relationships that were due to AML/KYC. In more than 25% of terminated relationships, banks report that there was no evidence or suspicion of noncompliance. This supports the contention that de-risking is having some spillover into legitimate relationships, particularly in certain markets.

An additional challenge is that compliance measures are expected to increase in 2015 by 93% of responding banks. This is a particular problem for those economies that are already experiencing gaps due to the complexity or cost of compliance.

Anti-financial crimes regulations are an important and beneficial feature of the postcrisis financial regulatory system. Both regulators and banks acknowledge the importance of these regulations in improving transparency, as well as stability, security and sustainability of the global financial architecture in an increasingly interconnected environment.

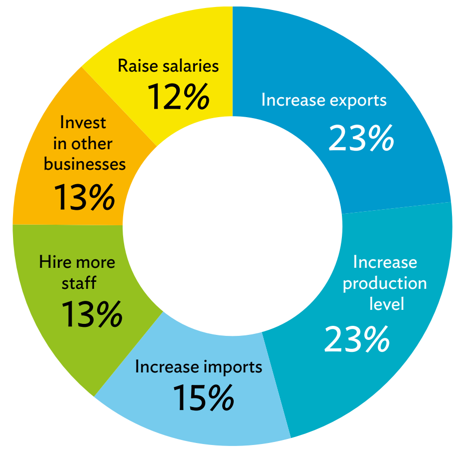
However, there is a real lack of clarity around how regulations are to be implemented and how both internal systems and external regulators define compliance. This lack of clarity has resulted in a system in which many banks are preoccupied with revamping internal compliance procedures to meet requirements without time to consider or advocate for the resulting adverse changes in the regulatory environment around trade finance.

IMPROVED ACCESS TO FINANCE WOULD INCREASE EMPLOYMENT, ESPECIALLY FOR WOMEN

Companies were asked how they would respond if the trade finance available to them were doubled (Figure 5). This was intended to explore the commercial impact of a less constrained environment. The most frequent responses reflected the direct impact of sufficient levels of finance: more exports and more production. This underscores the productivity limitations imposed by a lack of trade finance.

Employment would also improve. Of the companies surveyed, 14% report that they would hire more staff, and 12% would raise salaries. Of the additional staff, companies report a slight bias towards hiring women (56% of new staff would be female).

Figure 5: Trade Finance Allocation When the Amount Received is Doubled



Source: ADB. 2015 Trade Finance Gaps, Growth, and Jobs Survey.

An additional 13% of companies report that additional trade finance would enable them to invest in other businesses.This underscores the result of trade finance constraints on small businesses. In a constrained environment, responding companies still export, but must allocate a larger proportion of potentially productive capital to the process.

WHAT DOES THIS MEAN FOR ASIA AND THE PACIFIC?

Asia and the Pacific is the region that is the most commonly targeted growth market for many types of financial products. Credit insurance respondents, for example, report Asia as the region which presents the most significant growth opportunities for trade credit insurers. Specific growth markets mentioned are the PRC, Singapore, and India as well as Southeast Asia.

Asia and the Pacific is, however, a diverse region. It includes some of the world's most streamlined financial markets, as well as emerging economies at varying levels of financial development. The increasing geographic concentration of trade finance gaps in the least developed markets affects the overall regional trade finance environment.

Trade continues to be the engine of growth and employment in the region. Greater global focus on trade facilitation has raised attention to the need to support SMEs to promote production and employment in high-risk markets. But often this overlooks the critical role of trade finance.

There are several regional trends that will affect trade finance in coming years. As the Transpacific Partnership and the ASEAN

Economic Community come online over the next few years, new sources of demand will open up for trade finance. As trade linkages with the PRC continue to mature, demand for renminbi for international settlement in the region will continue to grow.[4]

The guarantees and loans offered by export credit agencies and MDBs like ADB seek to facilitate trade finance into the riskier markets where the survey finds gaps.[5] The concentration of gaps even in the relatively healthy 2014 global trade finance environment suggests that such guarantees and loans remain critical for trade facilitation to promote growth and employment.

Since first implemented in 2012, the annual ADB trade finance survey has progressed in a series of upgrades which address coverage, robustness and gap projections. For these reasons, survey responses results are not comparable year-on-year.

Each survey samples a different population. Bank respondents are drawn from the ICC Banking Commission membership, and the number and characteristics of responding banks differs from year to year.

The survey instrument is improved in each round. Consistency is maintained where possible, but some questions are modified for clarity and comprehension.

4 The renminbi is the second most used currency in SWIFT-reported L/Cs, representing 10.17% in 2014 of the total value, an increase compared to 9% in 2013.
5 Since 2009 ADB's TFP has supported over $20 billion in trade through more than 10,000 transactions. TFP has supported over 6,000 small and medium-sized business since 2009. For more information, see www.adb.org/tfp

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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 the majority 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.

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