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DFI INSIGHTS

BRIDGING BORDERS: GETTING STARTED ON TRADE FINANCE

THE BASICS

Trade finance is a set of tools to facilitate international trade transactions. By international trade we mean the flow of goods between two or more countries or economic areas. In this context, transactions occur between two parties: the exporter, person or company selling a product, and the importer, the person or company purchasing a product. Exporters and importers have specific, sometimes parallel, needs:

- Importers want to receive goods in the quantity, quality, and timeline requested and defer payment until they can get the goods and assess that they respect the quantity and quality agreed.
- On the other hand, exporters want to be sure of being paid completely and within the agreed timeframe, ideally as soon as possible. They also want to be able to deliver their goods securely and within the expected timeframe.

Both exporters and importers share the same desire to carry out a safe, efficient, and fast transaction. However, international trade presents many challenges, including language barriers, a lack of familiarity or trust, different currencies, and different regulations. **Trade finance services can be important to mitigate risks and diminish information asymmetries among the actors.**

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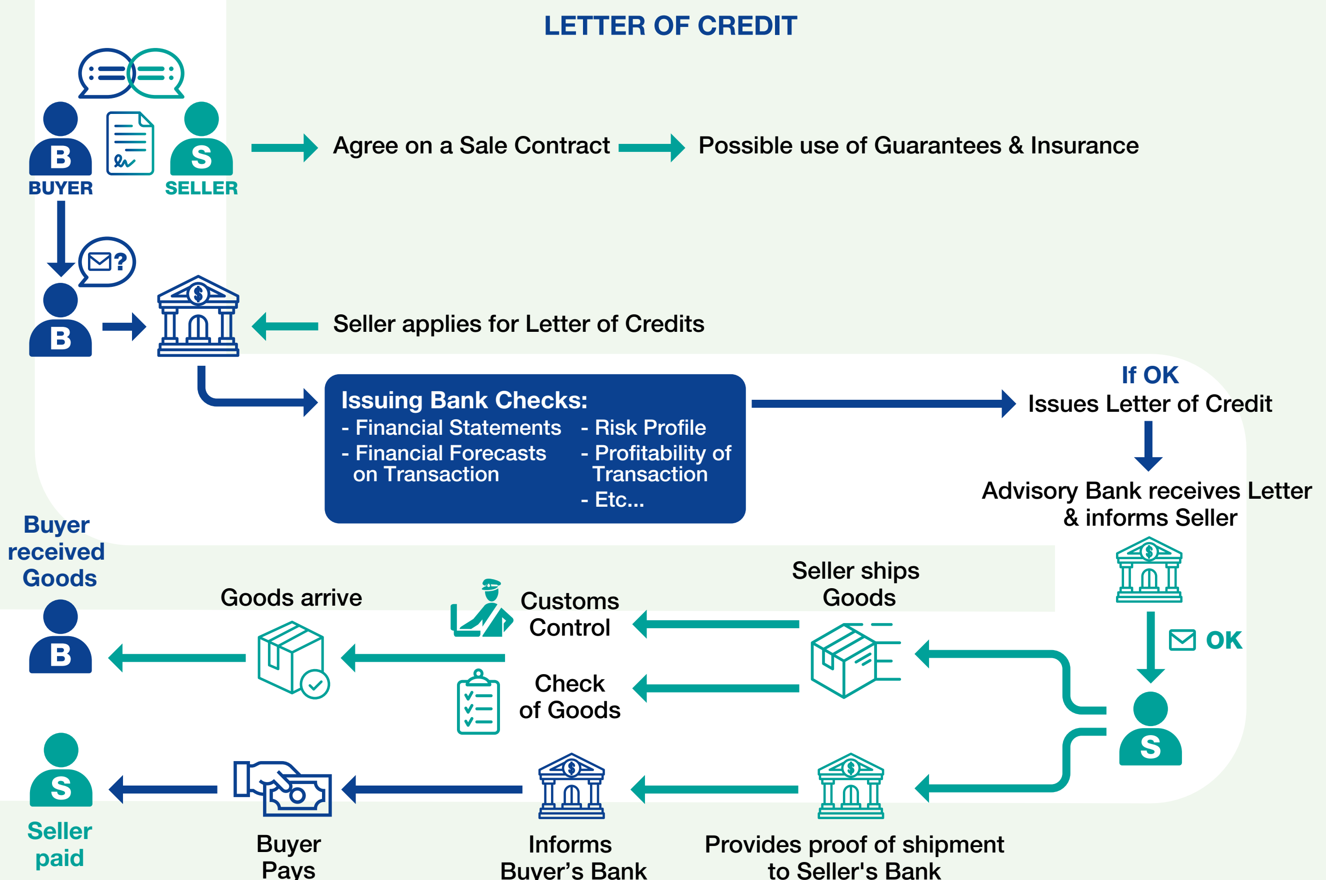
WE CAN DIFFERENTIATE TWO MAIN TYPES OF TRADE FINANCE:

- **Pre-shipment finance:** a type of financing provided by a financial institution to an exporter (i.e. seller of goods) and/or services before the goods are delivered to the importer (i.e. buyer). The purpose of this financing is to support various activities undertaken by the seller before the goods are shipped to the buyer (e.g. sourcing raw materials, manufacturing goods, or converting semi-finished goods into finished products). This type of financing can help exporters fulfil orders and expand their operations, while also providing importers with the assurance that their orders will be fulfilled on time.
- **Post-shipment finance:** any form of financing that a seller can access right after they have sent goods to a buyer. This type of financing allows sellers to receive payment for their goods more quickly, typically when they are loaded onto the ship for transport to the buyer, rather than waiting for the standard payment terms period, which can range from 30 to 90 additional days after the goods have been shipped. This type of financing can help sellers improve their cash flow and meet their financial obligations, while also enabling buyers to receive their goods more quickly and begin selling them to their customers.

THE MOST COMMON INSTRUMENTS USED IN TRADE FINANCE ARE:

- **Letters of credit:** a document from a bank that guarantees payment and provides security when buying or selling products or services. If the buyer fails to pay, the bank will pay the seller, if the seller meets the letter of credit's requirements. If the seller fails to deliver, the buyer is protected.



- **Guarantees or Bonding facilities**: guarantees that provide assurance to the importer regarding the performance and financial security of the exporter. Some common types are:

  - **Bid guarantees:** Bid guarantees are provided by the exporter to the buyer as a commitment to honour the terms of a bid or proposal submitted for a contract. This assures the importer that the exporter is serious about the bid and will proceed with the contract if awarded.

  - **Advance payment guarantees:** Advance payment guarantees assure the buyer that the exporter will utilise any advance payments received for the intended purposes, such as purchasing raw materials and hiring necessary labour, rather than for other unrelated business or personal expenses. This can help build trust and strengthen the relationship between seller and buyer.

  - **Performance guarantees:** Performance guarantees ensure that the exporter will fulfil their obligations under the contract, including delivering goods/services on time, meeting quality standards, and adhering to contractual terms. This provides assurance to the buyer that they will receive the expected value for their investment.

Moreover, **insurance** can be obtained to cover different types of guarantees or bonds, offering protection against potential losses or liabilities. This insurance provides an additional layer of security for both the exporter and the buyer.

Financial institutions can help facilitate cross-border invoice factoring and discounting by providing guarantees or risk-sharing arrangements for cross-border transactions:

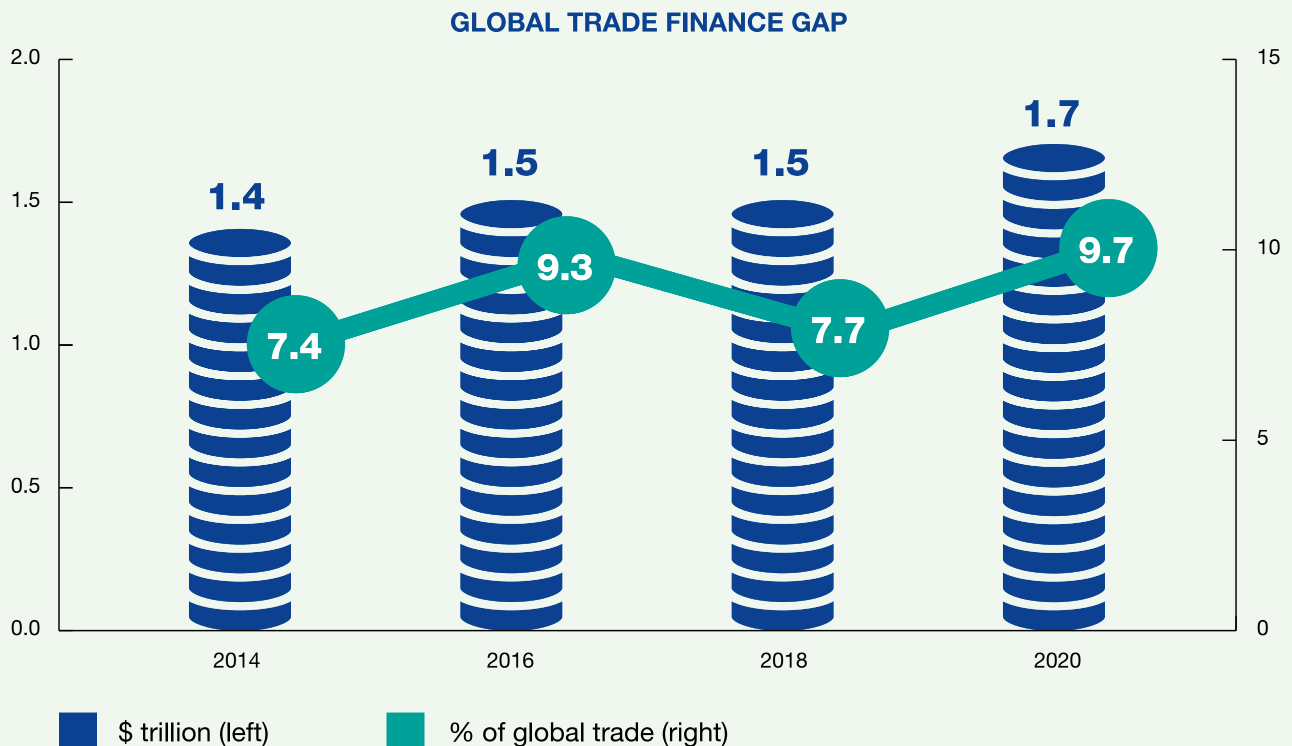
- **Invoice factoring:** a financial arrangement wherein a company uses its unpaid invoices, or accounts receivable, as collateral to secure funding, similar to a business loan. The company provides goods or services to its customers as usual and prepares invoices for these transactions. The company then «sells» these invoices to a factoring company. Upon verification of the validity of the invoices, the factoring company typically pays the company part of the invoiced amount immediately, usually up to 80-90% of the total value. The factoring company takes control of the company's sales ledger and directly collects payment from the customers. If necessary, it takes further action to recover payments from accounts in arrears. Once the factoring company receives full payment from the customers, it pays the remaining invoice amount to the company, minus its fee for providing the factoring service.

- **Invoice discounting:** similar to invoice factoring, it is a financial arrangement wherein a company borrows funds against its outstanding invoices to improve its working capital and cash flow position. However, with invoice discounting, the company retains responsibility for its sales ledger, payment recovery, and invoice processing. This means that the company's customers are unlikely to be aware of its relationship with the lender.

Thus, offering financial services to SMEs engaged in international trade can help reduce the credit risk associated with these transactions.

WHY MIGHT DFIS WANT TO ENGAGE IN TRADE FINANCE?

Trade finance is an effective instrument to mitigate risks for international trade. In a world that is more and more globalised, trade finance helps entrepreneurs diversify their network of suppliers or clients, doing business with a higher number of businesses in different countries. Consequently, international trade can increase diversification of income in the countries and contribute to developing local economies, thereby improving the credit profile of the region, fostering global, economic, and social development, which is often part of a DFI's mandate.



Source: ADB. 2021 Trade Finance Gaps, Growth, and Jobs Survey— Banks; and World Trade Organization. WTO Data. https://data.wto.org/ (accessed 23 August 2021).

There is an untapped demand for trade finance services. In 2021, the Asian Development Bank (ADB) initiated a survey, receiving responses from 79 banks across 43 countries and 469 firms spanning 72 countries. The survey revealed an estimated trade finance gap of 1.7 trillion USD in 2020, particularly impacting SMEs and businesses led by women. This underscores the significance of trade finance, which not only benefits entrepreneurs but also presents an opportunity for DFIs to narrow the gap and foster economic growth.

According to the survey, this gap is caused by various factors, from economic uncertainty to regulatory requirements. The responding financial institutions often cite anti-money-laundering and know-your-customer regulations as main barrier, as well as the complexities and costs associated with this type of services. However, the survey also highlights how these barriers could be overcome through more transparency on default and loss statistics by country, the creation of global standards (like the Digital Standards Initiative (DSI)) and improvement of regulations.

IMPLEMENTING TRADE FINANCE IN YOUR DFI

Assess the trade finance market in your context to understand the role you can best play. As we have seen, there are different types of trade finance instruments, and several important roles in each transaction. Your DFI should choose carefully which ones are feasible and interesting for your context. As with any new financial instrument, it will be important to assess the market in which your institution operates, existing trade finance services available in the financial sector, and identify any existing gap to meeting demand among exporters and importers in your context. By understanding the reasons for the market dysfunction or gap, you will be best able to identify the appropriate role for your DFI in unlocking the potential of trade finance in your market context.

Consider trade finance rules and regulations in other countries. That trade finance involves cross-border transactions, and rules and regulations can differ between partner markets or countries. To ensure compliance and maintain effective operations, your DFIs should stay informed about potential changes in these jurisdictions. Some useful resources might be:

- The Access2Markets website of the European Union, providing information on tariffs, procedures and requirements for each EU country.
- The United States' International Trade Administration's Country Commercial Guides, which collect reports on market conditions, opportunities, and regulations in all countries, compiled by commerce departments and other professionals at US Embassies worldwide.

Trade finance requires a thorough risk analysis. Trade finance transactions face country risk, commercial risk (e.g. the buyer does not pay, or the seller does not provide the goods as agreed), operational risk (all things that can go wrong during a transaction, like errors in the selling agreement, lack of insurance, third parties like customs not cooperating) and fraud risk. Your DFI should carefully consider risks to choose the instruments that fit best, and always plan time for risk analysis of every transaction.

There are international standards on how trade finance works that can guide DFIs getting started with this type of instruments. The Uniform Customs and Practices for Documentary Credits (UCP) is a set of rules developed by the International Chamber of Commerce (ICC) for the handling of letters of credits, which attempts to unify rules at international level and is used in more than 175 countries. The ICC also created the International Commercial Terms (Incoterms®), which are shared rules on the obligations, costs, and risks of goods transportation and delivery and they are accepted by most government and authorities. In some jurisdictions, Legal Entity Identifiers (LEIs) are mandatory for financial transactions. The LEI is a unique reference code used across markets and jurisdictions to identify distinct legal entities involved in financial transactions (businesses and financial institutions) thereby facilitating smoother and more transparent financial dealings.

As a DFI, you can choose different models of engagement:

- **Maximum Risk Participation Agreement (MRPA):** it is a risk sharing approach whereby multiple financial institutions or parties agree to share the risk associated with a trade finance transaction, typically involving import-export activities. The agreement sets forth the maximum amount of risk each party is willing to assume, thereby spreading the risk among several entities, rather than bearing it entirely on a single institution. This helps to diversify and reduce the exposure of any single participant to potential losses arising from the transaction.
- **On-lending via commercial banks:** these allow your DFI to transfer client risks to the commercial banks, which are often closer to clients and can rapidly and efficiently take care of this kind of operations.

To effectively manage trade finance activities, your DFI needs staff with specialised expertise:

- Technical proficiency in sourcing, assessing, and deciding on trade finance applications.
- Experienced documentary credit specialists capable of identifying flaws and fraud in submitted documents, with a strong background in trade finance.
- Proficiency in swift communication for effective interaction with counterparties.
- Familiarity with integrated IT platforms encompassing end-to-end functionalities, customer service applications, contextual chat services, online application platforms, and progress tracking.

In setting up trade finance activities, collaboration among various teams is crucial for success. The risk team plays a pivotal role in assessing and mitigating potential risks associated with trade transactions. Legal experts are essential for examining legal documentation and implementing a robust security package to safeguard the institution's interests. Treasury teams ensure the availability of resources necessary to facilitate trade finance operations smoothly and take care of the currency risk. Finance teams handle back-office activities, ensuring accurate processing of transactions and adherence to financial regulations. Administration teams provide crucial support in managing documentation and administrative tasks. A cohesive effort among these teams ensures effective decision-making and enhances the institution's ability to navigate the complexities of global trade.

When engaging in trade finance activities, gathering and analysing various documents is imperative to support different types of transactions. For instance, buyers and sellers should provide audited financial statements, business plans, financial forecasts specific to the transaction, credit reports, and director details. Insurance may also be necessary to mitigate risks during transit, necessitating certificates ensuring product quality. Moreover, customs clearance often requires specific documentation.

When analysing a trade finance transaction, the DFI should consider the following:

- **The contractual basis and Incoterms** of the transaction to understand the risk allocation and profitability.
- **The cash flow** related to the transaction to determine the funding need.
- **The quality of the receivables**, as they will be the final source of repayment.
- The exporter/importer's effort and level of involvement in the transaction.

Additionally, the DFI can consider **alternative solutions** (e.g. other types of trade finance instruments or other financial services than those proposed by the entrepreneur) to mitigate risk and ensure that the transaction is structured in the most efficient way possible.

By following this process, the DFI will be able to effectively set up trade finance activities and manage risk in a responsible and profitable manner.

KEY QUESTIONS AND IMPLEMENTATION STRATEGIES

WHEN SETTING UP TRADE FINANCE ACTIVITIES:

- **How does trade finance fit into your DFI's mission and vision?**
  This is important to communicate effectively and onboard all staff in this effort.

- **What are the different types of trade finance transactions used in your market, and which ones are most suitable for your DFI's context?**
  How would your DFI's trade finance activities fit into the existing offer in the market?

- **What risks are involved in trade finance transactions, and how can your DFI assess and mitigate them?**

- **What specialised expertise is required for your DFI staff to effectively manage trade finance activities?**
  Is it already present or how should it be acquired?

WHEN ANALYSING TRADE FINANCE TRANSACTIONS:

- **Contractual basis and Incoterms**:
  - What are the terms of the sale, delivery, and payment between the buyer and seller?
  - What is the profitability of the underlying transaction and how is risk allocated?

- **Cash flow analysis:**
  - What is the funding need that needs to be met?
  - What are the payment terms, and the timing and amount of cash flows?

- **Quality of receivables:**
  - Who are the buyers and what is their creditworthiness?
  - Can they pay and what is the likelihood of recovery?

- **Buyer and Seller's efforts:**
  - What are the parties' roles and level of involvement in the transaction?
  - Do the parties have sufficient "skin in the game"?

FURTHER READINGS

- Driving Inclusive Digitalization in Trade and Trade Finance (ADB, 2022)
- eUCP VERSION 2.1 – ICC Uniform Customs and Practice for Documentary Credits (ICC, 2023)
- Frequently Asked Questions on LEI (Office of Financial Research, accessed June 2024)
- How investing in trade finance can be profitable and help SMEs thrive (WEF, 2022)
- Incoterm rules (ICC, 2023)
- The 2021 ADB Trade Finance Gaps, Growth, and Jobs Survey (ADB, 2021)
- Toward Inclusive Access to Trade Finance: Lessons from the Trade Finance Gaps, Growth, and Jobs Survey (ADB, 2022)
- Trade finance and SMEs (WTO, 2016)

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