ADB BRIEFS

KEY POINTS

- The estimated global trade finance gap is $1.6 trillion.

- $692 billion of the gap is in developing Asia (including India and the People's Republic of China).

- 56% of SME trade finance proposals are rejected, while large corporates face rejection rates of 34% and multinational corporations are rejected only 10% of the time.

- Firms report that 25% more trade finance would enable them to hire 20% more people.

- Woman-owned firms face higher than average rejection rates.

- 70% of surveyed firms are unfamiliar with digital finance, uptake rates highest in peer-to-peer lending.

2016 TRADE FINANCE GAPS, GROWTH, AND JOBS SURVEY[1]

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INTRODUCTION

The trade finance ecosystem is going through a period of change. New types of providers are entering the market, banks are digitizing their internal processes, and the need to expand access to small and medium-sized enterprises (SMEs) is widely recognized. In 2015, banks report a relatively positive overall supply climate—more lines of credit available, and fewer correspondent relations canceled.

However, for some regions and client segments rejection rates remained high and stable through 2015. This is of particular concern in today's environment of slow trade growth and low commodity prices. Merchandise trade volumes fell by 13% in 2015, commodity prices fell by 30% and yet gaps are not closing. Without the underlying support of trade finance, trade opportunities that create growth and jobs are foregone.

The ADB trade finance survey quantifies market gaps for trade finance and explores their impact on growth and jobs. The 2016 survey had 337 responding banks from 114 countries. This year, the survey introduced new detail about the impact of financial technology (fintech) on market gaps, and how woman-led firms are impacted by unmet demand. We also include responses from a global company survey of 791 firms in 96 countries.

50 YEARS
ADB

UNMET DEMAND POOLS IN EMERGING MARKETS

The global trade finance gap for 2015 is estimated at around $1.6 trillion. About $692 billion of this is in developing Asia (including India and the People's Republic of China [PRC]). To put this in context, in 2014, the Bank for International Settlements estimated the global market for trade finance at between $6.5 trillion and $8 trillion.

Unmet demand has a stable geographic distribution. The consistency of this characteristic over the years of this survey and varying survey populations underscores the structural element to trade finance gaps.

Among developing regions, Asia and the Pacific continues to have both the highest proposal rate (40% of global proposals) and the

BASEL III CONTRIBUTES TO REGULATORY IMPEDIMENTS

Unintended consequences of regulatory compliance continue to contribute to market gaps for trade finance. There are two features of the regulatory impact in 2015. The first is that Basel III rose in importance as a regulatory constraint relative to previous years. The second is that banks expect the negative impact of Basel III to be more evenly distributed among client types compared to anti-money laundering/know your client (AML/KYC) impacts.

When asked about the major impediments to trade finance, bank responses fall into two categories: regulatory (including AML: 90% and Basel III: 77%) and risk-related (including credit rating of country: 82%, or issuing bank: 85%). Institutions involved in forfaiting report similar regulatory impacts. By contrast, export credit insurers report softer impact from regulatory issues.

Figure 1: Distribution of Proposed Transactions and Rejections (by region, %)
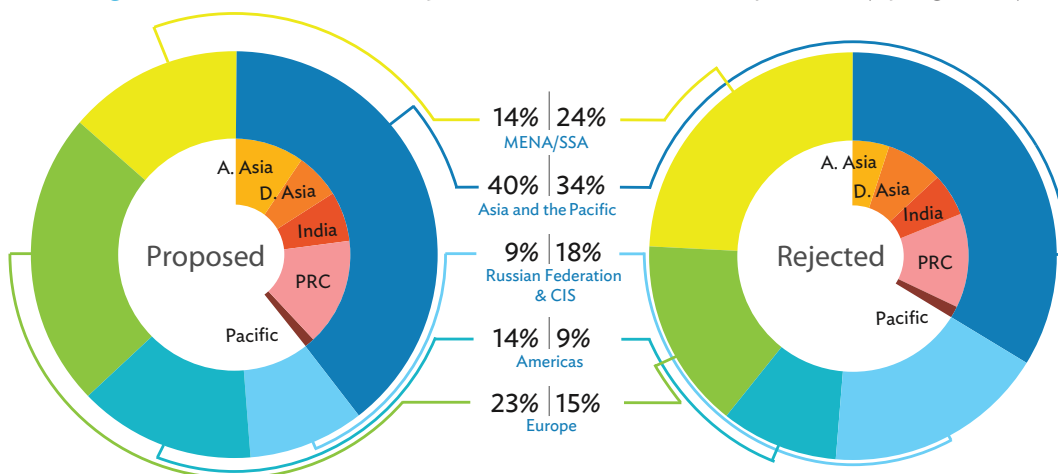
A.Asia= Advanced Asia (Hong Kong, China; Japan; Republic of Korea; and Singapore); D. Asia= Developing Asia excluding the PRC and India; PRC= People's Republic of China; CIS= Commonwealth of Independent States; MENA= Middle East and North Africa; SSA= Sub-Saharan Africa.
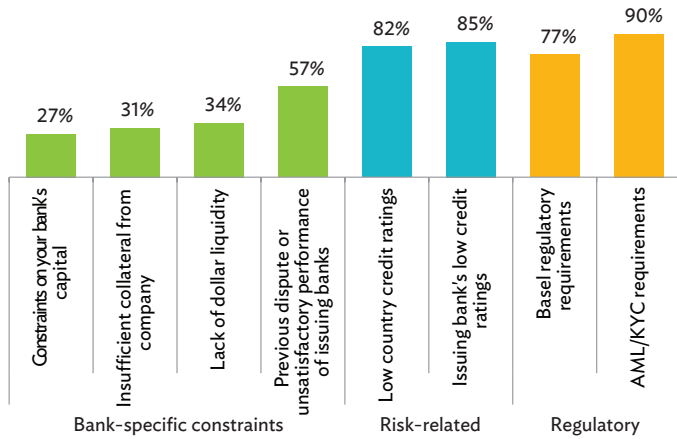Source: ADB. 2016 Trade Finance Gaps, Growth, and Jobs Survey.

highest rejection rate (34% of global rejections) for trade finance. As in previous years, this is largely driven by the PRC. Both developing Asia and advanced Asia recorded lower rejection rates as a percent of total global rejections than in past years. However, their total proposals were also lower.

SMEs are the only client segment that is more likely to have a transaction rejected than supported. They continue to generate the highest number of proposals and to face rejection rates above their proposal share (44% of all proposals, 56% rejected). Multinational corporations (MNCs) and large corporates are both rejected at a lower rate (10% and 34% rejected, respectively). Export credit insurers (both private firms and official export credit agencies) report a similar distribution.

In 2015, Basel III compliance rose in significance as an impediment. This is important because banks report that Basel III affects finance to all client segments. This is in contrast to AML, which banks expect to primarily impact trade finance to SMEs.

The regional impact of Basel III is also slightly different from AML. About 45% of bank respondents expect Basel III to have a moderate or great impact on their trade finance activities in the Middle East and North Africa (MENA)/Sub-Saharan African, Russian Federation/Commonwealth of Independent States (CIS), and Western Europe. Respondents expect that the Americas and Asia will experience less impact.

Figure 2: Significant Impediments to Expansion of Trade Finance (% responding banks)

Value	Category
27%	Constraints on your bank's capital
31%	Insufficient collateral from company
34%	Lack of dollar liquidity
57%	Previous dispute or unsatisfactory performance of issuing banks
82%	Low country credit ratings
85%	Issuing bank's low credit ratings
77%	Basel regulatory requirements
90%	AML/KYC requirements

Bank-specific constraints · Risk-related · Regulatory

AML/KYC= anti-money laundering/know your client.
Note: Replies to the question on impediments to trade finance expansion were on a 4-point scale where 1=very insignificant, 2=insignificant, 3=significant and 4=very significant.
Source: ADB. 2016 Trade Finance Gaps, Growth, and Jobs Survey.

Figure 3: Expected Impact of Regulatory Requirements by Client Segment (AML and Basel III)

Anti-Money Laundering
MNCs 5%
Large corporates 20%
SMEs 75%

Basel III
MNCs 78%
Large corporates 83%
SMEs 84%
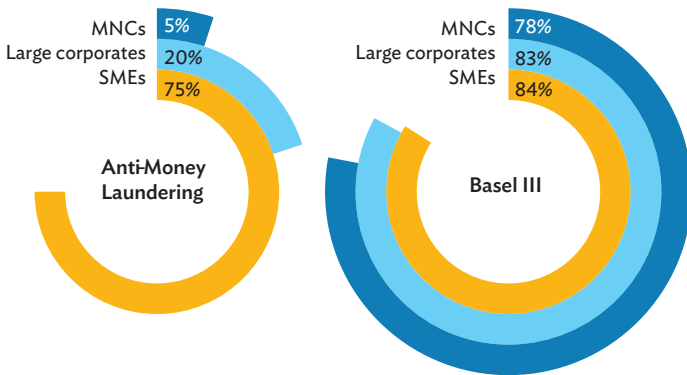
AML= anti-money laundering, MNCs = multinational corporations, SMEs = small and medium-sized enterprises.
Source: ADB. 2016 Trade Finance Gaps, Growth, and Jobs Survey.
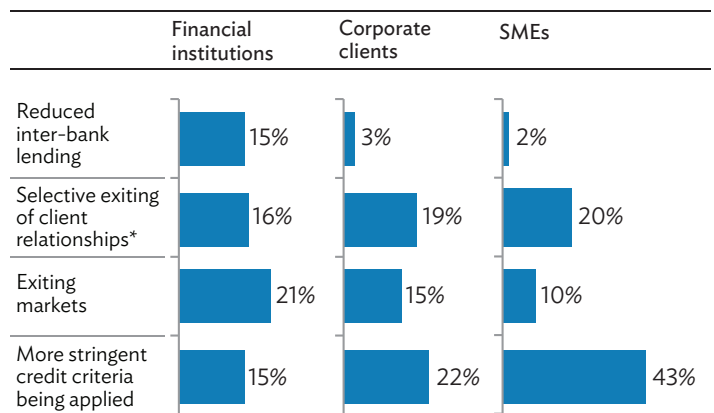
DERISKING IN 2015

In 2015, fewer respondent banks reported terminating correspondent relations due to the cost or complexity of anti-financial crimes regulatory compliance (40% in 2015 vs. 45% in 2014). This is most likely because banks have already undertaken a mass exiting of correspondent relationships. Bank-to-bank relationships underpin trade, particularly in emerging markets, so the fact that so many of these relationships have been terminated, at least partly due to unintended consequences of regulation, is of concern and needs to be monitored.

Aggregate effects are unevenly distributed across regions. Markets where more than 1/3 of bank respondents reported significant impact of compliance-based terminated correspondent relationships include: Russian Federation/CIS (50%), MENA/Sub-Saharan Africa (42%), and developing Asia (34%).

Changes in the number of credit lines also indicate that derisking is not over. Seventy-two percent of banks report that the number of credit lines remained the same or slightly increased in 2015. However, of the banks that reported decreasing lines of credit, the primary reason was "more stringent credit criteria being applied" for all client types.

Where credit lines to financial institutions declined, other prominent reasons included exiting markets (21%) and client relationships (16%), and reduced interbank lending (15%). In 2014, these issues were less prominent, with only 11% citing exiting markets, and 4% reporting reduced interbank lending. While this is not directly comparable because a breakdown of private sector clients was not introduced until this year, it supports recent data which shows a decline in active correspondent relationships since 2011.[2]

Figure 4: Reasons for Decreased Credit Lines to Various Client Groups (% responding banks)

	Financial institutions	Corporate clients	SMEs
Reduced inter-bank lending	15%	3%	2%
Selective exiting of client relationships*	16%	19%	20%
Exiting markets	21%	15%	10%
More stringent credit criteria being applied	15%	22%	43%

SMEs = small and medium-sized enterprises.
* Due to credit deterioration.
Source: ADB. 2016 Trade Finance Gaps, Growth, and Jobs Survey.

SMEs RESORT TO INFORMAL FINANCE

According to the bank survey, SMEs in all regions continue to face constraint in the trade finance space. How do they cope in an environment where their requests for trade finance are more likely to be rejected than funded? In addition to financial institutions, this study also surveyed companies seeking trade finance support, which provided three insights.

[2] Bank for International Settlements. 2016. *Correspondent Banking*.

First, companies report that the main cause of their high rejection rate is their inability to fulfill standard bank requirements. About 35% of surveyed SMEs report rejection on account of failure to fulfil standard requirements including collateral (47%), documentation (37%), and valid company records (34%).

Second, once a transaction is rejected by a financial provider, only 37% of firms report seeking alternative financing. Woman-owned firms are slightly more likely to try again with 41% of respondents seeking alternative financing. This is likely because woman-owned firms are more dependent on trade finance and also 1.5 times more likely to be rejected.

Third, SMEs across regions continue to turn to informal financial providers to finance transactions that were rejected by a bank. This is strongest among African (47%) and Asian (37%) firms, while firms in Latin America are more likely to report having found formal alternatives, but that were too expensive to use (40%). woman-led firms are twice as likely to turn to informal financial providers when their request is rejected by a bank.

FINTECH UPTAKE IN EARLY STAGES

Globally, digital finance solutions can help to narrow market gaps. Though in the early stages, digital finance targets market segments that have the most difficulty accessing bank-intermediated trade finance including niche exporters and SMEs. Recognition is low, but among firms that are familiar with digital finance, uptake of peer-to-peer (P2P) in particular is strong.

Across the sample, 70% of respondents indicated they were unfamiliar with any type of digital finance. This held across regions and firm sizes. There is variation by type of digital finance. P2P lending had the highest recognition rate (43%) and debt-based securities (18%) had the lowest.

Geographically, uptake is highest among African firms. Uptake refers to the proportion of users in the population that reports having considered or used digital finance. This is the case for all types of finance listed. For example, among African firms that are familiar with P2P, 54% report using it. For Latin America this number is 33% and 39% for Asia. Firms in the Pacific generally do not know or use digital finance, with the exception of one firm in Micronesia that has used P2P.

Users of digital finance are distinct from the average firm in the sample in several ways. First, firms that use digital finance experience higher average rejection rates for their proposed transactions with traditional financial institutions. They are also much more likely to seek alternatives for rejected transactions (47%) than the average firm in the sample (15%). Finally, woman-owned firms are more likely to use digital finance than other firms (35% vs 20%).

Figure 5: Recognition and Utilization Rates of Digital Finance (by type)
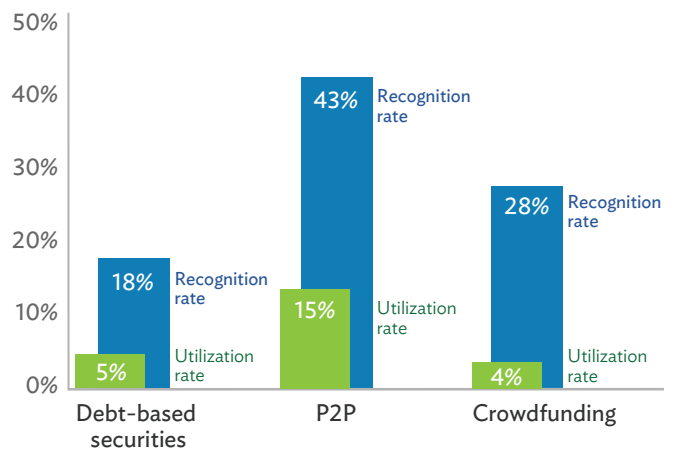
P2P= peer-to-peer lending; Recognition rate= % of responding firms that reported considering or using digital finance; Utilization rate=firms that have used digital finance platforms as a % of all respondents.

Source: ADB. 2016 Trade Finance Gaps, Growth, and Jobs Survey.

TRADE FINANCE PROMOTES JOB CREATION

Trade finance is a low-risk product.[3] However, it remains scarce in markets with the strongest potential for trade expansion. This matters for development, because trade finance generates additive effects on employment and growth.

Of firms that reported receiving more trade finance in 2015, 70% reported higher levels of employment in 2015 over 2014.

Since they began receiving trade finance, firms report hiring 17 new employees on average. Around 3% of firms that responded to this question hired 100 or more, while 41% report hiring 1-10 new employees. The average number of employees in responding firms was 221. Thus hiring 17 employees constitutes about 8% of the workforce in the average firm in our sample.

Firms were also asked how they might allocate a hypothetical increase in trade finance of 25%. Firms report that with this additional amount of trade finance they would increase the number of employees by an average of 20%. This effect was strongest among firms in MENA/Sub-Saharan Africa which would increase employment by 31%.

While it is difficult to quantify the direct impact of market gaps on growth and jobs, this survey bears out that there is certainly a relationship and that by closing market gaps for trade finance more growth and jobs will be created.

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3   International Chamber of Commerce (ICC). 2015. 2015 ICC Trade Register Report. Paris.

Figure 6: Percentage Increase if Company Receives 25% More Trade Finance (average for all respondents)

Increase production by **30%**

Increase employment by **20%**

Increase investment in new businesses by **19%**
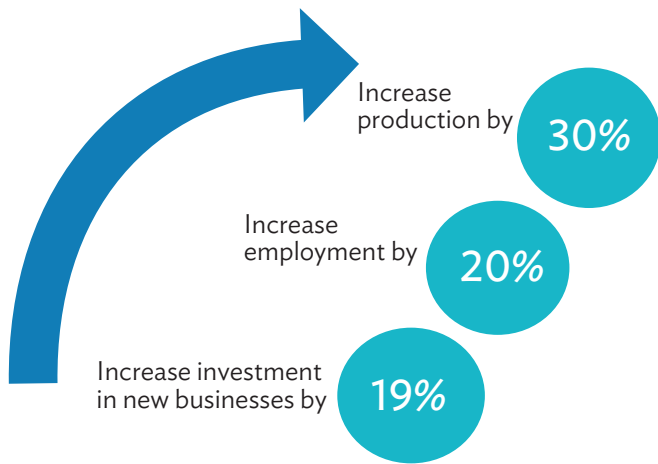
Source: ADB. 2016 Trade Finance Gaps, Growth, and Jobs Survey.

WHAT'S NEXT FOR TRADE FINANCE?

The persistence of unmet demand for trade finance is widely recognized as a development issue. But it isn't without solutions. Fintech startups are moving into underserved markets. Financial institutions are exploring ways to better engage with SMEs. Multilateral development banks are expanding the range of instruments to support banks and firms in emerging economies.

These developments are making a difference. Over 75% of banks reported that the trade finance programs of multilateral development banks help to narrow trade finance gaps. ADB's Trade Finance Program (TFP) provides loans and guarantees to banks to support trade. TFP works in 21 developing countries in Asia and the Pacific, supporting about 2,000 transactions a year valued (on average) at $3.5 billion. Over 75% of TFP's transactions support SMEs.

The trends identified by this year's survey suggest two ways forward. First, increase the visibility of SMEs. SME exporters can benefit directly from online business registries and global business identifiers. These create the identity that SMEs often struggle to prove.

Second, embrace disruption. Technology can be leveraged to benefit firms that are least linked into the financial system. Digitization in banks can promote transparency, efficiency, and equality. And fintech can make inroads into markets where traditional trade finance is limited.

Bank respondents came from both the ICC Banking Commission member banks as well as banks participating in ADB's trade finance program. The trade finance gap is estimated using the rejected value of proposed trade finance transactions as reported by responding banks and weighted to match a global distribution. The results reported here are indicative of the current survey only and not comparable across years. Each wave of the survey has a unique population with different characteristics.

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

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In this publication, "$" refers to US dollars.