Trade Facilitation and Trade Financing: Building New Bridges

Prepared in collaboration with the United Nations Centre for Trade Facilitation and Electronic Business (UN/CEFACT)
トレード・ファシリテーションとトレード・ファイナンシング：新しい架け橋を構築

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本レポートは、UN/CEFACT 副議長の Harm Jan van Burg 氏による序文に加え、OPUS Advisory Services International Inc./Alexander R. Malaket 社長、独立コンサルタント Peter Potgieser 氏、アイテグループ/シニアアナリスト Enrico Camerinelli が共同執筆を行った。

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・政府間の作業に焦点を当てた専門家を注意深く割り当て、本分野でさらに活発に活動している機関の情報を活用する。

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# TABLE OF CONTENTS

- IMPACT POINTS ........................................................................................................... 6
- FOREWORD.................................................................................................................. 7
- INTRODUCTION .......................................................................................................... 9
  - METHODOLOGY ........................................................................................................ 9
- THE MARKET ............................................................................................................. 10
- OVERVIEW OF TRADE FINANCE ............................................................................. 11
  - TRADE FINANCE: FOUR ELEMENTS ...................................................................... 12
- OVERVIEW OF SCF .................................................................................................... 19
  - RECEIVABLES PURCHASE SCF CATEGORY ............................................................. 21
  - LOAN OR ADVANCE-BASED SCF CATEGORY ......................................................... 21
- FINANCING TRADE FACILITATION ........................................................................... 22
  - BUILDING BRIDGES .............................................................................................. 23
- CONCLUSION ............................................................................................................. 26
- RELATED AITE GROUP RESEARCH ......................................................................... 27
- ABOUT AITE GROUP ................................................................................................. 28
  - AUTHOR INFORMATION ......................................................................................... 28
  - CONTACT ................................................................................................................ 28
- ABOUT UN/CEFACT .................................................................................................... 29

# LIST OF FIGURES

- FIGURE 1: SCF PORTFOLIO ....................................................................................... 12
- FIGURE 2: SETTLEMENT OPTIONS IN INTERNATIONAL TRADE ....................... 13
- FIGURE 3: THE BUY-SHIP-PAY REFERENCE MODEL ............................................ 15
- FIGURE 4: END-TO-END SUPPLY CHAIN PROCESSES ILLUSTRATED ................... 16
- FIGURE 5: LINKING THE PHYSICAL AND THE FINANCIAL SUPPLY CHAINS ........ 17
- FIGURE 6: TRADE FINANCE DEFAULT AND LOSS RATES ................................... 22

# LIST OF TABLES

- TABLE A: THE MARKET ........................................................................................... 10
IMPACT POINTS

- Trade facilitation programs and practices have concentrated on a variety of “mission-critical” elements in both the public and private sectors, from education to logistics, and from infrastructure to regulatory considerations. However, the role of trade financing has historically been viewed as “out of scope” by practitioners of trade facilitation.

- Focusing primarily on the physical movement of goods (i.e., the commonly understood scope of trade facilitation) and developing solutions around it are important. However, the exclusion of financing as an element of these efforts, and as a key component of trade facilitation, misses a critical commercial reality that underpins global trade flows, trade relationships, and international supply chains.

- Lack of adequate financing (including risk mitigation) is consistently identified, by small and midsize enterprises (SMEs) in particular, as a major obstacle to additional opportunities in international markets. This has been reflected in numerous surveys conducted through the UN system. Trade financing is said to be critical to the conduct of up to 80% of global merchandise trade flows, which today reach about US$20 trillion annually.

- This report provides a basic understanding of trade finance, a specialized form of financing that is generally not well-known even among trade professionals and practitioners, and articulates the strong connection between trade finance and supply chain finance (SCF), demonstrating potential linkages between trade facilitation and financing.
FOREWORD

The global financial crisis, from which the world is slowly recovering, has contributed to the surfacing of many systemic inconsistencies and issues to be dealt with. There is a generally accepted notion that facilitation of world trade is one of the drivers for economic recovery and growth. Facilitating SMEs, especially in developing economies, is essential to achieving the international-trade goals being set by political leaders, industry specialists, businesses and entrepreneurs, and other relevant stakeholders.

UN/CEFACT, the United Nations Centre for Trade Facilitation and Electronic Business, has—with the help of hundreds of experts—worked for several decades on providing tools and recommendations to effectively facilitate trade. Even the authoritative and well-recognized “Buy-Ship-Pay” international-trade model devised by UN/CEFACT has not adequately addressed the critical role of financing in international commerce, nor has it sufficiently recognized the processes that take place before the model’s “Buy” phase.¹

The missing link is trade finance/SCF. Without appropriate financing solutions that also target SMEs, even targets set in the Bali Agreement will be very difficult to realize. New but necessary banking regulations have, in many cases, made access to trade finance more difficult for SMEs than before, particularly when SMEs are based in developing and emerging markets, as is the case today for many SME suppliers linked to global supply chains.

During our work in the UN/CEFACT project on trade financing/supply chain financing, we have noticed that there are actually substantial gaps between the “traditional” trade facilitation community and the “traditional” (trade) financing and banking communities. That is to say, there is insufficient awareness of the dependencies and linkages of the work of each group; limited communication and engagement between specialists from each area; and only limited concrete activity and collaboration between these critical enablers of international commerce, trade-based development, and economic value creation.

We believe that bridging these gaps will help build solutions that will better leverage synergies in the work of trade facilitators and trade financiers, even in the current context of necessary regulation and oversight, enabling access to both effective facilitation support and timely financing. Each is critical to the success—and growth—of international trade.

This Aite Group report, the latest in a series of blog posts, publications, and presentations that first began at the Asia-Pacific Trade Facilitation Forum in Beijing in 2013, provides a timely overview of the nature of trade finance and SCF, advances our efforts to articulate the importance of the facilitation/financing bridge, and brings us one step closer to the proposal and development of concrete, substantive initiatives aimed at enabling practitioners from both sides of the bridge to cross it effectively, to the benefit of the clients, stakeholders, and economies they each serve.

The report is developed on the foundations of significant research, deliberations, energetic debate, and analysis contributed by a small core team of specialists affiliated with UN/CEFACT.

The members of the core team follow:

- Enrico Camerinelli, Aite Group
- Alexander R. Malaket, President, OPUS Advisory Services International Inc.
- Peter Potgieser, independent consultant

My primary role has been to bring these brilliant experts together. I thank Aite Group for producing and publishing this report and for providing yet another channel for the dissemination of our observations to date on what we believe to be a topic of fundamental importance to international trade.

Harm Jan van Burg
Vice Chair, UN/CEFACT
Project Leader
INTRODUCTION

The fundamental objective of this report, written in collaboration with the UN/CEFACT Supply Chain Programme Development Area, is to articulate the linkages and complementary nature of trade facilitation activity with the financing of international commerce under the broad array of “trade finance and SCF solutions.” Of the various trade facilitation practices available, the one most renowned and utilized is the single-window system—a portal-based technology by which international (i.e., cross-border) traders electronically submit regulatory documents (e.g., customs declarations, applications for import/export permits, certificates of origin, trading invoices) to a single location and/or single entity.

This paper proposes that there is currently a missed opportunity in the gaps between trade facilitation and trade financing (including both traditional trade finance and SCF), and asserts the strategic importance of bridging this material gap in current strategy and practice.

The paper explores the opportunity and value in bridging instruments, practices, and supporting technologies for, respectively, trade facilitation, trade finance, and SCF, demonstrating that the inclusion of such financing as an in-scope element of trade facilitation presents significant untapped potential in trade-based international development.

METHODOLOGY

Aite Group wishes to thank the contribution of the UN/CEFACT Supply Chain Programme Development Area in the preparation and elaboration of this report. The findings must be attributed to a joint working group effort that leveraged the conclusions of the Asia-Pacific Trade Facilitation Forum 2013 through various project iterations and consultations with key stakeholders, including the following:

- Trade sector specialists from banks
- Nonbank providers of trade finance
- Trade finance and SCF domain experts

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THE MARKET

Trade facilitation is a mature discipline with business solutions that facilitate trade, exemplified by single-window programs that are deployed both in economically advanced countries and in developing economies. Single-window initiatives span various stages of development, but they don’t include financial capabilities as part of comprehensive programs. The exclusion of financing as a key component of trade facilitation misses a critical commercial reality: the lack of adequate financing that is consistently identified as a major obstacle to the achievement of additional trade business opportunities in international markets. According to the International Finance Corporation, only 15% of the 400 million SMEs in developing countries have access to credit, with a concerning 40% that need credit but do not have access to any credit, and 10% that have a loan and/or line of credit but find financing constrained. Access to finance is declared a major constraint by 25% of the SME population.1

SMEs play a significant role in global trade flows and economic value creation, as long as they can access timely and affordable financing—especially financing for their import-export trade operations. Following the 2008 global economic crisis, the financing of international trade has gained an unprecedented visibility among political and business leaders, with trade now being acknowledged as one of the major mechanisms that support economic recovery.

Trade finance and SCF’s practices, technology, and financial instruments provide the financial support to ensure the execution of global trade flows (Table A).

Table A: The Market

<table>
<thead>
<tr>
<th>Market trends</th>
<th>Market implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>While single-window initiatives are at various stages in development, general</td>
<td>The exclusion of financing as an element of these efforts, and as a key component of trade facilitation, misses a critical commercial reality that underpins global trade flows, trade relationships, and international supply chains.</td>
</tr>
<tr>
<td>implementation plans still lack the financial component.</td>
<td></td>
</tr>
<tr>
<td>The role of SMEs in global trade flows and economic value creation is widely</td>
<td>Lack of adequate financing (including risk mitigation) is consistently identified as a major obstacle to the pursuit of additional opportunities in international markets.</td>
</tr>
<tr>
<td>acknowledged, but access to finance is still low.</td>
<td></td>
</tr>
<tr>
<td>Robust global trade is one of the major mechanisms to enable economic recovery.</td>
<td>Trade facilitation practitioners need to recognize critical importance of trade finance and SCF in enabling trade flows.</td>
</tr>
</tbody>
</table>

Source: Aite Group

OVERVIEW OF TRADE FINANCE

International trade in goods and services is increasingly being recognized as a force for creation of economic value, growth, and recovery since the 2008 global crisis. One of the key characteristics of trade is that public policy can influence change on a global scale. This has led regulators and policy-makers across jurisdictions to foster trade policies that create economic value and raise standards of living. Developing economies are placing trade at the center of development strategies and, thus, at the center of policy priorities. Market-access initiatives span single-window and other focused trade facilitation initiatives that invest in the development of trade-related technical competencies and capacity.

Despite the relevance of financial inclusion in trade facilitation initiatives, trade finance and SCF specialists have been working in the background with limited visibility, contributing to the reality that finance in trade is perceived by global trade practitioners as a rather niche business only understood by senior bankers and finance and treasury executives, and as the battleground of poorly understood disputes between policy-makers.

The credit crunch of the 2008 global financial crisis was a wake-up call for corporate executives who had to quickly find alternative sources of funding. Pockets of free cash were found by improving receivables collection and rescheduling payments with trading partners. Trade then became an engine of recovery and a subject of focus. With market analysis estimating that over 80% of international trade flows could not take place without financial support, it is clear that much of global trade is enabled by some form of trade finance and SCF.

Trade finance refers to the financing of trade flows on a short-term basis, from instruments with tenures ranging from less than 360 days to 24 months. Traditional mechanisms and techniques for financing trade are documentary collections and documentary letters of credit. There is growing consensus across bankers, nonbank financiers, and corporate clients that these instruments fall in the same SCF category of emerging propositions, such as receivables finance, invoice discounting, approved payables finance, inventory finance, dynamic discounting, and distribution finance.

The view that documentary trade finance belongs to a subset of SCF is one of the salient findings of recent market guides. This is graphically illustrated in Figure 1.

Figure 1: SCF Portfolio

<table>
<thead>
<tr>
<th>Receivables purchase SCF category</th>
<th>Loan or advance-based SCF category</th>
<th>Enabling framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables discounting</td>
<td>Loan or advance against receivables</td>
<td>Bank payment obligation (BPO)</td>
</tr>
<tr>
<td>Forfaiting</td>
<td>Distributor finance</td>
<td></td>
</tr>
<tr>
<td>Factoring and its variations</td>
<td>Loan or advance against inventory</td>
<td></td>
</tr>
<tr>
<td>Payables finance</td>
<td>Pre-shipment finance</td>
<td></td>
</tr>
</tbody>
</table>

Source: Global Supply Chain Finance Forum, 2016

Traditional trade finance mechanisms involve trade on a bilateral basis (i.e., one buyer and one supplier), while more elaborate SCF schemes look at trade more holistically, in terms of the ecosystem of commercial relationships that make up an international (or global) supply chain. This foundation can then lead to consideration of the potential for better linking trade finance and SCF to trade facilitation practices, including single-window market-access initiatives.

**TRADE FINANCE: FOUR ELEMENTS**

Trade finance is characterized by four main constituents that, by virtue of trade finance being an integral part of SCF, are immediately extended to the other components of the larger SCF portfolio:

1. The facilitation of timely and secure payment (across borders)
2. The provision of appropriate risk-mitigation strategies and solutions in support of international trade
3. The provision of financing options and solutions for one or more of the parties engaged in trade
4. The support of information flow about the state of a trade transaction, from the status of the physical shipment to the status of related financial flows

**SECURE AND TIMELY PAYMENT**

New trading relationships as well as relationships involving trade with one or more relatively risky markets should be conducted through secure mechanisms, the most secure (for both parties concurrently) being the documentary letter of credit. Similarly, well-established and trusted trading relationships, perhaps particularly those involving secure markets, should be

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conducted on the basis of less risk-mitigated (and thus less complex and less costly) mechanisms, such as open account terms, whereby supplier (exporter) and buyer (importer) simply agree to the transmission of a payment at a point in the transaction (Figure 2). This form of payment opens the way to SCF programs.

**Figure 2: Settlement Options in International Trade**

![Settlement Options in International Trade Diagram](image)

*Source: Malaket*

Trade finance also enables secure and timely payment across borders, thanks to SWIFT’s cross-border interbank payments processing network, which runs a wide range of structured messages to transmit trade finance instruments (e.g., letters of credit), payment instructions, and financial settlements in formats that are standardized and easily interpreted across all markets in the world.

**RISK MITIGATION**

The most effective way for a supplier to minimize the risk of not being paid by its client (i.e., the importer) after the goods have been delivered is to rely on a trusted third party—a bank (or more than one bank)—that carefully verifies whether the agreed terms and conditions of payment, sometimes very detailed and extensive, have been met before payment is effected and the goods are released to the buyer. The documentary letter of credit represents the principal trade finance instrument of this kind.

Other trade finance risk-mitigation instruments take the form of guarantees or insurance solutions, including political risk insurance, transport insurance, and export credit insurance, all variations that enable the successful conduct of commerce in the most challenging markets around the globe. Expert advice from specialist trade financiers who know about both...
transactional solutions and regional and market dynamics likely to pose risk to either or both trading parties increases the available forms of trade risk-mitigation structures and solutions.

Risk mitigation invariably implies a cost, usually in proportion to the level of risk being mitigated. Accordingly, it is more accurate to speak in terms of risk optimization—striking an appropriate balance of risk tolerance, cost of mitigation, and an acceptable level of residual risk. Whichever the case, the mitigation/optimization of risk is a core element of trade finance and SCF’s value proposition, allowing successful trade in and between developed/developing economies, and thus linking directly to trade facilitation.

The credibility of banks involved in international finance for trade are central to international commerce. In developing and emerging markets, export credit agencies play a decisive role to contain trade risk, usually complemented by programs and activities undertaken by the various multilateral development banks. The trade finance and SCF programs of these various institutions have been critical in assisting developing market banks to engage effectively in the global trade facilitation business.

FINANCING

Financing is the lending of funds for the purpose of enabling the conduct of business. In the case of international trade, in which long lead times are the norm, a supplier may need to source components of production or fund the transport of the final product to its destination long before collecting the invoiced payment. Similarly, a buyer may seek financing that enables the purchase of the goods. Whichever the case, with trade finance’s preshipment financing instruments, such loans can be repaid, for example, from the proceeds of the sale of the goods after the goods have been received.

Trade facilitation specialists frequently present the practice of facilitation using the “Buy-Ship-Pay” reference model (Figure 3).

7. See Aite Group’s reports How U.S. Banks Help Corporate Customers Go Global, October 2015, and How European Banks Help Corporate Customers Go Global, December 2015.
While financing is not specifically considered within the scope of the model’s core activities, the details of each of the three major elements suggest possible linkages to the events that can trigger a financing solution or proposal for a buyer, supplier, bank, or other member of an international supply chain.

If access to finance was less critical for a number of years prior to the 2008 global crisis, the post-crisis cash-constrained environment is such that the ability to include a financing package with an export sale is a competitive advantage for suppliers.

Additionally, financing can be attractive if it can be secured through trade finance mechanisms from jurisdictions where the availability of credit is greater and thus the cost of financing is materially lower. SMEs based in developing economies, for example, are challenged not only by
limited financing but also by the reality that whatever financing is available is often prohibitively expensive. The IFC Enterprise Finance Gap Database estimates SMEs in developing economies are suffering from a US$2.4 trillion total credit gap.

Certain techniques and structures of SCF are showing promise as ways to enable access to financing for suppliers based in high-cost developing markets, on the basis of large global buyers’ credit standing and (cost-effective) borrowing capabilities. Trade finance practitioners, particularly those that have embraced the evolving propositions under SCF, take a holistic view of the relationship ecosystem that makes up international supply chains in order to be able to identify such points. Additionally, a comprehensive view of a trade transaction life cycle shapes the value proposition around trade finance and SCF, as illustrated in Figure 4. The life cycle is referred to as “source-to-pay” (sometimes also referred to as the “procure-to-pay”) and “order-to-cash.”

Figure 4: End-to-End Supply Chain Processes Illustrated

Financing can be provided at numerous points in the transaction life cycle, including against a legally recognized payment obligation (such as an invoice approved for payment), or against a receipt evidencing that the goods are held in a trusted/secure warehouse facility and can remain accessible to the lender until repayment is made. Suppliers may prefer to obtain payment immediately by having a bank discount the draft and remit monies through a loan, with repayment of the loan to take place when the obligation comes due. Similarly, a buyer can delay the point at which it remits payment by arranging for a bank to pay the supplier but only seek reimbursement from the buyer at some agreed future date.
At many points in the life cycle of a trade transaction, a financing option or solution can be offered to one or more parties. Some options are linked to specific steps—or phases—of a trade transaction, such as the issuance of a commercial invoice or the transfer of ownership between supplier and buyer. Such event-triggered (i.e., event-based) financing might be offered at one or more points in a typical trade transaction (Figure 5).

**Figure 5: Linking the Physical and the Financial Supply Chains**

![Diagram of supply chain processes](image)

*Source: Supply Chain Finance, EBA European Market Guide v.2, 2013*

Finance practitioners may present solutions in connection with transaction-related events that can serve as a basis for financing (e.g., the creation of a purchase order, the issuance and acceptance of an invoice, the acceptance of a bill of exchange under a letter of credit). Practitioners also link trade finance and SCF discussions to working capital management and optimization, and the management of days sales outstanding or days payable outstanding.

**INFORMATION FLOW**

The state, condition, and location of a shipment, the status of a payment, or the status of document verification processes that determine the execution of the payment are examples of key information that can flow between trading partners, bankers, insurers, and other interested parties about the business being conducted. Parties across global supply chains are pressed by the accelerated pace of international trade and increasingly demand access to near-real-time information about the transactions they are working on. Despite the use of paper-based financial instruments, corporations are putting growing pressure on banks to enhance the efficiency, security, and trust of global trade value chains. Technology has evolved in its functionality and capabilities to address the need for timely information and rich data from
trading partners, regulatory authorities, financiers, law enforcement and intelligence officials, and numerous other stakeholders in trade and in cross-border supply chains.

Data flows, transaction status, and the tracking of related financial flows are integral to trade partners’ management needs and are thus increasingly central to trade finance and SCF providers’ solution offerings, whether they are banks or nonbank providers. Banks have traditionally managed trade finance as a paper-intensive practice. While internet-based technologies have made giant steps into banks’ departments, trade finance remains anchored at “business as usual.” Banks are looking to offer trade finance products and services through the internet, but they face obstacles to fully deploying electronic and internet-based trade finance.
OVERVIEW OF SCF

The migration from traditional paper-based documents and forms to data-triggered e-trade finance may give banks access to their corporate clients’ supply chain information (e.g., date of order, invoice issuance, accounts payable and receivable postings), which banks would then use to facilitate the issuance of funds to the corporate clients’ suppliers and distributors in a phased approach. SCF is evolving quickly and is, without doubt, the high-growth and high-potential area in the financing of international commerce. SCF is a response to the global shift by buyers and suppliers to trade on open-account terms. This has compelled the banking industry to seek to re-engage with buyers and suppliers by developing a value proposition aimed at meeting the needs of traders operating on these terms.

SCF can be based on the financing of payables, receivables, and inventory, and can offer financing and working capital solutions to buyers and/or to their suppliers, enabling positive impacts for each group on days sales outstanding and days payable outstanding. As with traditional trade finance, SCF can offer pre- and post-shipment financing options, and can enable access to affordable financing in markets where and/or to parties for whom financing would otherwise be very expensive or simply unavailable.

SCF has become such a significant phenomenon in the market that basic terminology and definitions had to be clearly determined and agreed, with the objective of creating some consistency of use and nomenclature and—from there—a globally adopted set of definitions. The International Chamber of Commerce (ICC) Banking Commission has led a global initiative in collaboration with several industry associations to develop such a set of definitions to benefit clients, regulatory authorities, service providers (e.g., accountancy and audit firms), and others. The resulting document is the “Standard Definitions for Techniques of Supply Chain Finance,” published in 2016.

Companies (with many located in developing and emerging markets) that supply large buyers see value in these SCF programs as a means of accessing affordable liquidity through a channel that does not impact their (limited) borrowing capacity. Buyer-led SCF programs provide value to a buyer as well as to the buyer’s sometimes very large supplier community. Additionally, such a program provides a clear illustration of the multiparty nature of SCF programs, in contrast to certain traditional trade finance mechanisms aimed at meeting the needs of one buyer and one supplier in a single trade transaction.

SCF programs are still established on instruments known as reverse factoring and dynamic discounting, both based on the foundation that the invoice approved by a large anchor buyer is the security for the repayment of the funding. Because the ordering party—usually a large company with a high-quality credit rating—starts the process, it is that party’s liability that is engaged. This principle of SCF would lead one to believe that almost all existing SCF programs are running with strong credit-rated buyers. But Aite Group market research uncovered that, on the contrary, a significant portion of reverse factoring programs are anchored around subinvestment-grade companies, and the global SCF market is morphing into more articulated...
schemes with various models available to service the needs of corporate clients that want to support the relationships with their international trade business partners.8

While SCF can be considered a “repackaged” collection of long-established banking and finance mechanisms, the innovation in SCF is less in the constituting components and more in the way it motivates companies and banks to look at international commerce as an ecosystem of commercial relationships that crosses borders, with major buyers developing supplier communities that could number in the tens of thousands. The opportunity to integrate classical trade finance and SCF processes and solutions into trade facilitation activities, including single-window market-access programs, is clearly there and can be pursued through a range of industry players active in financing international commerce.

Figure 1 reminds that SCF is an umbrella term covering a suite of tools ranging from financing suppliers, to trade and receivables finance, and to buyer funding discounts. Definitions vary by region and practitioners, considering that SCF’s original focus on working capital and receivables financing has expanded to take on many different forms, including invoice-based, portfolio-based, with or without recourse; domestic or international; and confidential or with notification. SCF propositions have evolved at different rates and in varying directions, so it becomes necessary for the financial industry, regulatory authorities, clients, and other stakeholders to develop and disseminate standard definitions and terminology.

The matter is so sensitive that the Global Supply Chain Finance Forum—an initiative of a number of sponsoring industry associations facilitated by the ICC Banking Commission9—recently published and championed a set of commonly agreed standard market definitions for SCF and SCF-related techniques.10 The initiative intends to help create a consistent and common understanding of SCF, starting with terminology definitions and following this with advocacy in support of global adoption of the standard definitions. The document provides more than a list of techniques and a set of high-level definitions. The scope and extensive detail are offered with a view to the larger objective of global adoption and recognize the various audiences to which the document will be of interest.

According to this work, SCF is defined as the use of financing and risk-mitigation practices and techniques to optimize the management of the working capital and liquidity invested in supply chain processes and transactions. SCF is typically applied to open-account trade and is triggered by supply chain events. Visibility of underlying trade flows by the finance provider(s) is a necessary component of such financing arrangements, which can be enabled by a technology platform. The definitions for the individual SCF techniques and the enabling framework follow.

9. Global SCF Forum participating organizations: The International Chamber of Commerce (ICC) Banking Commission, Bankers Association for Finance and Trade (BAFT), the Euro Banking Association, Factors Chain International (FCI), and the International Trade and Forfaiting Association (ITFA).
**RECEIVABLES PURCHASE SCF CATEGORY**

Receivables discounting is a form of receivables purchase, flexibly applied, in which sellers of goods and services sell individual or multiple receivables (represented by outstanding invoices) to a finance provider at a discount.

Forfaiting is a form of receivables purchase consisting of a without-recourse purchase of future payment obligations represented by financial instruments or payment obligations (normally in negotiable or transferable form) at a discount or at face value in return for a financing charge.

Factoring is a form of receivables purchase in which sellers of goods and services sell their receivables (represented by outstanding invoices) at a discount to a finance provider (commonly known as the factor). A key differentiator of factoring is that typically the finance provider becomes responsible for managing the debtor portfolio and collecting the payment of the underlying receivables.

Payables finance is provided through a buyer-led program within which sellers in the buyer’s supply chain are able to access finance by means of receivables purchase. The technique provides a seller of goods or services with the option of receiving the discounted value of receivables (represented by outstanding invoices) prior to their actual due date and typically at a financing cost aligned with the buyer’s credit risk. The payable is due to be paid by the buyer until its due date.

**LOAN OR ADVANCE-BASED SCF CATEGORY**

Loan or advance against receivables is financing made available to a party involved in a supply chain on the expectation of repayment from funds generated from current or future trade receivables. This financing is usually made against the security of such receivables but may be unsecured.

Distributor finance is financing for a distributor of a large manufacturer to cover the holding of goods for resale and to bridge the liquidity gap until the receipt of funds following the sale of goods to a retailer or end customer.

Loan or advance against inventory is financing provided to a buyer or seller involved in a supply chain for the holding or warehousing of goods (either presold, unsold, or hedged) and over which the finance provider usually takes a security interest or assignment of rights, and exercises a measure of control.

Preshipment finance is a loan provided by a finance provider to a seller of goods and/or services for the sourcing, manufacture, or conversion of raw materials or semifinished goods into finished goods and/or services, which are then delivered to a buyer. A purchase order from an acceptable buyer—a documentary or standby letter of credit, or a bank payment obligation—issued on behalf of the buyer in favor of the seller is often a key ingredient in motivating the finance, in addition to the seller’s ability to perform under the contract with the buyer.
FINANCING TRADE FACILITATION

There are aspects in the business of trade finance (and SCF) that banks and corporate clients must consider. From a bank perspective, regulatory pressures, demands, and requirements present a very significant challenge and cost on a global basis. Those realities, together with capital adequacy/reserve requirements, are raising the cost of trade finance and SCF for banks while concurrently limiting banks’ capacity to provide trade-related finance. Similarly, risk constraints in terms of country, foreign bank, and corporate risk have been significant, and again impact banks’ capacity to respond to market needs related to financing trade transactions.

High interest rates, lack of collateral, and certain macro factors, such as high country risk attributed to the client’s home country and possibly an absence of supporting legal frameworks, all combine to contribute to the difficulty in accessing trade finance and SCF, particularly for SMEs located in developing and emerging markets. The financing of international commerce is perceived to be fundamentally high-risk, due to its cross-border nature and frequent engagement in higher-risk markets.

An incorrect understanding of the transactional characteristics of trade finance and a lack of proper information make central credit or risk committees in banks erroneously ascribe a very high risk to the business of trade finance. Extensive collection and analysis of transaction-level data contributed by top trade finance banks shows, on the contrary, that this form of financing exhibits near-negligible levels of default and loss, even in some of the most challenging markets on the globe. Figure 6 from the ICC Trade Register Project, which collects and analyzes default and loss data in traditional trade finance since 2007, and paints a remarkable picture of the very low default and loss experience in trade finance over a period of multiple years and across millions of transactions from contributing banks that represent around 60% of bank-intermediated trade finance globally.

Figure 6: Trade Finance Default and Loss Rates

<table>
<thead>
<tr>
<th>Year</th>
<th># Customers</th>
<th># Defaults</th>
<th>Default Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>796</td>
<td>2</td>
<td>0.25%</td>
</tr>
<tr>
<td>2008</td>
<td>1,049</td>
<td>1</td>
<td>0.10%</td>
</tr>
<tr>
<td>2009</td>
<td>1,189</td>
<td>24</td>
<td>2.02%</td>
</tr>
<tr>
<td>2010</td>
<td>1,537</td>
<td>15</td>
<td>0.98%</td>
</tr>
<tr>
<td>2011</td>
<td>1,747</td>
<td>19</td>
<td>1.09%</td>
</tr>
<tr>
<td>2012</td>
<td>1,736</td>
<td>23</td>
<td>1.32%</td>
</tr>
<tr>
<td>2007-2012</td>
<td>8,054</td>
<td>84</td>
<td>1.04%</td>
</tr>
</tbody>
</table>

Source: ICC Trade Register, ICC Banking Commission, 2015

There is significant attention around the need to adequately support SMEs as drivers of a wide range of economies. Similarly, the role of trade in enabling international development is getting increasing traction in policy circles. Developments in trade finance, specifically the evolution of propositions in SCF, provide a solid basis on which to serve SMEs, including SME suppliers
located in developing markets that are supplying large buyers. Buyer-centric SCF programs allow SMEs to gain access to affordable financing on the basis of the importing corporation’s credit capacity.

BUILDING BRIDGES

Trade finance/SCF supports the vast majority of international merchandise trade flows and is, increasingly, equally important to the flow of services-sector trade activity. Lack of financing has been confirmed almost globally as a serious obstacle to growth and sustainability, in particular for SMEs. SME suppliers linked into cross-border and international supply chains are often based in developing and emerging markets, where the challenges of accessing affordable financing are further complicated. It is often the case that financing available locally in developing markets is simply too expensive for SMEs to take advantage of; thus, the challenge is about access to finance but also about the affordability of financing for SMEs.

International institutions, regulators, regional and national governments, and other stakeholders should collaborate to help ensure a robust, sustainable, and innovative global architecture for trade finance and SCF. This architecture must be aimed at enabling increased trade, increased international development, and the creation of economic value through support of real-economy commercial activity that is inclusive of developing markets and allows SMEs to engage successfully in international markets.

Trade facilitation has not typically given significant attention to the financing aspect of international trade, even broadly defined in terms of the four elements of trade finance and SCF (i.e., payment, financing, risk mitigation, and information flow). The core proposition of the UN/CEFACT Supply Chain Programme Development Area initiative, and a fundamental message of this paper, is that trade facilitation ought to extend, proactively, to trade finance and SCF. 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. While best-practice trade development and promotion programs include a degree of focus on the financing dimension, such a component must become a more common element of trade development and promotion programs. 11

It remains clear that there is a direct connection between cross-border trade and international development. It is well-recognized that trade creates economic value and that trade can be an effective contributor to development and poverty reduction. Export performance, especially when it involves the SME sector, has been clearly linked to the availability of trade finance and SCF, including preshipment or pre-export finance, which can be critical in enabling SME suppliers to pursue international sales. In many jurisdictions, from developing markets (where small and microenterprises are central to commercial activity) to so-called advanced economies, SMEs are acknowledged as the backbone of economic growth and value creation.

With the link between availability of trade finance/SCF and trade activity firmly established, the further link to development is logically compelling and carries increasing credibility among trade facilitation practitioners, policy specialists, and government authorities. There is an opportunity to highlight these linkages to communities of trade finance practitioners, trade facilitation experts, and specialists in international development, with the ultimate objective of proposing that the integration of trade finance and SCF into trade facilitation practices should be fostered.

International Finance Corporation’s estimated global financing gap of US$2.4 trillion annually reminds one that the gap is mostly based on the difference between the demand for trade finance among buyers and suppliers and what is approved primarily by trade finance banks. While the definition of a trade finance gap or its exact size may be debatable, it seems undeniable that there is an excess of potential demand for trade-related financing support, and thus, by extension, a missed opportunity in terms of economic value creation and poverty reduction/development.

The role of multilateral development banks and export credit agencies in supporting trade finance and SCF, even ensuring its accessibility (especially in times of crisis), highlights the reality that pure private-sector capacity is insufficient to assure levels of liquidity to meet current needs, let alone to close a significant global market gap. Private-sector actors can quite suddenly reduce their risk tolerance or simply decide on a commercial basis to exit markets, reduce the size and scope of international activities, and otherwise reduce the availability of finance, as was done during the 2008 global financial crisis and in its aftermath. Multilateral institutions and (public-sector) export credit agencies ensure ongoing availability of trade finance and SCF on the basis of international development objectives and public policy, and are thus not hampered by commercial considerations or risk tolerance.

While banks provide the majority of support in international trade transactions through traditional trade finance and SCF mechanisms, banks’ role is less dominant when consideration is given to trade facilitation broadly, defined as including interfirm trade credit and the financing or settlement support typically provided for trade on open account terms. Even with banks now heavily focused on offering solutions under the umbrella of SCF (Figure 1), it is notable that bank portfolios in trade-related financing reflect somewhere around 15% to 20% focused on open-account trade through SCF solutions, despite the market reality that trade today is conducted on open account terms in perhaps 80% of transactions worldwide. Nonbank providers, including factoring firms, technology-based platform providers, and numerous other competitors are reshaping the business of financing international commerce and are driving banks to invest in new propositions and new business models around the financing of international commerce. The addition of trade finance and SCF into trade facilitation practice can and should involve banks as well as nonbank providers of financing solutions.

There is an imperative for a clearly articulated top-level vision related to the evolution of global trade finance and SCF, and there is an urgent need for a well-placed, trusted facilitator to identify and gather key stakeholders. This facilitator must also oversee the execution of a medium-term program to ensure that all-important international commerce can be supported and enabled through a well-matched global system of trade finance and SCF, explicitly integrated into

established practices and disciplines in trade facilitation and trade-related international development.

Since global trade fundamentally relies on access to adequate levels of financing, the premise of this paper is that there must be a strong integration of financing components into next-generation trade facilitation practices and disciplines. A global, concerted, and consistent approach to the creation of an enabling environment around trade finance and SCF will be an important addition to the growth of trade flows and the related increase in international development and poverty reduction.

While trade finance and SCF nowadays enjoy an unprecedented visibility in international institutions, such as the World Trade Organization, the International Monetary Fund, the World Bank, and various multilateral organizations, the reality is that these disciplines do not typically attract significant attention at the level of domestic public policy. There are clear opportunities to create linkages between trade facilitation programs and various forms of trade finance and SCF, as illustrated by the Buy-Ship-Pay model (Figure 3) and the related event-based financing representation of a trade transaction life cycle (Figure 4).
CONCLUSION

UN/CEFACT practitioners:

- Explicitly integrate and include (i.e., bridge) trade finance and SCF into current frameworks and practices related to trade facilitation.
- Identify and deploy an international and cross-functional working group to assess and make recommendations relative to the global trade finance gap’s impact on international development and trade-based poverty reduction.
- Carefully allocate scarce resources, focusing on the intergovernmental remit and using and building on well-used deliverables of established entities in the playing field.

Financial institutions:

- Devise a global program, in collaboration with industry associations, aimed at raising awareness and technical competencies in trade finance and SCF in light of a looming shortage of this skill set and as a complement to existing technical assistance programs in this area.
- Contribute to industry efforts aimed at attracting additional financial capacity to the business of trade and SCF, through information, education, and legal and regulatory changes that would allow additional capital to flow into international trade activity.

Public authorities:

- Multilateral institutions and public-sector export credit agencies must ensure ongoing availability of trade finance and SCF.
- Avoid the development of public-sector interoperability stacks.

Regulators:

- Design and facilitate a process to assess the adverse/unintended consequences of regulatory requirements on trade-related liquidity, ensuring that the economic cost of such consequences is objectively measured and that political authorities are engaged to achieve an appropriate balance between prudential regulation and the ability to conduct legitimate business.
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ABOUT UN/CEFACT

Within the United Nations framework of the Economic and Social Council, the United Nations Economic Commission for Europe (UNECE) serves as the focal point for trade facilitation recommendations and electronic business standards, covering both commercial and government business processes that can foster growth in international trade and related services. In this context, the United Nations Centre for Trade Facilitation and Electronic Business (UN/CEFACT) was established, as a subsidiary intergovernmental body of the UNECE Committee on Trade, mandated to develop a program of work of global intergovernmental relevance to achieve improved worldwide coordination and cooperation in these areas.