BNY Mellon

2019 Global Survey

Overcoming the Trade Finance Gap: Root Causes and Remedies

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Introduction

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> **Trade finance rejection rates accelerated in a third of institutions surveyed**

The much-publicised US$1.5 trillion global trade finance gap, as reported by the Asian Development Bank (ADB), continues to present challenges for global trade. Critically, the size of the gap is affecting development and investment flows and financial inclusion, which in turn, is impacting business and economic growth. Addressing the gap is, therefore, understandably a key concern and a priority for the trade finance industry.

This lack of financial inclusion could have a detrimental impact on the wider economy, with persistent trade finance rejections potentially cutting off some businesses from the trading ecosystem—particularly those in certain small countries with limited financial markets.[1]

In light of this, BNY Mellon—with support from the International Chamber of Commerce (ICC)—has conducted a global survey titled *Overcoming the Trade Finance Gap: Root Causes and Remedies*. Carried out between April 2018 and January 2019, and consisting of 10 questions (see Appendix A), the survey asked more than 100 global bankers, regional and domestic banks, specialist trade providers and other market participants from around the world to help pinpoint the factors that are driving the gap and what might be done to address them. As well as analysing overall outcomes of each question, we also drilled down into the results according to type of institution in order to identify institution-specific trends and patterns.

Although credit was cited as an issue, our survey supports existing findings that compliance costs are a key—though by no means the sole contributor—to the volume of rejected trade finance transactions. Of particular note, our findings also revealed that trade finance rejection rates accelerated in a third of institutions surveyed during the previous year. This is a worrying trend, and emphasises the very real need for effective action to help narrow the gap—and ensure it doesn't widen further. Participants identified two potential solutions as equally important: regulatory revision and technology, with respondents highlighting the value of centralised know your customer (KYC) databases in particular with respect to how technology could help. The survey also investigates what could most effectively help to drive regulatory revision, and the role of correspondent banks in helping to close the gap.

Our survey reconfirms the ongoing issue of the trade finance gap. It is imperative that we continue to seek and implement the means to enable businesses to connect effectively to international value chains and help global trade to realise its full potential.

We would like to thank those who contributed to our survey. We hope that publishing our findings on the perspectives of industry specialists will help to pinpoint how the trade finance gap can best be addressed, and act as a platform for further discussion.

[1] http://www.worldbank.org/en/topic/financialmarketintegrity/brief/de-risking-in-the-financial-sector

Survey Findings

Trade finance transaction rejection rates are increasing in a third of institutions

One third of survey participants said that the rejection rate for trade finance transactions has accelerated in the past 12 months

N = 84

One third of respondents reported that the rejection rate for trade finance transactions from their institution had accelerated in the past 12 months. When respondents were asked if they had noticed a rise in rejection rates from other institutions, this figure rose to over half (52%). These numbers are substantial, and underscore the challenge many businesses face when it comes to accessing funding for trade. The problems persist and appear to be increasing.

Regional and domestic bank respondents say that they have noticed an increase in trade finance transaction rejection rates. Over half (53%) reported an increase within their own institution in the past 12 months (compared with 32% of specialist trade providers and 24% of global banks); and nearly two thirds (64%) of regional and domestic banks claimed to have seen an increase in rejection rates from other institutions (compared with 56% of specialist trade providers and 46% of global banks).

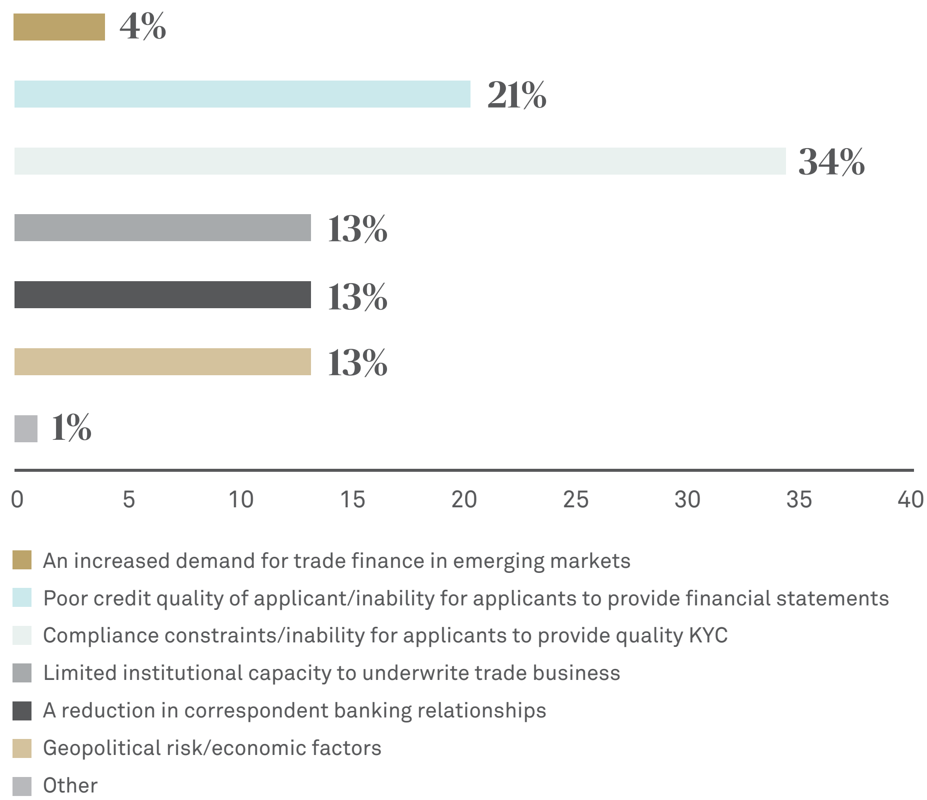
If increases in rejection rates from regional and domestic banks are occurring, this could compound the issues experienced by these businesses—further impacting financial inclusion, business growth, and the robustness of global trade.

> “One third of respondents reported that the rejection rate for trade finance transactions from their institution had accelerated in the past 12 months

> Compliance constraints and the inability for applicants to provide quality KYC was identified as the core factor influencing the volume of rejection rates

Compliance constraints were reaffirmed as the primary contributor to trade finance rejections

Top reasons that transactions are rejected



N = 82

All respondents

"Compliance constraints and the inability for applicants to provide quality KYC" was identified as the core factor influencing the volume of rejection rates. Some 34% selected this as the main reason and 71% claimed it to be either the main or second main reason. This reflects the findings of other surveys exploring the trade finance gap, which have revealed that heightened regulatory requirements indirectly contributed to the trade finance gap due to the associated rise in compliance costs. As a result, banks have had to be more selective in who they do business with and subsequently move away from geographies and sectors that appear to hold greater risk for less reward. Without the support of global banks, many local and regional banks in emerging markets have been less able to offer trade finance to businesses such as small and medium enterprises (SMEs)—an issue that is affecting Asia in particular.

Specialist trade finance providers

While compliance constraints was the main contributing factor for all types of banking institutions surveyed, specialist trade finance providers were more likely to choose “poor credit quality/inability for applicants to provide financial statements” as the primary reason for trade finance rejections. Thirty-five percent rated this as the main reason (compared with 21% in the overall responses); and 81% of specialist providers ranked it as the most or second most important reason. This supports the fact that specialist trade finance providers are typically not subject to the same degree of regulatory and compliance requirements as banks. It also indicates that specialist providers are more likely to be approached for support by businesses with poorer credit quality, due to decreasing support from banks.

Regional and domestic banks

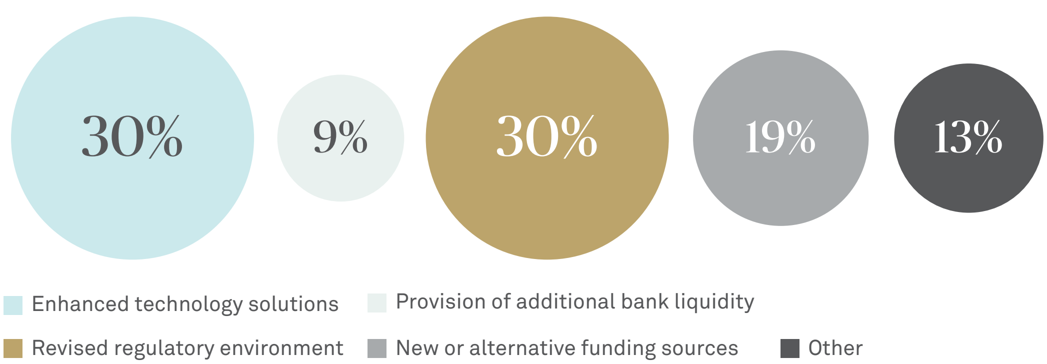
Regional and domestic banks were more likely to count “a reduction in correspondent banking relationships” as an important contributor—reflecting the move of many banks away from some markets. Thirty-five percent identified this as the most or second most important reason.

All respondents

Numerous factors affect the accessibility of trade finance, and “geopolitical risk/economic factors” was also cited by all as an important contributor (43% of overall respondents highlighted this as either the main or second main reason). Protectionism and anti-globalisation have created a degree of uncertainty with respect to global trade which, in turn, could impact trade relationships and activity—and the ability to access finance.

Technology and regulatory revision are priority solutions

Technology solutions and a revised regulatory environment are viewed as the top ways to help address the trade finance gap



N = 118

> Respondents highlighted that revising existing regulatory requirements could be one of the top ways to close the gap

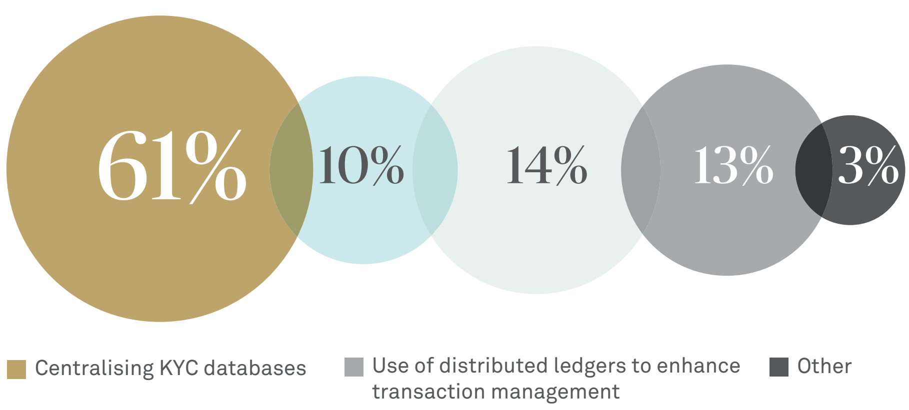
Two solutions were ranked equally (by 30% of all respondents) as the most effective means of reducing the trade finance gap: revising the regulatory environment and enhanced technology solutions. With compliance constraints identified as the main contributor to rejection rates, respondents highlighted that revising existing regulatory requirements could be one of the top ways to close the gap. Such developments would require greater harmonisation between regulators and banks in order to achieve a compliance landscape that meets the needs of all parties.

With existing regulatory requirements firmly in place, however, the industry also recognises the potential for technology to help overcome compliance challenges. Efforts are underway to explore the role of digital capabilities in trade finance, with the belief that new initiatives could significantly enhance current procedures, including streamlining compliance processes, whilst reducing collateral, operational and compliance costs.

While nearly a third of respondents identified technology as one of the most effective ways of bridging the gap, contrastingly, nearly a third of respondents ranked it the least effective option—a view that was evenly split across global, regional and domestic banks, and specialist trade finance providers. This suggests that there could be a great deal of debate still to be had regarding the most effective way of closing the trade finance gap. While technology holds much promise with respect to improving security, transparency, efficiency and data management, these results indicate that there may be a lack of confidence in, or understanding of, technology's potential to transform trade finance.

The role of technology: centralised KYC databases hold promise

KYC databases are seen as the topmost effective technology solution for addressing compliance issues



N = 109

When asked how technology could most effectively address compliance-related issues, centralising KYC databases was the most popular choice by far (61%). Shared platforms could help to streamline current KYC processes by removing the need for multiple banks to duplicate due diligence on the same companies—reducing costs and ensuring data integrity, whilst maintaining the sanctity and probity of the global financial ecosystem. Numerous initiatives are already underway in this respect, such as the SWIFT KYC Registry, which aims to facilitate the management and exchange of standardised KYC data.

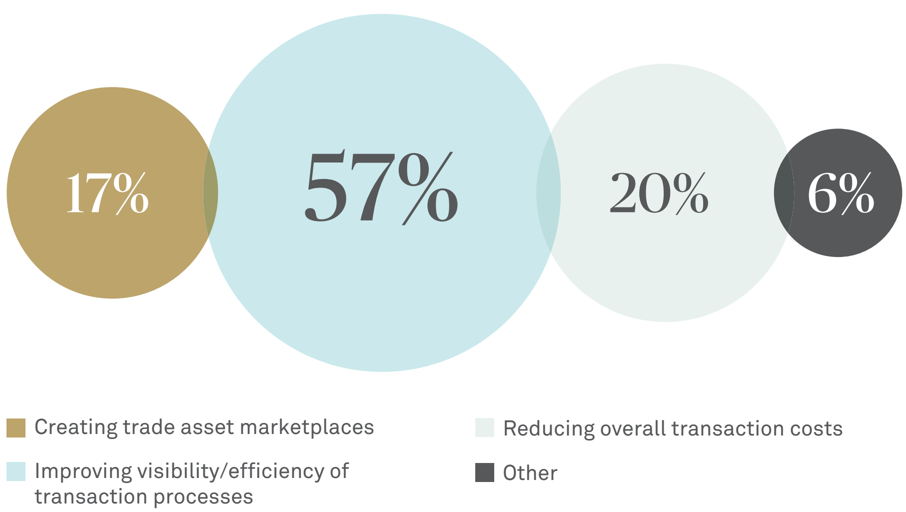
While another such initiative—Legal Entity Identifiers (LEI)—received the fewest votes as the most effective option, it was considered the second most effective solution. This reinforces the view that shared databases can provide the most value in addressing the trade finance gap. A total of 71% of respondents selected either centralised KYC databases, or LEIs specifically, as the top choice to address compliance-related issues.

Despite the hype around blockchain within the finance industry, 43% ranked distributed ledger technology (DLT) the least effective approach. With DLT still under development, and many challenges with regard to its application yet to be overcome, it may be that industry participants are placing a greater focus on tangible solutions that can make a difference to compliance costs—and thereby trade finance availability—in the shorter term.

> **Shared platforms could help to streamline current KYC processes**

Enhanced transparency and efficiency are needed to help drive more trade finance to markets with high levels of unmet demand

Most institutions would provide more trade finance to SMEs, or in geographies where there are high levels of unmet demand for trade finance, if visibility and efficiency of transaction processes were improved



N = 81

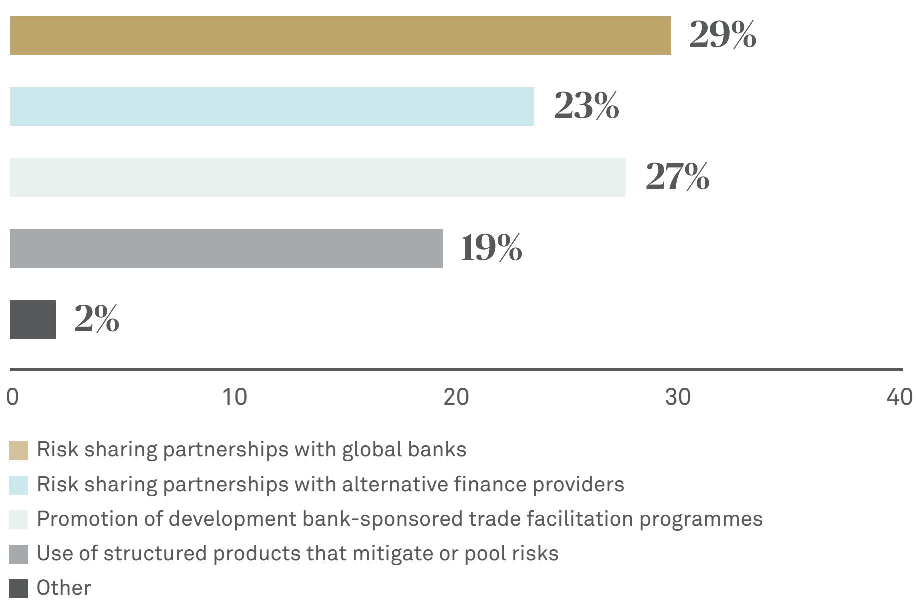
> **"Institutions would be more prepared to provide more trade finance to geographies where there are high levels of unmet demand for trade finance, if there was improved visibility/ efficiency of transaction processes**

Institutions would be more prepared to provide more trade finance to SMEs, or in geographies where there are high levels of unmet demand for trade finance, if there was improved visibility/efficiency of transaction processes (57%). This compares with 20% for "reducing overall transaction costs" and 17% for "creating trade asset marketplaces". This indicates that enhancing transactions as a whole—addressing efficiency and reducing risk through improved transparency—rather than focusing specifically on cost reduction or distributing risk, is what is most required to help providers deliver funding to markets that are struggling to access finance. By streamlining such transactions and allowing greater visibility, providers could be better positioned to extend trade financing to so-called "riskier" markets.

The creation of trade asset marketplaces was labelled as the least important factor. This could potentially be due to its nascence and the "originate to distribute" strategy (i.e. lenders making loans with the intention of selling them to other institutions and investors) traditionally being more associated with longer-term assets, rather than trade asset distribution. But in light of new regulations, effective portfolio management has become a priority, and trade asset distribution is a growing trend. There are challenges to overcome, however, including greater education for both distributors and investors.

Risk sharing partnerships with global banks ranked top for creating additional financing capacity

Partnerships with global banks needed to drive additional financing capacity



N = 99

All respondents

This question resulted in a split response, however, risk sharing partnerships with global banks was ranked overall the most effective way of encouraging additional financing capability (29%). This shows that the value of correspondent banking in trade finance continues to be recognised, with local-global bank partnerships still playing a key role in delivering trade finance solutions and facilitating trade growth. All types of banking institutions identified risk sharing partnerships with global banks as the most or second most important way of creating additional financing capacity (65% of global banks and a combined figure of 64% of domestic and regional banks).

> **"The value of correspondent banking in trade finance continues to be recognised**

Global banks and specialist trade finance providers

Both global banks and specialist trade finance providers acknowledged the important role that their respective institutions play in the industry: 65% of global banks rated "risk sharing partnerships with alternative finance providers" as the most or second most effective, while "risk sharing partnerships with global banks" was rated the most or second most effective by 71% of specialist trade finance providers. As alternative finance providers have become more prominent in the market—a trend fuelled by the global financial crisis, technology developments and de-risking—engagement between global banks and specialist providers has increased as a means of supporting trade opportunities.

Domestic and regional banks

Domestic and regional banks were most likely to rank "promotion of development bank-sponsored trade facilitation programmes" the highest, which may partly be due to the de-risking trend seen in recent years from numerous global banks. Overall, this was voted a close second as the most effective means of creating additional financing capacity (27%). Local banks regarded development banks—which aim to promote growth by providing credit in sectors underserved by mainstream commercial banks—as a key potential source of finance capacity, suggesting that the industry as a whole might explore how such trade facilitation programmes could help generate funding resources for those markets struggling to access finance.

Regulator and bank alignment is key

With respect to potential regulatory revision, greater collaboration between banks and regulators is seen as crucial

- Industry bodies establishing partnerships to collaborate on regulatory advocacy
- Corporates and SMEs advocating for regulatory flexibility/convergence
- Greater collaboration between banks and regulators on the design of appropriate regulation

N = 107

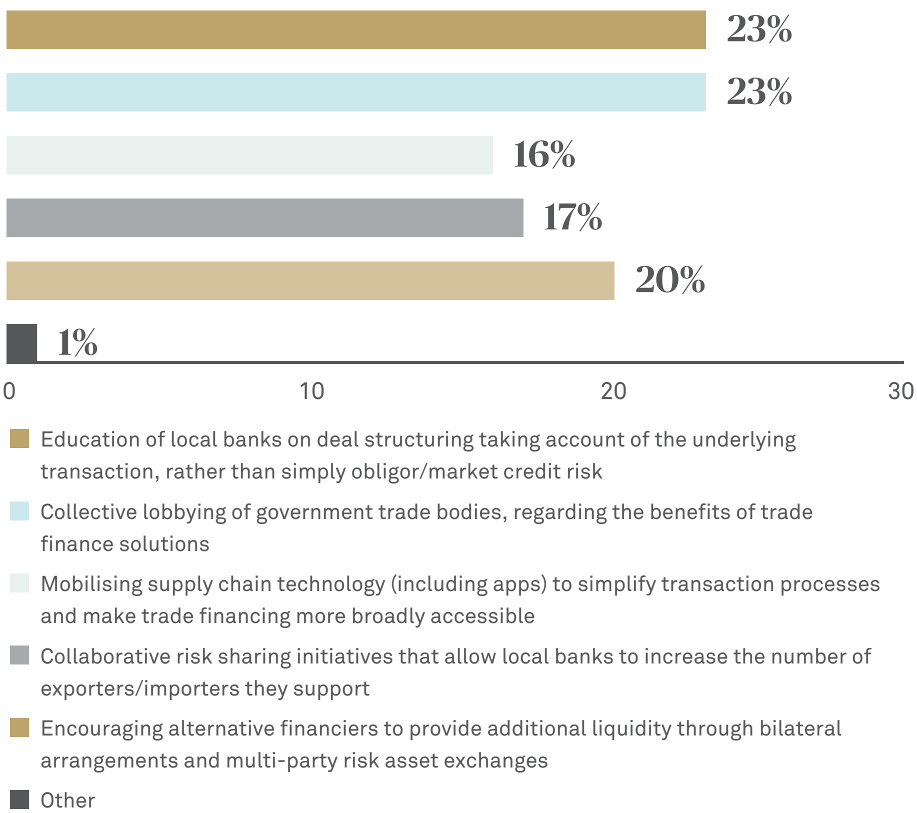
> “Banks in particular are crucial when it comes to driving effective regulatory developments

The most helpful approach regarding potential regulatory revision was seen to be “greater collaboration between banks and regulators on the design of appropriate regulation”, with 55% ranking it most effective. The role of banks was deemed significantly more important than “industry bodies establishing partnerships to collaborate on regulatory advocacy” (23%) and “corporates and SMEs advocating for regulatory flexibility/convergence” (21%). This suggests a degree of consensus within the industry that banks in particular are crucial when it comes to driving effective regulatory developments and overcoming the compliance issues facing banks—as well as “the gap”. By actively engaging with regulators, banks can act as advocates for the industry, including their clients; communicating their needs to help drive positive change in the industry.

Enhanced and coordinated data-based industry advocacy has meant that regulatory authorities are gaining a more comprehensive understanding of trade finance characteristics—for strong, effective regulation. But opportunities to further align regulatory objectives and trade finance value-creation remain and, as indicated by the results of this survey, more work needs to be done.

A voice for trade: the role of correspondent banks

Correspondent banks can help to address the trade finance gap via education, lobbying and more



N = 105

Asked how correspondent banks could help address the trade finance gap, participants delivered a split response. “Education of local banks on deal structuring taking account of the underlying transaction, rather than simply obligor/market credit risk” and “collective lobbying of government trade bodies regarding the benefits of trade finance solutions” were ranked the highest, with 23%.

As already identified, correspondent banking partnerships continue to be a fundamental component of global trade, and a key element of this is global banks providing support and guidance to local banks to help facilitate business growth.

> “Correspondent banking partnerships continue to be a fundamental component of global trade

The value placed upon banks in optimising and reinforcing the trade landscape is evident. However, respondents placed equal importance on correspondent banks acting as advocates for trade finance, collectively lobbying government trade bodies on the value and importance of promoting trade finance, and ensuring financial inclusion. For example, there is growing demand from correspondent banks around the globe for the introduction of international standardised documents as a means of making trade finance more accessible.

What both leading responses have in common is the emphasis on global correspondent banks using their knowledge, experience and position to inform and guide the wider industry.

Implications

The availability of trade finance is fundamental for a healthy, well-functioning trading system: the WTO estimates that 80-90% of world trade relies on trade finance.[2] If trade finance cannot be accessed, opportunities for trade, growth and development are missed. Regulation is crucial to ensuring that trade can be carried out effectively and securely. But if a trade gap persists, it could have severe implications for trade and the global economy. With both emerging markets and SMEs likely to be key sources of global trade and economic growth in the coming years[3][4]—and valued trading partners for companies across the world—access to trade finance is of paramount importance for the industry.

The responses in our survey reflect the scope and scale of the problem that the industry is facing. According to these findings, the rejection of trade finance transactions is growing in a significant number of institutions. While we are unable to say whether rates are rising overall (it could be possible that rejections are decreasing in some institutions), it is worrying that many of the institutions surveyed—particularly local banks—are increasingly unable to provide trade finance.

[2] https://www.wto.org/english/thewto_e/coher_e/tr_finance_e.htm

[3] https://iccwbo.org/publication/2017-rethinking-trade-finance/

[4] https://iccwbo.org/publication/global-survey-2018-securing-future-growth/

Closing the gap: Recommendations from our survey

Compliance

Regulatory revision and technology are equally ranked the most important means of helping to reduce the trade finance gap.

Our survey reinforces other findings that indicate that compliance is the primary contributor to the increase in trade finance rejections.[5] The solutions that we have identified most effective are directly linked to addressing regulatory challenges.

Collaboration

Correspondent banking—long a keystone of global trade—continues to be regarded as a key facilitator of robust trade growth, with risk sharing partnerships with global banks ranked the most effective way of making additional financing capacity available. The role of global banks in supporting trade finance goes beyond that of sharing risk. Correspondent banking is also a powerful means for local and global banks to share expertise and capabilities in order to provide the very best trade service and experience for clients. As highlighted in this survey, with participants noting the importance of their role in educating local banks, partnerships between local and global banks in underserved markets could help kick-start a renewed buoyancy in trade.

Technology

Technology is increasingly being used to help enhance processes across the trade finance industry, and the majority of participants believe that centralised KYC databases hold the most value. Data sharing within trusted user groups is becoming a reality due to technology advances, with data extremely valuable in improving the ease of doing business and helping to drive down due diligence costs linked to the trade finance gap.

> "
> **Regulatory revision and technology are equally ranked the most important means of helping to reduce the trade finance gap**

[5] https://www.adb.org/sites/default/files/publication/190631/trade-finance-gaps.pdf

> **This highlights the will of banks to have greater engagement and influence in shaping the development of the regulatory landscape**

Legal Entity Identifiers (LEIs) store details of registered companies worldwide; assign each LEI holder with a 20-digit unique identification number; and contain all the details needed to automate both KYC and Know Your Customer's Customer (KYCC) checks. Furthermore, with the purchase cost as low as US$45,[6] it is possible for an SME with limited resources to obtain an LEI and improve its chances of securing trade finance.[7] If LEIs achieve critical mass, this initiative could be transformative, with global adoption potentially able to save banks issuing letters of credit upwards of US$250 million annually.[8] With clear support for centralised databases for KYC, there needs to an agreed industry approach to help ensure such capabilities are utilised to support global trade.

The trade sector can often be slower to adopt new solutions than others in the finance industry. In fact, 37% of bank respondents to the *2018 ICC Global Trade Finance Survey* stated that technology implementation was not on their agenda at all.[9] Another 30% of respondents to this survey ranked technology the least important means of addressing the gap—likely a reflection of this trend. One of the primary reasons that new innovations and concepts can take longer to be adopted by the trade industry is the number of parties involved in the trade value chain, which can make it challenging to achieve buy-in and standardisation.

Regulatory revision

Engaging with regulators to address the issue "at the source" (as opposed to dedicating resources to meet increased compliance demands and invest in new technologies) was a favoured solution by participants. Respondents identified that greater collaboration between banks and regulators would be most effective in helping to drive more attuned, mutually beneficial compliance requirements. This highlights the value of bank involvement in particular (with SME, corporate and industry body advocacy ruled less important), and the will of banks to have greater engagement and influence in shaping the development of the regulatory landscape.

Dialogue and cooperation between banks and regulators - while maintaining the security and sanctity of the finance industry through robust regulatory standards - was deemed an effective way of reducing regulatory challenges.

[6] https://www.txfnews.com/News/Article/6419/Identity-cheques

[7] https://www.txfnews.com/News/Article/6419/Identity-cheques

[8] https://www.txfnews.com/News/Article/6419/Identity-cheques

[9] ICC Global Survey 2018: Securing Future Growth, p.129.

Conclusion

The results of our survey illustrate that, **in the view of the participants**, the trade finance gap remains a significant issue for global trade, with trade finance rejection rates accelerating during the previous 12 months for 33% of the institutions that took part. Subsequently, there are businesses that appear to be facing an increasingly uphill struggle in accessing the resources and support needed to fulfil their trade needs. This makes the ongoing mission to bridge the gap all the more pressing. Indeed, a trade support system that is compromised holds implications for global trade as a whole, as well as the wider economy—to which global trade is inextricably linked.

Participants identified two key approaches that would be most effective in narrowing the gap: technology and regulatory revision. While work is underway within the industry to progress digital solutions, and build strengthened, more aligned relationships between banks and regulators, more must be done with respect to achieving standardisation and harmonisation if the industry is to begin to deliver tangible results.

This was also evidenced in the survey. In addition to regulatory revision and technology innovation as means of helping to close the gap, a clear theme throughout has been the importance of collaboration—including risk sharing partnerships with global banks—to support trade finance. As trade participants, we all have a responsibility to advocate true financial inclusion and help to reinvigorate trade. To spark real growth, the barriers that are locking access to trade finance must be tackled in a strategic and collaborative way. Whether it is through correspondent banking, regulatory change, technological change or a combination of these approaches, it is with dialogue and cooperation between all industry participants—banks, alternative providers, corporates, regulators, and industry and governmental bodies—that we can most effectively and efficiently work to support trade and ensure it flourishes.

Appendix A

Survey Questions:

Responses were anonymous.

1. - What type of institution do you work for?

- What is your role?

2. Tick all the regions in which you do business

Latin America and the Caribbean

Europe and Central Asia

Middle East and North Africa

East Asia and Pacific

North America

South Asia

Sub-Saharan Africa

3. In the past 24 months, has there been an increase in rejection rates for trade finance transactions from your institution?

- If yes, has the rejection rate accelerated in the past 12 months?
- If no, have you noticed an increase in rejection rates from other institutions?

4. Are transactions mainly being rejected due to…

(please rank in order of importance on a scale of 1 – 6, with 1 being the highest and 6 being the lowest)

a) An increased demand for trade finance in emerging markets

b) Poor credit quality of applicant/inability for applicants to provide financial statements

c) Compliance constraints/inability for applicants to provide quality KYC

d) Limited institutional capacity to underwrite trade business

e) A reduction in correspondent banking relationships

f) Geopolitical risk/economic factors

g) Other (please specify)

5. What could most effectively help to address the issue of the trade finance gap?

(please rank in order of importance on a scale of 1 – 4, with 1 being the highest and 4 being the lowest)

a) Enhanced technology solutions

b) Provision of additional bank liquidity

c) Revised regulatory environment

d) New or alternative funding sources

e) Other (please specify)

6. **With respect to addressing compliance related issues, which of the following technological solutions do you think the most effective?**
   (please rank in order of importance on a scale of 1 – 4, with 1 being the highest and 4 being the lowest)
   a) Centralising KYC databases
   b) Legal Entity Identifiers (LEIs)
   c) Common credit scoring for SME borrowers
   d) Use of distributed ledgers to enhance transaction management
   e) Other (please specify)

7. **Would your institution be prepared to provide more trade finance for SMEs, or in geographies where there are high levels of unmet demand for trade finance, if any of the following were addressed?**
   (please rank in order of importance on a scale of 1 – 3, with 1 being the highest and 3 being the lowest)
   a) Creating trade asset marketplaces
   b) Improving visibility/efficiency of transaction processes
   c) Reducing overall transaction costs
   d) Other (please specify)

8. **How could additional financing capacity best be made available?**
   (please rank in order of importance on a scale of 1 – 4, with 1 being the highest and 4 being the lowest)
   a) Risk sharing partnerships with global banks
   b) Risk sharing partnerships with alternative finance providers
   c) Promotion of development bank-sponsored trade facilitation programmes
   d) Use of structured products that mitigate or pool risks
   e) Other (please specify)

9. **With respect to potential regulatory revision, what would be the most helpful?**
   (please rank in order of importance on a scale of 1 – 3, with 1 being the highest and 3 being the lowest)
   a) Industry bodies establishing partnerships to collaborate on regulatory advocacy
   b) Corporates and SMEs advocating for regulatory flexibility/convergence
   c) Greater collaboration between banks and regulators on the design of appropriate regulation
   d) Other (please specify)

10. How could correspondent banks help to address the issue of the trade finance gap?

(please rank in order of importance on a scale of 1 – 5, with 1 being the highest and 5 being the lowest)

a) Education of local banks on deal structuring taking account of the underlying transaction, rather than simply obligor/market credit risk

b) Collective lobbying of government trade bodies, regarding the benefits of trade finance solutions

c) Mobilising supply chain technology (including apps) to simplify transaction processes and make trade financing more broadly accessible

d) Collaborative risk sharing initiatives that allow local banks to increase the number of exporters/importers they support

e) Encouraging alternative financiers to provide additional liquidity through bilateral arrangements and multi-party risk asset exchanges

f) Other (please specify)

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