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Trends in Trade Finance across the APEC Region

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KEY MESSAGES

Background to the APEC 2013 Trade Finance Survey

1. Trade finance, despite being a relatively low risk type of lending, was among the first casualties of the reduced credit availability in the wake of the 2008 Global Financial Crisis (GFC).
2. In the APEC 2009 Trade Finance Survey, 15 out of 17 members responding to the survey indicated that there were signs of trade finance shortages in their economies, with eight economies considering the problem to be moderately to very serious.
3. Towards the end of 2008, governments around the world enacted swift and coordinated monetary and fiscal policies to arrest the decline in economic growth and trade, with some implementing measures aimed specifically at reviving trade finance. These actions resulted in a noticeable improvement of trade finance by the third quarter of 2009.
4. However, in the second half of 2011, bank funding conditions in Europe deteriorated as a result of weak economic performance and fiscal sustainability challenges. Concerns were again raised as to whether the provision of trade finance has been or will be affected given large scale deleveraging by European banks and stricter international banking regulatory standards.
5. As 2013 Chair of the APEC Finance Ministers Process, Indonesia has made trade finance one of their priorities. The objective of this study, which is based around the APEC 2013 Trade Finance Survey, is to provide a comprehensive overview of the trends in trade finance since the 2008 GFC.

Recovery for trade finance since the 2008 Global Financial Crisis has been uneven

6. An examination of the trends in the markets for selected trade finance products – such as letters of credit and factoring – reveals that the recovery for trade finance has been tepid and uneven.
7. According to data provided by SWIFT, there was a downward trend in the global traffic of trade messages for two consecutive years in 2011 and 2012. The issuance of documentary credit in 2012, for example, was still below the level seen in 2010.
8. For the APEC region, the issuance of documentary trade credit registered sharp declines. On the one hand, this may simply indicate that increasing competitiveness in the global trade arena has accelerated the shift away from traditional trade finance products such as letters of credit towards open account methods since they lessen the burden of risk for importers.
9. Other possible causes may include a more cautious approach in issuing documentary trade credit adopted by banks in response to higher perceived risks brought about by increased volatility in the global financial system and ongoing uncertainty over global economic conditions. Stricter risk management policies have resulted in a tightening of bank-intermediated trade finance supply, making it more difficult for firms to obtain trade finance.
10. In the market for factoring, an open account trade finance instrument, there were signs that the APEC region was affected by the turmoil in Europe in late 2011. The value of factoring in the APEC region that is offered for international trade fell sharply by 20% in 2011.

APEC 2013 Trade Finance Survey suggests an improvement in the current state

11. Eleven respondents to the APEC 2013 Trade Finance Survey reported that the volume of trade finance in their economies is above its pre-crisis level, four stated that the level is around its pre-crisis level, and one indicated that it is currently below its pre-crisis level.
12. Some APEC members noted the importance of European banks in the supply of trade finance in their economy. Based on responses from 14 APEC members, four indicated that European

banks provided more than 30% of the total volume in their economies prior to the 2008 GFC and three reported the share to be in the range of 10% to 30%.

13. However, 80% of the APEC 2013 Trade Finance Survey respondents indicated that the retrenchment in European banks has reduced their share of the total supply of trade finance in their economy since 2010. The reduction was by less than 10% in the majority of the economies.
14. APEC economies have benefited from increased lending for trade finance by domestic banks or by other international banks, with 80% of survey respondents reporting an increase in the provision of trade finance from non-European banks in their economies since 2010.
15. However, a recent annual trade finance survey of bank representatives around the world found that there has been a substantial increase in the share of respondents stating that there had been a reduction in trade credit lines for corporate customers in 2013, and that there has been progressively fewer respondents reporting an increase in trade finance revenues since 2010.

Trade finance is poised to improve, but risks remain

16. APEC members are overwhelmingly positive on the outlook for trade finance. The APEC 2013 Trade Finance Survey reveals that 61% of 18 respondents expect the trade finance situation to improve through the end of 2014, with the rest expecting it to stay about the same.
17. There are, however, significant downside risks to trade finance. Since the GFC, the availability and cost of credit has been supported by abundant liquidity associated with large-scale monetary easing policies. Any changes to this ultra-accommodative monetary stance could have an impact on the availability and the cost of lending, most likely impacting trade finance.
18. In addition, the implementation of new and enhanced prudential regulations, namely Basel III, will have significant consequences on the activities of the banking sector, most likely leading to a general reduction in overall lending capacity.
19. By overstating its tenor and risk profile, Basel III is expected to have a disproportionately negative impact on the provision of trade finance, with many bankers stating that its implementation will most likely result in a reduction in their support for trade finance.
20. The recent decision by the European Parliament to exempt trade finance instruments from some of the rules under Basel III for European banks could lead to regulatory arbitrage if other jurisdictions do not follow since it will therefore be less expensive for European banks to provide trade finance, putting banks in the Asia-Pacific region at a disadvantage.

Securing trade finance is critical for sustainable economic growth

21. International trade has played as one of the key determinants in promoting economic growth in the APEC region. Since 1990, real GDP in the APEC region has grown by 80%, with an increase in exports contributing to nearly half of this growth.
22. Trade finance is critical to trade for at least two reasons: (1) it provides the necessary insurance against counterparty risk; and (2) it provides working capital, which is vital to the maintenance of a healthy cash flow for businesses.
23. In comparison with domestic trade, international trade involves a greater number and a higher level of risks, stemming from the difficulty in evaluating counterparty risk in foreign locations and the greater probability of loss or damage during shipment. It also carries a larger financial constraint than domestic trade given its longer gap between production and payment.
24. The larger financial cost and greater risk associated with international trade makes it more vulnerable to financial crises, during which credit lines for trade finance are often diminished. Empirical evidence shows that when a firm’s credit lines are constrained, it reduces exports at a faster rate than domestic sales.

25. The reduction in trade finance was among the attributing factors to the 10.5% contraction in export earnings in the APEC region in 2009. Since then, the uneven recovery for trade finance has also been accompanied by subdued growth in APEC trade. In 2012, trade value in the region grew at 3.3%, a sharp deceleration from the 28% growth registered in 2010.
26. Securing access to trade finance is therefore important to ensure the robust trade growth necessary to support a sustainable recovery of the global economy.

Trade finance can also play a role in promoting inclusive growth

27. Small and medium-sized enterprises (SMEs) account for over 90% of all enterprises in every APEC economy. However, less than 15% of SMEs in most APEC economies are engaged in exporting. Enhancing and supporting trade finance will provide the much needed financing to help SMEs grow their operations and expand their markets internationally, ultimately providing a boost to trade growth.
28. In the APEC 2013 Trade Finance Survey, 79% of respondents indicated that an increased risk aversion of financial institutions towards smaller companies is the most common impediment for SMEs to access trade finance.
29. Given this general risk aversion, anecdotal evidence suggests that SMEs have not in fact been able to benefit from the abundant liquidity in the global economy that has held the cost of funding low. Thus, any reduction in trade finance will also disproportionately affect SMEs.
30. Through export-import credit agencies, APEC members offer a range of products to support access to trade finance for the SMEs in their economy, including export credit insurance and working capital guarantees. Multilateral banks also play an important role in facilitating access to trade finance for SMEs in the region.
31. Many APEC members responded to the impact of the 2008 GFC by implementing either new or enhanced measures to facilitate trade finance, with around half of the APEC 2013 Trade Finance Survey respondents introducing or enhancing their provision of export credit insurance and export credit in their economies since 2009.
32. Even though the APEC region includes a wide range of members with varying levels of depth and sophistication in their domestic financial systems, publicly-provided trade finance facilities still have a role to play in all APEC economies.

APEC could address some of the current challenges to trade finance through the following

- **monitor the volume of trade finance in the region as well as whether there are any issues in the ability of businesses to access trade finance, especially in certain sectors;**
- **continue to facilitate access to trade finance for SMEs in the region by helping to build capacity in the export credit agencies of the developing economies and by acting as a forum for members to engage in the sharing of best practices;**
- **regulators should take caution in their implementation of Basel III to ensure that banks in the region are not at a disadvantage in their provision of trade finance;**
- **policy makers should implement policies that help to facilitate access to open account trade finance for both exporters and importers given its increasing use in international trade transactions; and**
- **conduct further research to assess the feasibility of developing trade finance instruments as an asset class.**

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1. INTRODUCTION

Among the most important events over the past few decades has been the rapid acceleration of the economic globalization process. Markets across borders have become increasingly interdependent as international trade in commodities and services has expanded rapidly. Since 1970, the value of world trade has risen by more than 57 times (in nominal terms), from USD 387 billion to USD 22 trillion in 2011[1]. This fast acceleration of trade is also evident in the increase in trade value as a share of global output. In 1960, the world trade to GDP ratio was 11.6%; after accelerating sharply in the early 1990s, this ratio had risen to 31.4% by 2008 (Figure 1).

Figure 1. World Trade to GDP Ratio

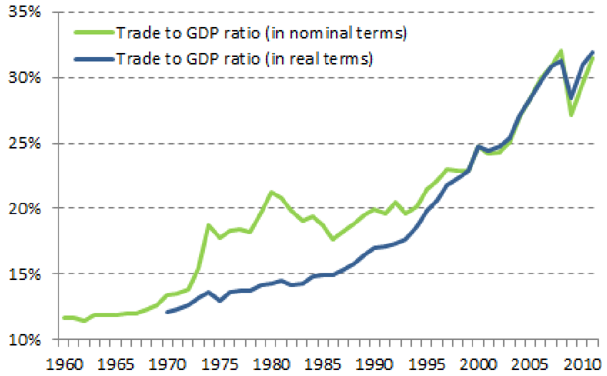
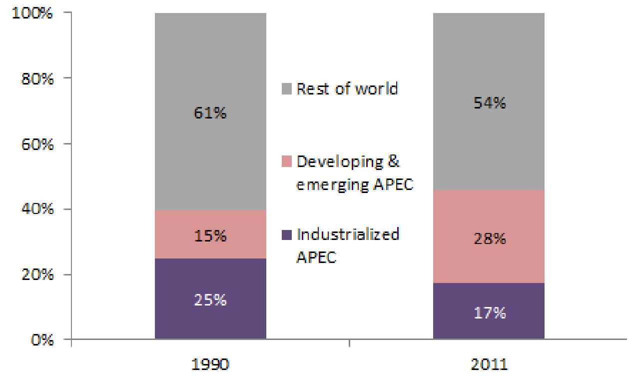


Figure 2. Share of Total World Exports



Source: World Bank, World Development Indicators and APEC PSU calculations.

The APEC region in particular has become a key player in the international trading arena. The share of the region's exports in total world exports rose from around 40% in 1990 to 46% in 2011 (Figure 2). Moreover, the growth in exports from the APEC region accounted for almost 64% of the total increase in world exports between 1990 and 2011. Trade has also played as one of the key determinants in promoting economic growth in many APEC economies. Since 1990, real GDP in the APEC region has grown by over 80%, with the increase in exports contributing to nearly half of this growth. The importance of trade to economic well-being in the APEC region became even more pronounced between 1990 and 2008, during which time the share of trade to GDP greatly accelerated. However, international trade is also particularly susceptible to global economic conditions and is often severely impacted in times of crisis.

In addition, international trade typically involves a greater number and a higher level of risks than domestic trade, including exchange rate risk, political risk, as well as the risk of non-payment or non-performance. These risks stem from the difficulty faced by firms in evaluating counterparty risk in foreign locations. For example, in the event of default, it is often more difficult and more costly for exporters and importers to find recourse in foreign jurisdictions. In addition, the risk of loss or alteration of merchandise goods during shipment is also often greater in international trade since the need to physically move goods across borders and to comply with customs procedures typically takes significantly more time. It has been estimated that the the median time to move standard cargo from the factory gate to the

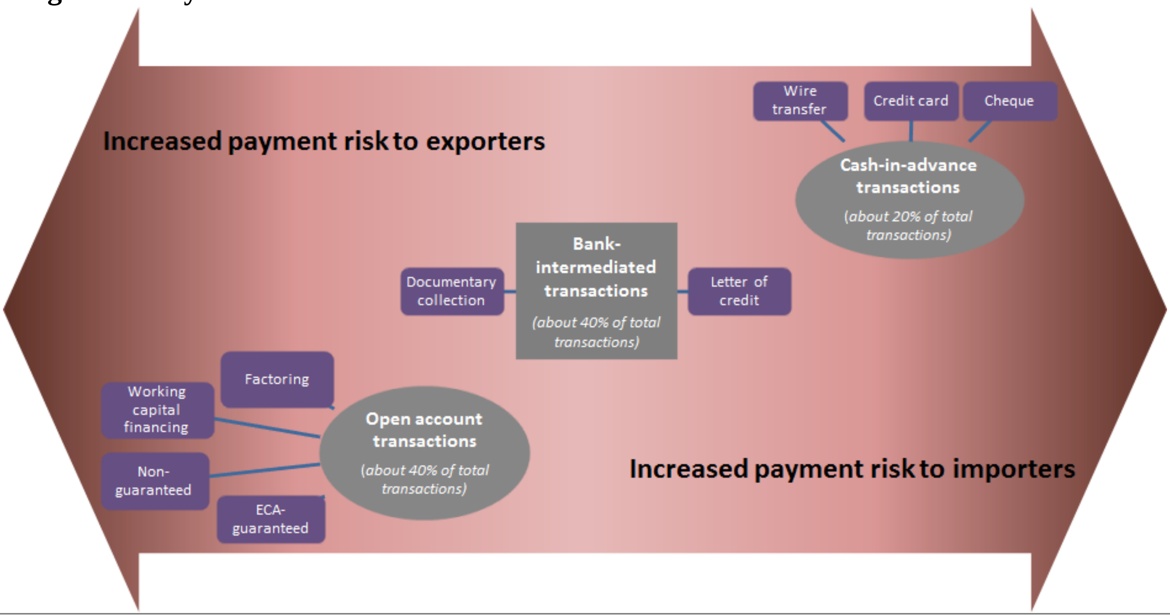
[1] World trade is measured as the average of global exports and imports of merchandise goods and commercial services.

shipping port is around 21 days[2]. In addition, a recent study found that ocean-borne cargo from Europe normally spends about 20 days on a vessel before reaching U.S. ports and around 30 days to arrive in Japan[3]. Putting these two estimates together, it is not uncommon for internationally traded goods to spend around two to three months in transit.

Given the greater risks and the longer gap between production and payment, international trade also carries with it a larger financial constraint than does domestic trade. Most global merchandise trade is financed on an open account basis, in which importers pay exporters only after receipt of the goods. Under this payment method, without either lending or insurance from third parties, the exporter effectively supplies working capital to the importer and also takes on the risk of non-payment. Cash-in-advance arrangements are at the opposite end of the spectrum. Under these, importers pay for goods before they are shipped, placing the burden of working capital, as well as the risk of non-performance, on the importer.

Trade finance is therefore critical for cross-border trade for at least two reasons: (1) it provides the necessary insurance against counterparty risk; and (2) it provides working capital, which is vital to the maintenance of a healthy cash flow especially given the long time lag between production of the goods and receipt of payment. Research also argues that trade finance serves as a quality signal and thus further reduces the uncertainty that comes with international trade[4]. Trade finance therefore helps to mitigate the risks involved in international trade through a variety of financial products and services (Diagram 1). It is now a well-accepted fact that about 80% to 90% of world trade is supported by some form of trade finance[5].

Diagram 1. Payment Methods and the Balance of Risk in International Trade



Instruments of trade finance used to facilitate and support international trade include loans, guarantees, insurance, and credit extensions (Box 1). Such financing can come from not only private banks, but also from other providers of financial services, including domestic export

[2] Djankov et al. (2006).
[3] Hummels and Schaur (2012).
[4] Eck et al. (2012).
[5] Auboin (2009).

credit agencies and multilateral banks. Trade finance differs from other types of credit in several fundamental ways, making it a relatively low risk type of lending. The main characteristics of trade loans include the following:

- short-term – trade finance loans typically last from as few as 30 days to 180 days, with letters of credit having an average maturity of close to 90 days[6].
- collateralized – the underlying goods in the transaction are often used as collateral for trade loans, which can then be sold to fulfill the obligations of the loan.
- self-liquidating – trade loans are usually repaid with money that is generated by the goods in which the loan is used to purchase, with the loan maturity and repayment schedule coinciding with the payment from the underlying transaction.
- low rate of default – the International Chamber of Commerce (ICC) found a default rate of just .02% based on data from over 8 million short-term trade finance transactions between 2008 through 2011[7].

Given that the facilitation of trade is one of APEC's main objectives, trade finance is an important area that should not be overlooked. APEC has in fact previously looked into the issue of trade finance in 2009, shortly after the start of the 2008 Global Financial Crisis (GFC). In June and July of that year, Singapore conducted the APEC 2009 Trade Finance Survey, which found that nearly half (47%) of the members responding to the survey indicated that the trade financing problem was serious in their economy. An update to the survey in October and November 2009 revealed a substantial improvement with 37% of the respondents indicating that the trade financing problem in their economy remained serious. That year also saw progress in the Asia-Pacific Trade Insurance Network (APTIN), including the establishment of additional bilateral re-insurance agreements among some APEC members[8]. In May 2011, APEC Trade and SME Ministers identified the lack of access to financing as one of the top nine barriers facing SMEs in expanding their trade activities; the APEC Small

Box 1. Definitions of Common Trade Finance Instruments

Letter of credit – Commitment by an importer's bank (issuing bank) to an exporter's bank (accepting bank) to pay a specified sum in a specified currency provided the seller submits the requisite documents within a fixed timeframe.

Export credit insurance – Insurance policy offered to an exporter that protects against loss due to credit risks such as protracted default or bankruptcy by the importer.

Working capital guarantee – Encourages commercial lenders to make working capital loans to exporters that are backed by a government guarantee.

Export credit – Credit provided to an exporter by a financial institution in the exporting economy so that the exporter can extend credit to a foreign buyer to finance the purchase of goods or services from the exporter.

Import loans – Loan offered to an importer under which the goods themselves are used as collateral.

Buyer's credit – Credit extended to a foreign buyer (directly or indirectly) by a financial institution in the exporting economy to finance the purchase of goods or services from the exporter.

Forfaiting – Cash purchase of an exporter's receivables (the amount importers owe the exporter) at a discount; used with capital goods, commodities, or other high-value exports and when the importer's period to complete payment is at least six months.

Factoring – Similar to forfaiting, but involves ordinary goods with the importer's payment due upon delivery or shortly thereafter.

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[6] International Chamber of Commerce (ICC) Banking Commission (2011).
[7] International Chamber of Commerce (ICC) Banking Commission (2013a).
[8] APTIN is spearheaded by Japan's export credit agency, Nippon Export and Investment Insurance (NEXI).

and Medium Enterprises Working Group (SMEWG) has subsequently made capacity building in this area a priority.

As 2013 Chair of the APEC Finance Ministers Process (FMP), Indonesia requested that the APEC Policy Support Unit (PSU) update the 2009 Trade Finance Survey. The redesigned APEC 2013 Trade Finance Survey was then conducted between 6 June and 26 July 2013 among the APEC FMP members with responses to the survey received from 19 APEC economies[9]. The objective of the survey was to not only build on the previous 2009 Trade Finance Survey, but to also gain a better understanding of the level and composition of trade finance in the region since the 2008 GFC. This issues paper has been prepared to provide a more comprehensive overview of the trends in trade finance since the GFC as well as present the results of the APEC 2013 Trade Finance Survey. It includes an analysis of the following, drawing out the issues currently facing the APEC region in the area of trade finance:

- recent trends in trade finance, both globally and regionally, with an emphasis on the impact of the GFC;
- particular challenges that SMEs face in accessing trade finance;
- impact of Basel III and other regulatory measures on the provision of trade finance; and
- the outlook for trade finance as well as policy recommendations on the way forward for APEC economies to support trade finance, both in their economies and regionally.

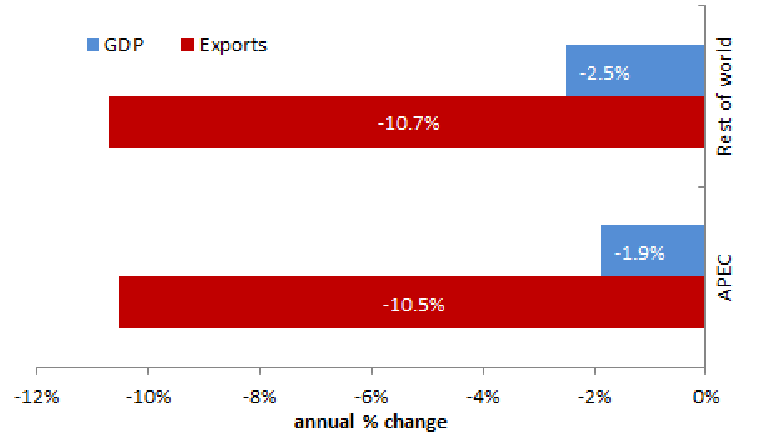
[9] The APEC 2013 Trade Finance Survey is at Annex 1. Responses were received from the following APEC members: Australia; Brunei Darussalam; Canada; Chile; China; Hong Kong, China; Indonesia; Japan; Korea; Malaysia; Mexico; New Zealand; Peru; Philippines; Russia; Singapore; Thailand; Chinese Taipei; Viet Nam.

2. RECENT TRENDS IN TRADE FINANCE

A. TRADE FINANCE DURING THE GLOBAL FINANCIAL CRISIS

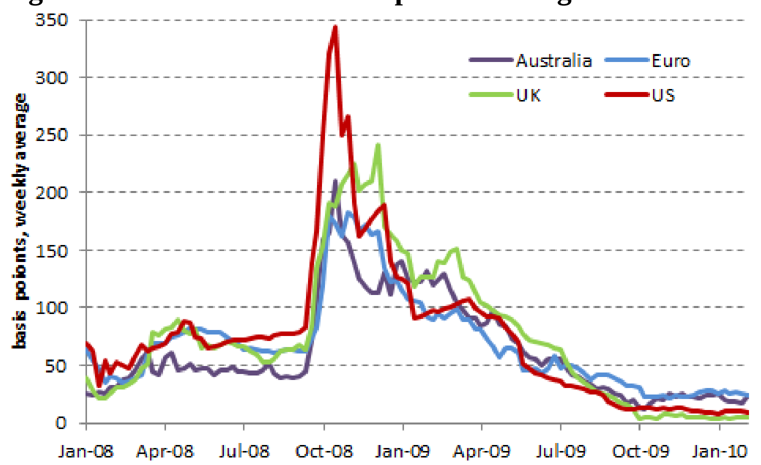
There was a globally synchronized slowdown in trade in the wake of the 2008 Global Financial Crisis (GFC) in both volume and value terms as reduced demand, combined with lower prices for traded goods, heavily impacted trade receipts. In fact, the rate of contraction for trade was much swifter and sharper than that for GDP during this period. While real GDP in the APEC region contracted by 1.9% in 2009 from the previous year, the value of exports in real terms fell by 10.5% (Figure 3). For the rest of the world, GDP declined by 2.5%, while exports decreased by 10.7%. The underperformance of trade relative to output following the GFC can be attributed to many factors, including reduced demand, falling prices for traded goods, as well as increasingly globalized supply chains. Given the financial origin of the crisis, reduced trade finance is often cited as one of the factors responsible for the precipitous fall in international trade in 2009.

Figure 3. Exports and GDP Performance in 2009



Source: World Bank, World Development Indicators and APEC PSU calculations.

Figure 4. 3-Month Libor-OIS Spreads during the GFC



Source: Thomson Reuters and APEC PSU calculations.

Following the failure of Lehman Brothers in September 2008, there was a drastic reduction in global cross-border lending and a subsequent decline in domestic lending in many economies. Heightened concerns about counterparty risks, coupled with the difficulty in raising funds, translated into a dramatic rise in interbank borrowing rates. During the January 2008 to July 2008 period, the spread between the 3-month London Interbank Offered Rate (Libor) and the overnight index swap (OIS) for the USD averaged 43 basis points[10]. However, this spread spiked in October 2008, reaching a

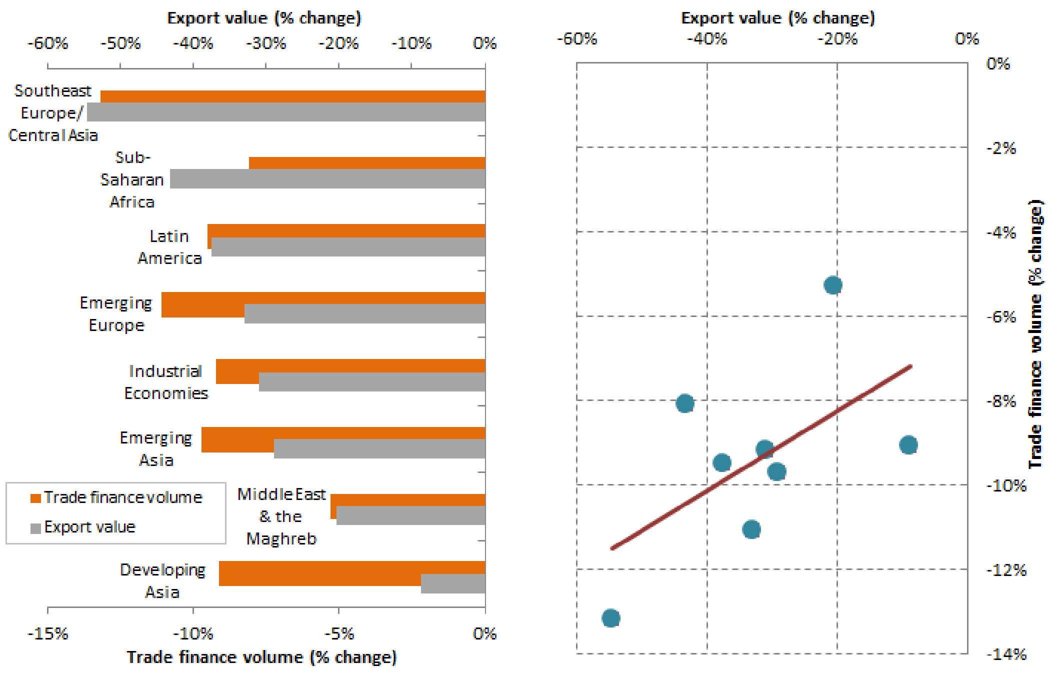
[10] The Libor-OIS spread is the difference between Libor and the OIS rates and is considered to be a measure of risk and liquidity in the money market. A liquid market is associated with a lower spread, while a higher spread implies that banks are more reluctant to lend.

record high of 364 basis points on 10 October 2008. The 3-month Libor-OIS spread also rose substantially in other industrialized markets during this period, including Australia, the Euro area, and the United Kingdom (Figure 4).

Credit constraints were more severe among larger banks, reflecting their greater need for deleveraging. This prompted many of these institutions to adopt stricter risk management practices and to curtail lending. Despite its low risk, trade finance was among the first casualties of the reduced credit availability as it was easier for banks to restrict short-term lending in the wake of the GFC. In the March 2010 IMF/BAFT-IFSA Trade Finance Survey, 41% of the respondents from large banks indicated that they could not satisfy customer demands for trade finance[11]. This was also evident in the reduced availability of trade finance in almost all markets in early 2009. Some regions, including emerging Asia and Latin America, reported a nearly double-digit contraction in trade finance for the period between October 2008 and January 2009 (Figure 5).

Trade finance in the APEC region was also affected by the 2008 GFC. In the APEC Trade Finance Survey conducted in June and July of 2009, 15 out of 17 economies responding to the survey indicated that they had a trade financing problem. Seven economies did not consider the problem to be serious, while eight considered it to be moderately serious to very serious. Increased risk aversion of financial institutions towards companies and higher perceived counterparty risks of banks were the top two factors contributing to the deteriorating trade finance situation in the APEC region. Additional studies reveal that trade finance in some APEC economies, such as China; Russia; Thailand; and the United States, were particularly affected[12].

Figure 5. Export Value and Trade Finance Volume, October 2008 - January 2009



Note: Fitted trend line is a linear regression of changes in trade finance volumes against changes in export values for the eight regions shown.
Source: Asmundson et al. (2011).

[11] Asmundson et al. (2011).
[12] Liu and Duval (2009).

However, an important question that has attracted the attention of both policy makers and researchers remains: exactly what role did the contraction in trade finance play in the collapse of world trade immediately following the start of the 2008 GFC? The large degree of dependence of international trade transactions on trade finance suggests that exports and imports would be more sensitive to the health of the financial system. Although a lack of precise data makes it difficult to determine the exact relationship, exports do indeed appear to have fallen more sharply in regions that experienced larger contractions in trade finance between October 2008 and January 2009 (Figure 5).

Research also provides empirical evidence of the link between credit constraints and international trade. A study that examined monthly data of French exporters during the Global Financial Crisis found that credit constraints accounted for about 20% of the reduction in exports for some firms, especially smaller exporters who are highly dependent on external finance[13]. Similarly, another study attributed a reduction in trade finance to around one-third of the fall in Japanese exports following the 1997 Asian financial crisis and around 20% of the decline following the 2008 GFC[14]. Using a database containing information on Japanese firms and their main banks, the researchers of that study also found that financial shocks affect a firm's exports and domestic sales differently. Since exports rely more heavily on trade finance, firms reduce exports at a faster rate than domestic sales when their bank becomes unhealthy.

Figure 6a. Factoring Value between 2008 & 2009

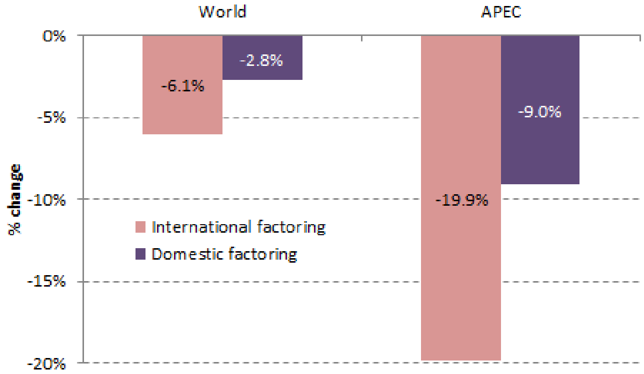
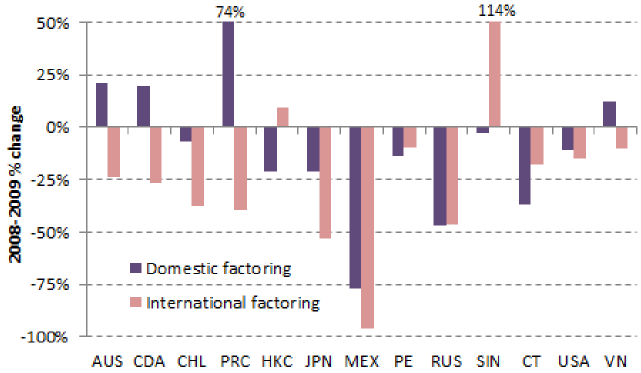


Figure 6b. Factoring Value in APEC Economies



Source: Factors Chain International and APEC PSU calculations.

During the 2008 GFC, financing for international trade transactions was indeed more affected than financing for domestic trade transactions. This was particularly evident in the factoring market. Data provided to the APEC Policy Support Unit by Factors Chain International (FCI) show that the global value of factoring offered for international trade fell by 6.1% in 2009, twice the contraction rate as that for domestic sales financing (Figure 6a). The APEC region fared worse than the rest of world as the value of international factoring for the region fell by almost 20% in 2009, compared with a 9.0% contraction in the value of domestic factoring across the region. The pattern of international factoring underperforming domestic factoring in times of crisis was observed across most APEC economies, with two notable exceptions being Singapore and Hong Kong, China (Figure 6b). In some economies, including Australia; Canada; China; and Viet Nam, domestic factoring remained resilient in 2009 whereas international factoring recorded negative growth.

[13] Bricongne et al. (2010).

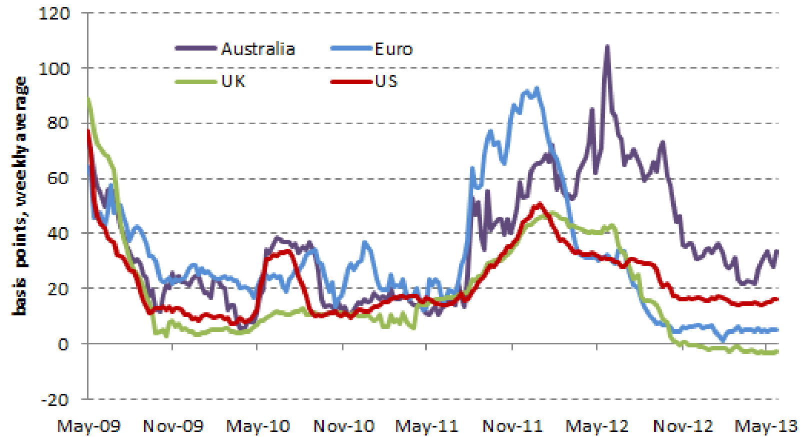
[14] Amiti and Weinstein (2011).

B. TRADE FINANCE FOLLOWING THE GLOBAL FINANCIAL CRISIS

In response to weakening economic growth as well as the steep drop in trade, governments around the world enacted swift and coordinated expansionary monetary and fiscal policies to restore confidence towards the end of 2008. By May 2009, some of these policies had helped to bring down the Libor-OIS spreads to pre-crisis levels. Policy makers also implemented measures specifically aimed at improving trade finance. For example, the G20 responded with a package of USD 250 billion to support trade finance through their export credit and investment agencies and multilateral development banks[15]. Export credit agencies in many economies also implemented emergency measures and increased credit insurance and risk mitigation capacity. Together, these actions resulted in a visible improvement of trade finance by the third quarter of 2009, which was also accompanied by an improvement in global trade.

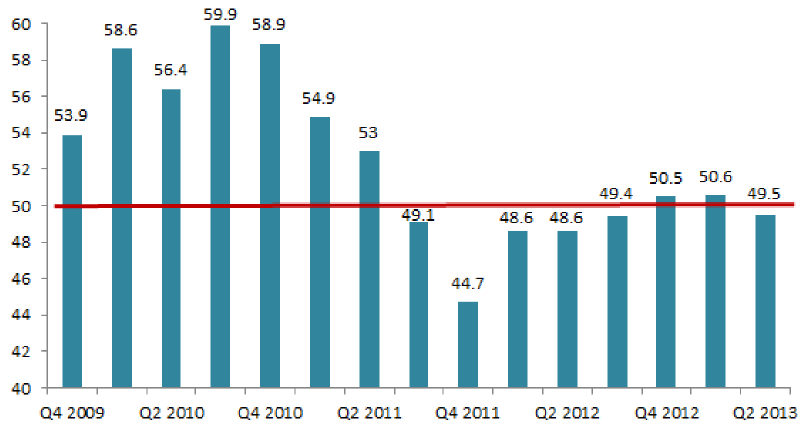
However, bank funding conditions in Europe deteriorated towards the second half of 2011 as weak economic performance and fiscal sustainability challenges undermined the value of bank balance sheets. In addition to constrained interbank lending and issuance of debt, European banks also faced stricter international regulatory standards. As a result, most banks in Europe were required to deleverage on a large scale. Between the third quarter of 2011 and the second quarter of 2012, the collective asset reduction of 58 large banks in the European Union amounted to USD 600 billion[16]. It is estimated that these banks may be required to sell as much as USD 4.5 trillion in assets by the end of 2013.

Figure 7. 3-month Libor-OIS Spreads since the GFC



Source: Thomson Reuters and APEC PSU calculations.

Figure 8. Emerging Markets Bank Lending Conditions Index



Note: Values above 50 indicate improving conditions; values below 50 indicate deteriorating conditions.
Source: Institute of International Finance.

Partly due to European bank deleveraging, the 3-month Libor-OIS spread for the Euro rose steadily from May 2011, with the weekly average peaking at over 92 basis points in late December 2011, before stabilizing in the second half of 2012 (Figure 7). Libor-OIS spreads

[15] The G20 announced in April 2009 that they would ensure the availability of USD 250 billion for trade finance over the following two years.
[16] International Monetary Fund (2012b).

also widened in other markets as the stress in European financial markets produced considerable spillover effects in global financial markets. Although the increases in the Libor-OIS spreads in 2011 were less than one-third their peak in 2008, they were sufficient enough to cause a strain in the funding conditions for emerging and developing economies. The pace of credit tightening in developing markets was most notable in the fourth quarter of 2011 when the Emerging Markets Bank Lending Conditions Index compiled by the Institute of International Finance fell to a trough of 44.7 (Figure 8).

Figure 9. SWIFT Trade Traffic Messages Worldwide

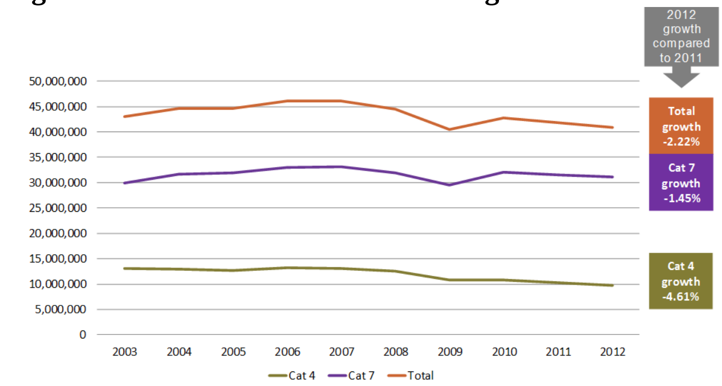
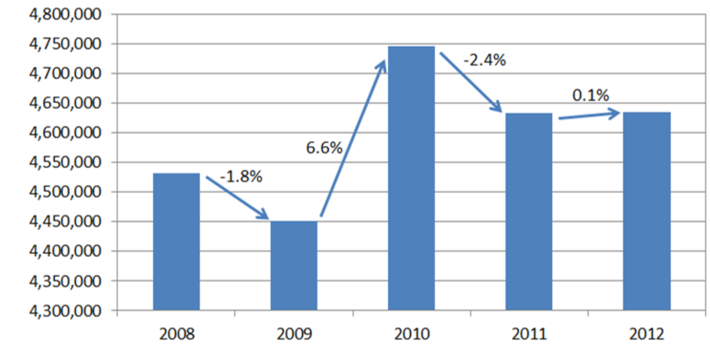


Figure 10. SWIFT MT 700 Messages Worldwide



Source: SWIFT (2013).

A closer examination of the market trends for the more traditional bank-intermediated trade finance instruments reveals the extent of constrained credit conditions on the provision of trade finance. According to SWIFT data, there was a downward trend in global trade traffic for two consecutive years in 2011 and 2012 (Figure 9)[17]. As a result, the number of trade traffic messages has not yet recovered from its contraction following the 2008 GFC. Underlying the slowdown in 2012 was a 4.6% drop in category 4 (documentary collections) and a 1.5% fall in category 7 (commercial and standby letters of credit, and guarantees). The issuance of MT 700 (documentary credit) – which is often considered as a good barometer of trade finance – registered a very marginal rise in 2012 of just 0.1% (Figure 10)[18]. However, compared with the volume in 2010, traffic of MT 700 messages was still substantially lower in 2012.

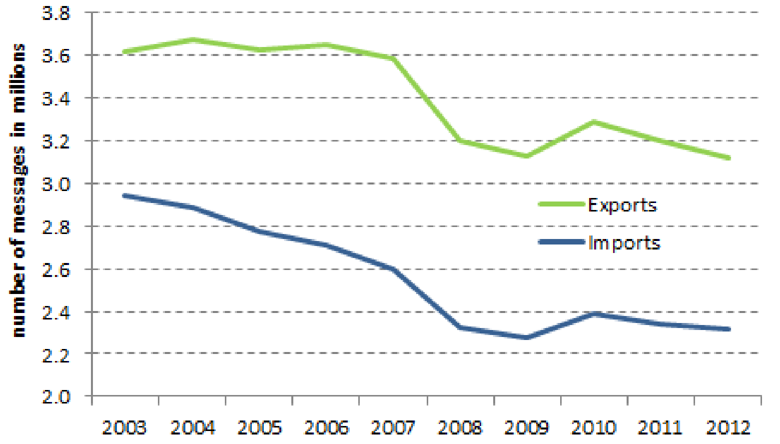
Contrary to the slight increase in global traffic for documentary credit in 2012, data for the APEC region showed sharp declines for both exports and imports. However, this may simply indicate that APEC economies have been switching away from the more traditional trade finance products such as letters of credit and documentary collections and moving towards open account payment methods. One attributing factor to this shift is the increasing competitiveness in the global trade arena, which places stronger negotiating power on buyers

[17] SWIFT traffic statistics can be considered a good indication of the usage of letters of credit as confirmed by International Chamber of Commerce (ICC) reports. Traffic refers to the live transaction messages, both domestic and international, that are sent over the SWIFT network. When global figures are recorded, messages sent (i.e., import transactions) equal messages received (i.e., export transactions).

[18] MT 700 is often used as an indicator of trade finance because it is a structured message that includes a field which contains the currency code and the amount of the documentary credit. However, MT 700 represents only 15% of total category 7 traffic.

(i.e., importers) over payment terms. For buyers, open accounts are often the preferred choice of payment as this shifts the burden of risk to suppliers (i.e., exporters).

Figure 11. SWIFT MT 700 Messages in the APEC Region

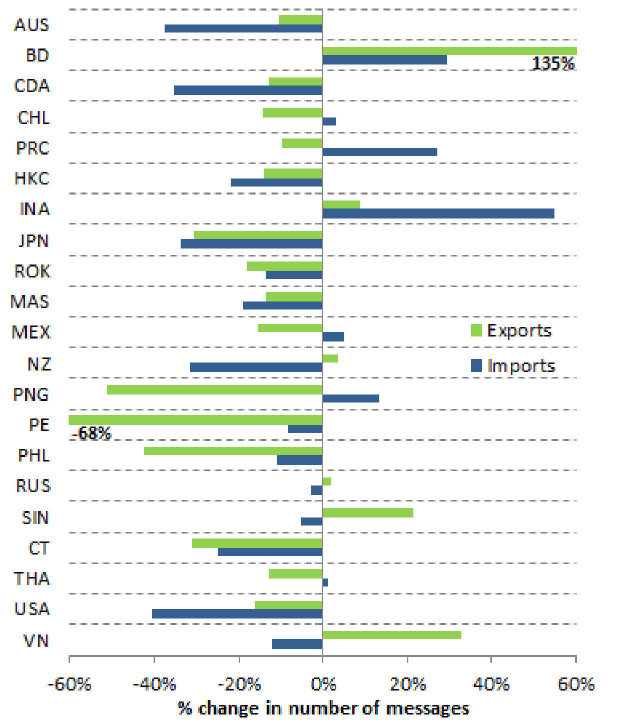


Source: SWIFT and APEC PSU calculations.

In the APEC region, the gradual shift away from traditional bank-intermediated products is quite evident in imports. Since 2003, the flow of documentary credit for imports has been moving progressively downwards (Figure 11). The flow for exports, however, was relatively stable over the period 2003 and 2007, but fell sharply by 10.7% in 2008. Since then, the pace of decline in the traffic of documentary credit for exports has accelerated relative to the 2003-2007 period, suggesting that other factors may also be at play. Among the APEC economies, Peru; Papua New Guinea; and the Philippines saw notable declines in the issue of letters of credit for export transactions between 2007 and 2012, with the usage of documentary credit for exports decreasing at a much faster rate than that for imports (Figure 12). Conversely, there has been an increase in the trade messages for documentary credit for exports in Brunei Darussalam; Viet Nam; and Singapore in recent years.

One possible cause for the recently accelerated decline in documentary credit may include the stricter risk management policies adopted by trade finance providers in response to higher perceived risks following the GFC. This higher perception of risk may be the result of ongoing uncertainty over global economic conditions and increased volatility in the global financial system itself. The change in banks' assessment of risk has made it more difficult for firms to obtain confirmation from banks in some regions, effectively resulting in a tightening of liquidity. In fact, the International Chamber of Commerce (ICC) recently found that the rejection rate of trade documents under letter of credit on spurious or questionable grounds has been high[19]. Such operational measures add to the already cumbersome and relatively high cost involved in obtaining documentary trade credit, thus

Figure 12. SWIFT MT 700 Messages in APEC Economies between 2007-2012 (% change)



Source: SWIFT and APEC PSU calculations.

[19] International Chamber of Commerce (2013b).

exacerbating the decline in its usage to facilitate trade payments.

Figure 13a. Value of Domestic Factoring Worldwide

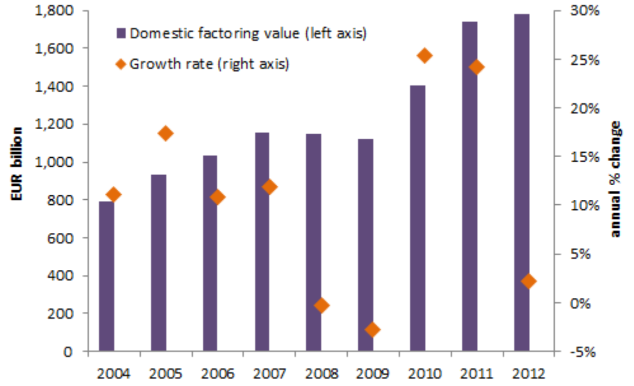
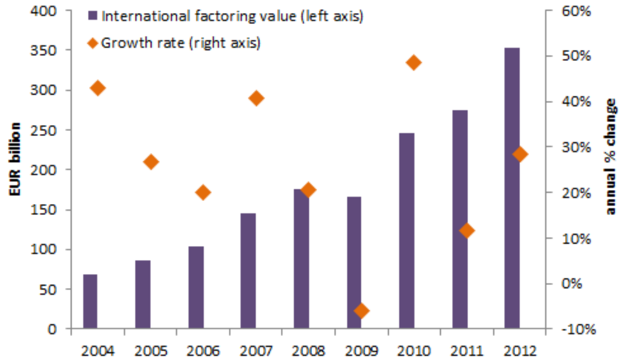


Figure 13b. Value of International Factoring Worldwide



Source: Factors Chain International and APEC PSU calculations.

In contrast to the trend of declining usage of traditional bank-intermediated trade finance products, instruments that are geared towards facilitating open account payments have fared somewhat better. Annual data on factoring provided to the APEC Policy Support Unit by Factors Chain International show that the factoring market has sprung back from the dips in 2008 and 2009. After contracting by 3.2% in 2009, the value of global factoring rose by over 20% in 2010 and in 2011 and reached a record high of EUR 2.1 trillion in 2012. However, growth in the factoring market also began to moderate in 2012, increasing by 5.8% compared with an average annual growth rate of 14.4% between 2004 and 2007. The weaker growth rate in 2012 was underpinned by slower growth in domestic factoring (Figure 13a). On the other hand, international factoring – which is offered to exporters rather than to domestic sellers – has demonstrated some dynamic developments. Its value of EUR 352 billion in 2012 was more than double its total turnover of EUR 165.5 billion in 2009 (Figure 13b).

Figure 14a. Value of Factoring in the APEC Region

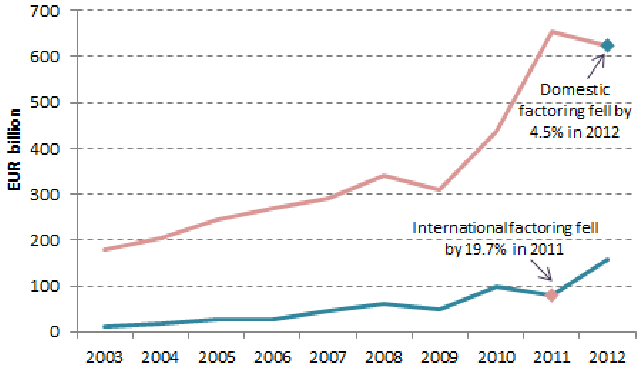
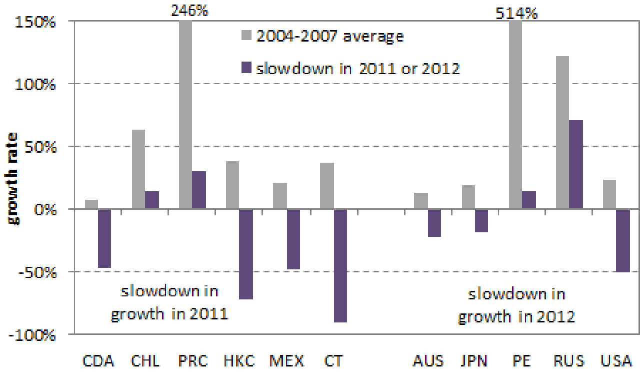


Figure 14b. Growth in the Value of International Factoring in Selected APEC Economies



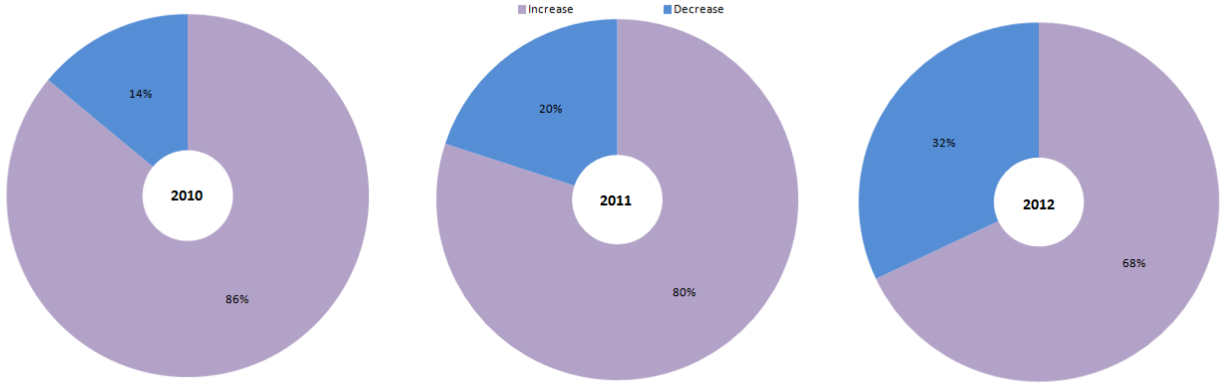
Source: Factors Chain International and APEC PSU calculations.

For the APEC region, the total value of factoring also bounced back strongly following the 2008 GFC, growing tremendously by 49% in 2010 and by 37% in 2011, before beginning to slow in 2012 in line with the global trend. However, it is clear that the APEC region was indeed affected by the turmoil in Europe in late 2011 as the value of international factoring in the region fell sharply by 20% in 2011 (Figure 14a). Among the APEC members, the magnitude and timing of the impact from the bank deleveraging in the Euro area on international factoring varied widely. Some economies experienced a slowdown in 2011, with Chinese Taipei; Hong Kong, China; Mexico; and Canada witnessing quite acute contractions in the value of international factoring (Figure 14b). Other APEC economies experienced a decrease in 2012, including the United States; Australia; and Japan. However, some APEC members managed to buck the trend, notably Singapore where the value of international factoring has grown at an average annual rate of 48% since 2009, which is triple its average annual growth rate of 14% between 2004 and 2008.

C. CURRENT STATE OF TRADE FINANCE

Although the sharp contraction in the provision of trade finance experienced in late 2008 and early 2009 has not been repeated since, the recovery in the trade finance market has recently moderated. Annual trade finance surveys conducted by the International Chamber of Commerce (ICC) of bank representatives across the world reveal that there has been progressively fewer respondents reporting an increase in trade finance revenues since 2010[20]. In 2012, 68% of survey respondents indicated that their trade finance revenues had increased (Figure 15). In comparison, 80% of the respondents in 2011 saw a boost in activity, while 86% did so in 2010.

Figure 15. Value of Trade Finance Activity

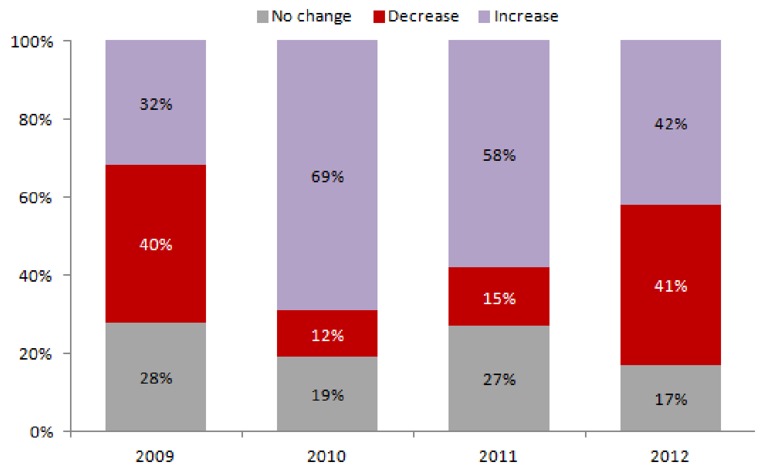


Note: Percentages are the share of respondents stating that there has been an increase or decrease in trade finance revenues over the previous year.
Source: International Chamber of Commerce, Global Surveys on Trade Finance 2011-2013.

A similar trend is observed in the survey results for trade credit lines, which can be used to gauge the gap between the demand and supply of trade finance. In 2012, the percentage of respondents indicating that trade credit lines for corporate customers had been reduced jumped substantially to 41%, from 12% in 2010 and 15% in 2011. In fact, the number of respondents reporting that corporate trade credit lines had decreased in 2012 is comparable to the rate seen at the height of the global financial crisis when corporate credit lines were severely constrained (Figure 16). Conversely, the share of respondents indicating that there had been an increase in corporate trade credit lines in 2012 was lower in comparison to the previous three years. The implication being that the capacity of financial institutions to extend trade finance to corporate customers was curtailed in 2012.

[20] The ICC Global Survey on Trade Finance 2013 received responses from 260 banks located in 112 economies.

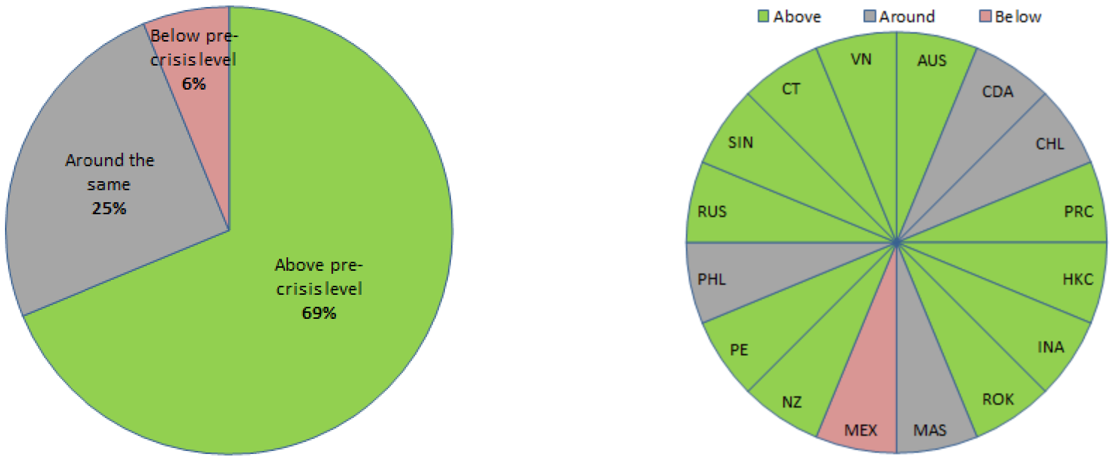
Figure 16. Availability of Trade Finance



Note: Percentages are the share of respondents stating that there has been an increase or decrease in the number of trade credit lines for corporate customers over the previous year.
Source: International Chamber of Commerce, Global Surveys on Trade Finance 2010-2013.

For the APEC region, the results of the APEC 2013 Trade Finance Survey suggest that trade finance has recovered since the 2008 GFC in most APEC economies. Of the 16 APEC members responding to the question on whether the volume of trade finance in their economy is currently consistent with the level prior to the 2008 GFC, 11 reported that the current volume is above its pre-crisis level (Figure 17)[21]. Meanwhile, four of the respondents stated that the volume of trade finance in their economies is currently around the pre-crisis level, while just one reported that it is currently below the pre-crisis level.

Figure 17. Volume of Trade Finance in APEC Economies since the 2008 GFC

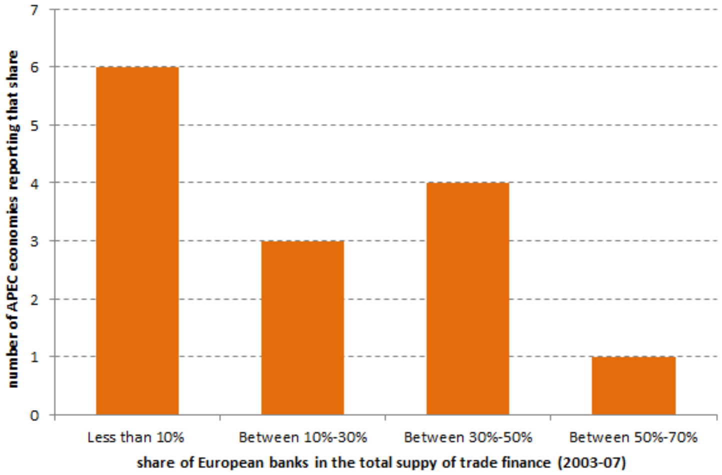


Source: APEC 2013 Trade Finance Survey.

European banks have traditionally played an important role in the banking sector in many APEC economies. Thus, the retrenchment of European banks has prompted policy makers to assess the role of these banks in the provision of trade finance in the APEC region. This question was also addressed in the APEC 2013 Trade Finance Survey. Based on the responses of 14 APEC members as to the role of European banks in the provision of trade finance in their economies, six reported that the share of European banks in the total supply of trade finance in their economies over the period 2003-2007 was less than 10% (Figure 18). However, some APEC members noted a more important role in the supply of trade finance from European banks, with seven reporting the share to be in the range of 10% to 50% and one member stating that European banks accounted for 50% to 70% of the total pre-crisis supply of trade finance in their economy.

[21] In the APEC 2013 Trade Finance Survey, the pre-crisis level is defined as the 2003-2007 average.

Figure 18. Role of European Banks in Providing Trade Finance in APEC Economies



Source: APEC 2013 Trade Finance Survey.

A recent report from the IMF revealed that European banks have also started deleveraging in their overseas operations, during which the provision of trade finance would inevitably be affected [22]. Indeed, 80% of the respondents to the APEC 2013 Trade Finance Survey indicated that the retrenchment in European banks has reduced their share of the total supply of trade finance in their economy since 2010 (Figure 19a). However, a majority of the survey respondents (60%) indicated a slight reduction of less than 10%, while the rest reported a moderate to substantial reduction.

Figure 19a. Share of European Banks in the Total Supply of Trade Finance in APEC Economies since 2010

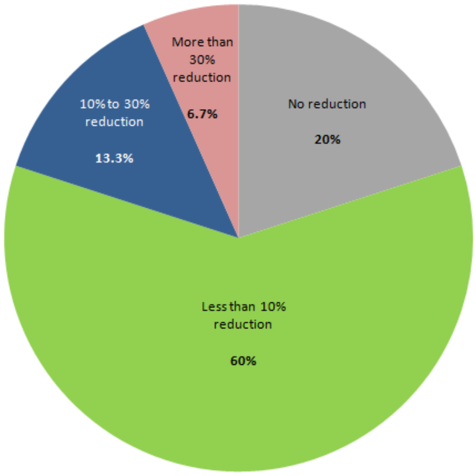
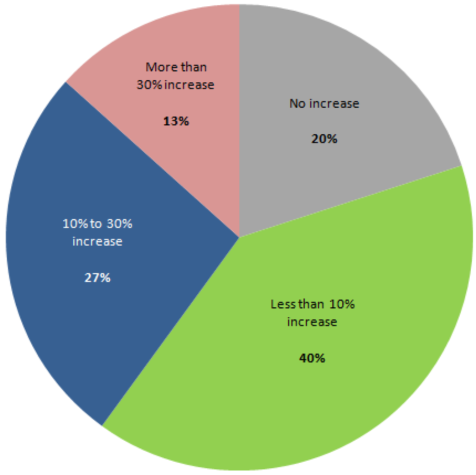


Figure 19b. Share of Other Banks in the Total Supply of Trade Finance in APEC Economies since 2010



Note: 15 APEC members provided a response to these two survey questions.
Source: APEC 2013 Trade Finance Survey.

Globally, the scaling back of European bank activity has been partially offset by banks from other regions, including Asia and North America. Consistent with this trend, the provision of trade finance in many APEC economies has also benefited from increased lending by other international banks or by domestic banks. Encouragingly, 80% of survey respondents reported an increase in the provision of trade finance from non-European banks in their economies since 2010 (Figure 19b). In some economies, other international banks as well as domestic banks have substantially increased their share of the total supply of trade finance by over 30%, while the majority of respondents (67%) reported slight to moderate increases in the share of these banks.

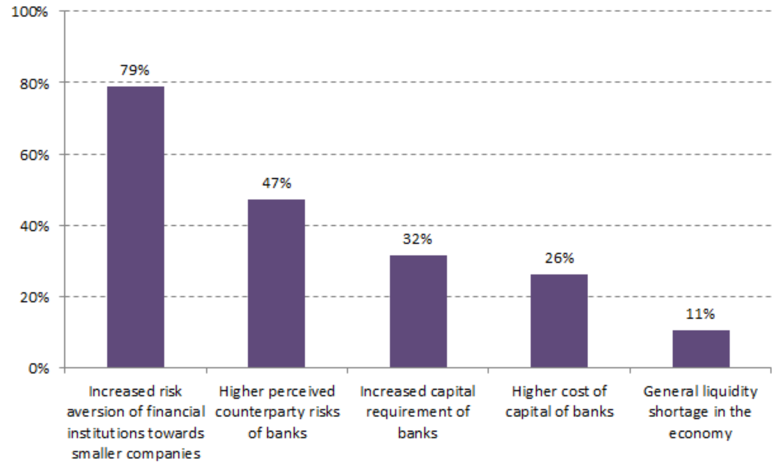
[22] International Monetary Fund (2012a).

3. ACCESS TO TRADE FINANCE FOR SMALL AND MEDIUM-SIZED ENTERPRISES

Small and medium-sized enterprises (SMEs) make up a substantial part of the economies throughout the APEC region. Previous research by the APEC Policy Support Unit found that SMEs account for over 90% of all enterprises in every APEC economy and employ more than half the workforce in most APEC economies[23]. Although data are limited, the study also found that less than 15% of SMEs in most APEC economies are engaged in exporting, with SMEs contributing less than 30% of total export value in 2010. Addressing this is an important area for APEC. Through its Committee on Trade and Investment (CTI), APEC has been actively involved in promoting the role of SMEs in global value chains[24]. In order to help boost their exports, it is therefore important that SMEs are able to access trade finance.

Empirical evidence reveals that access to trade finance enhances the probability of a business becoming an exporter[25]. In addition, research indicates that economies in which trade finance is either more difficult or more expensive to obtain tend to export less[26]. Furthermore, access to trade finance often improves the competitiveness of an economy's exporters. For instance, access to pre- and post-shipment financing enables exporters to produce and ship products throughout the entire cash flow cycle. Therefore, enhancing and supporting trade finance can result in a boost to trade growth as well as its sustainability, ultimately having a positive impact on the real economy given the linkages between trade and economic growth.

Figure 20. Main Impediments for SMEs to Access Trade Finance in the APEC Region



Note: Survey respondents could select more than one option.
Source: APEC 2013 Trade Finance Survey.

However, SMEs often face challenges in accessing all types of financing given their higher perceived risk relative to larger enterprises. And in fact, SMEs do indeed typically have a higher risk profile compared to larger businesses since they often have a weaker financial structure, including a lack of collateral. Nonetheless, trade finance should also be easier for an SME to access than other types of financing, such as start-up capital for example, since trade loans are typically self-liquidating and collateralized, and are therefore less risky than other types of lending. A lack of access to trade finance therefore constrains the ability of SMEs to grow their operations and to become exporters.

[23] APEC Policy Support Unit (2010).
[24] For an analysis of the challenges that SMEs face in their participation in global production chains, please see the APEC Policy Support Unit's "SMEs' Participation in Global Production Chains" (Issues Paper No. 3).
[25] Berman and Héricourt (2010).
[26] Manova (2008).

As part of the APEC 2013 Trade Finance Survey, members were asked to identify the main impediments for SMEs to access trade finance in their economies. Although two APEC members indicated that there were no significant impediments for SMEs to access trade finance in their economies (Hong Kong, China and Chinese Taipei), the other APEC members responding to the survey indicated a range of reasons. The most common impediment for SMEs to access trade finance is an increased risk aversion of financial institutions towards smaller companies, with 79% of respondents selecting this option as a barrier (Figure 20). Higher perceived counterparty risks of banks and an increased capital requirement of banks were the second and third most commonly selected options. Some respondents also stated additional obstacles facing SMEs in accessing trade finance. These include (1) how the costs of arranging and managing trade finance facilities often outweigh the returns received on what are usually smaller trade loan amounts; and (2) the fact that the opaqueness of financial statements of SMEs makes it difficult to price corresponding risks on SME exposures.

Worryingly, anecdotal evidence suggests that SMEs have not in fact been able to benefit from the abundant liquidity in the global economy that has held the cost of funding low as a result of the expansionary monetary policies being pursued by large central banks in many advanced economies across the world. Given the general risk aversion many private financial institutions have towards smaller companies, SMEs continue to remain disadvantaged in their access to trade finance regardless of the cost of funding. Larger enterprises, which are perceived to be less risky and thus have better access to trade finance, have therefore been the main beneficiaries of the low interest rates with respect to trade loans.

Table 1. Selected Instruments Available to Facilitate Trade Finance to SMEs in APEC Economies

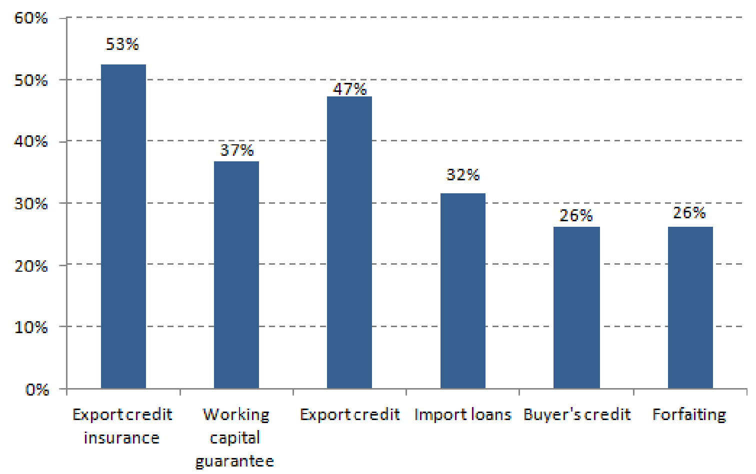
Economy	Export credit insurance	Working capital guarantee	Export credit	Import loans	Buyer's credit	Forfaiting
Australia		✓			✓	
Brunei Darussalam			✓			
Canada	✓	✓				
Chile		✓	✓			
China	✓	✓	✓	✓	✓	✓
Hong Kong, China	✓	✓				
Indonesia	✓	✓	✓	✓		✓
Japan	✓				✓	
Korea	✓		✓	✓		✓
Malaysia	✓	✓	✓	✓		
Mexico	✓	✓				
New Zealand	✓	✓	✓			
Peru	✓	✓	✓			✓
Philippines	✓		✓	✓		✓
Russia	✓	✓				
Singapore	✓	✓				
Chinese Taipei	✓	✓	✓	✓	✓	✓
Thailand	✓	✓				
Viet Nam			✓	✓		

Source: APEC 2013 Trade Finance Survey.

Given the barriers that SMEs often face in accessing trade finance through financial institutions such as commercial banks, domestic export credit agencies are often able to fill the gap in providing trade finance services to SMEs. Through these publicly-provided trade finance facilities, APEC members offer a range of products to support access to trade finance for the SMEs in their economy. Table 1 provides an overview of some of the trade finance instruments that are available to SMEs through the publicly-provided trade finance facility in the economies that responded to the APEC 2013 Trade Finance Survey. Most survey respondents indicated that they provide export credit insurance and working capital guarantees to facilitate trade finance to SMEs in their economies, while more than half provide export credit services.

Encouragingly, many APEC members responded to the 2008 Global Financial Crisis (GFC) and its impact on the availability of credit by implementing either new or enhanced measures to facilitate trade finance in their economies. The APEC 2013 Trade Finance Survey asked which trade finance products their economy has introduced or enhanced since 2009. Of the 19 APEC members responding to the survey, over half had either introduced or made enhancements to the export credit insurance implemented through their publicly-provided trade finance facility, while nearly half introduced or improved the provision of export credit in their economies (Figure 21). Of particular note in the developments to facilitate trade finance in the APEC region since 2009 is the establishment of the Export Insurance Agency of Russia (EXIAR) in October 2011.

Figure 21. New or Enhanced Measures to Facilitate Trade Finance in APEC Economies since 2009



Note: Survey respondents could select more than one option.
Source: APEC 2013 Trade Finance Survey.

APEC members were also asked to provide data on the number of projects and the amount funded through the domestic export agency in their economy as part of the 2013 Trade Finance Survey. Unfortunately, only a few members were able to provide limited information on their publicly-provided trade finance facility. However, based on the data that were provided, it does not appear that there was a large increase in the demand placed on domestic export credit agencies in the immediate wake of the GFC, with the exception of Hong Kong, China. In fact, Hong Kong, China initiated a time-limited scheme, which included trade finance related loans, in December 2008 with the stated intent to meet general business needs to tide over the liquidity problem arising from the 2008 GFC.

Multilateral development banks such as the Asian Development Bank (ADB) and the Inter-American Development Bank (IDB) also play an important role in facilitating access to trade finance for SMEs in the region. Launched in 2009, the ADB's Trade Finance Program (TFP) has provided guarantees and loans to banks in order to support trade in the region. Through over 200 partner banks, TFP supported USD 4 billion in transactions in 2012, with over 1,500 transactions involving SMEs[27]. Likewise, the IDB's Trade Finance Facilitation Program (TFFP), which began in 2005, provides credit guarantees and direct trade loans through a network of 90 issuing banks in Latin America and the Caribbean and 267 confirming banks

[27] Asian Development Bank (2013b). More information on the ADB's Trade Finance Program can be found at http://www.adb.org/site/private-sector-financing/trade-finance-program.

in the rest of the world[28]. Both the TFP and TFFP reported an increase in demand for their facilities in the immediate wake of the 2008 GFC, indicating that the liquidity crunch and subsequent drop in lending severely impacted SMEs in the region. In fact, the IDB began to offer trade loans under the TFFP in response to the economic crisis.

Finally, it is important to note that the APEC region includes a wide range of members at varying stages of economic development, with correspondingly different levels of depth and sophistication in the domestic financial systems across the region. This results in differing ideological viewpoints concerning the public provision of financial services, i.e., crowding-out versus crowding-in of the private sector. In the provision of trade finance, crowding-out occurs when the scope and scale of publicly-provided trade finance facilities prevent commercial banks from participating fully in the market. Meanwhile, crowding-in occurs when the public provision of trade finance products and services enables private financial institutions to better evaluate and assess the risks involved, eventually spurring their involvement in this type of lending.

This ongoing debate will not be explored in this paper, except to note that these differing approaches to the role of the public sector are often reflected in the public provision of financial services. The need and role for the public provision of trade finance services in economies with less sophisticated financial systems is rather clear. These facilities, including those services offered by development banks, provide much needed financing that helps SMEs to grow their operations, ultimately leading to increased employment and greater economic growth. However, even in economies with highly sophisticated financial markets, SMEs may still struggle to access trade finance through private banks, suggesting that publicly-provided facilities continue to have a role to play even in the more developed economies (Box 2).

Box 2. Importance of SME Access to Trade Finance

"When a pet food manufacturer approached the New Zealand Export Credit Office (NZECO) in early 2010, it had just secured its first significant foreign buyer – a publicly listed U.S. pet store chain. The buyer wanted 60-day credit terms which the manufacturer could not afford to offer without stifling the company's cash flow. At the time, private sector insurers declined to cover the buyer because the manufacturer's total insurable turnover was insufficient and the sector had very limited appetite for single buyer risk. NZECO stepped in to provide a credit insurance policy which was assigned to the Bank of New Zealand (BNZ) to support a trade receivables funding facility, enabling the manufacturer to access finance prior to repayment by the buyer. Over the following two years, NZECO insured additional buyers in Canada, U.K. and the U.S. This supported the growth of the manufacturer, leading them to being the fifth-fastest growing business in the Deloitte Fast 50 in 2011, with 800% p.a. growth the previous year. In January 2012, a private insurer stepped in to pick up the NZECO portfolio of buyers given the increase of the manufacturer's insurable sales."

Source: New Zealand Export Credit Office (2012).

[28] Inter-American Development Bank (2013). More information on the IDB's Trade Finance Facilitation Program can be found at http://www.iadb.org/tffp.

4. IMPACT OF BASEL III AND OTHER REGULATORY MEASURES ON TRADE FINANCE

In response to the deficiencies in financial regulation that were revealed during the 2008 Global Financial Crisis (GFC), the Basel Committee on Banking Supervision developed the Third Basel Accord, or Basel III, an international regulatory framework for banks. Announced in September 2010, Basel III is a comprehensive set of reform measures to strengthen the regulation, supervision, and risk management of the banking sector, with the reforms to be phased in from January 2013 through January 2019[29]. Basel III builds on and supersedes the capital adequacy requirements of Basel I and Basel II – which had previously set out a framework for the international convergence of capital measurement and capital standards – and also adds leverage and liquidity components to the framework.

Most notably, Basel III raises the minimum common equity capital ratio from 2% to 4.5% and adds a capital conservation buffer of 2.5%[30]. Since banks whose capital falls within the buffer zone will face constraints on their discretionary distributions, including the payment of dividends, this effectively raises the amount of Tier 1 capital that banks must hold to 7% of their risk-weighted assets. In addition, Basel III introduces a liquidity coverage ratio to ensure that financial institutions hold an amount of liquid assets in order to meet short-term obligations, so as to withstand short-term liquidity disruptions. The minimum requirement for the liquidity coverage ratio is to be phased in from 60% in 2015, reaching 100% by 2019. In other words, financial institutions will need to hold an amount of liquid assets (such as cash or government bonds) that is equal to their short-term obligations.

Although its objective is to strengthen the financial sector by decreasing leverage and increasing liquidity, Basel III is also expected to have a large impact on the activities of the banking sector. This includes a general reduction in overall lending capacity since the substantial increases in capital and liquidity required under the regulations will most likely lead to a reduction in a bank's capacity to lend and/or a significant increase in their cost of lending. In addition, the liquidity requirements under Basel III are expected to lead banks away from short-term lending towards more long-term lending. In general, although rates for short-term lending are lower than those for long-term lending, short-term lending is also less costly to provide since banks do not need to put aside as much capital as well as less risky given its shorter time horizon. Thus, raising the amount of capital that banks need to hold makes short-term lending even less profitable, ultimately leading to a greater preference for the relatively more profitable long-term lending.

After several delays, the trade finance sections of the Basel III requirements are currently scheduled to enter into force in January 2014. Transaction bankers in particular have long cautioned that Basel III will have a disproportionately negative impact on the provision of trade finance since trade loans differ significantly from other types of corporate lending as discussed earlier. There are several regulations under Basel III (as it was originally proposed) that are expected to have a detrimental impact on the provision of trade finance. Table 2

[29] For complete information on the Basel Accords, please see http://www.bis.org/bcbs/basel3.htm.

[30] The common equity capital ratio is assets minus liabilities divided by risk-weighted assets. Tier 1 capital is the core measure of a bank's financial strength and includes common stock and disclosed reserves and may also include preferred stock. It differs from Tier 2 capital, which includes supplementary capital such as undisclosed reserves, revaluation reserves, general loan-loss reserves, hybrid capital instruments, and subordinated debt.

details four of the main regulations under the Basel III framework that will have severe consequences for trade finance since these requirements tend to overstate both the tenor and risk profile of trade loans, thereby substantially raising the cost of providing trade finance and ultimately potentially reducing its capacity.

Table 2. Impact of Basel III on Trade Finance

Regulation	Description and impact on trade finance
One-year maturity floor	Credit facilities must have capital set aside against potential losses based on a minimum loan maturity of one year such that a 60-day letter of credit would need the same amount of capital set aside as a 1-year letter of credit, for example. Given the short-term nature of trade finance, with most loans having maturities of less than one year, such a requirement would significantly raise the cost of lending for trade finance.
Risk-weighted assets (RWA) calculation	The calculation used to determine the capital that a bank must hold is based on a one-year probability of default and a counterparty asset value correlation (AVC), among other variables. However, the use of a one-year probability of default overstates the capital requirement for trade finance instruments, as it does with the one-year maturity floor, given its short-term nature. In addition, the counterparty AVC overstates the risk profile of trade loans, which have been shown to have lower default rates as well as lower default correlation given the diversification of trade loans. By increasing the amount of capital that must be held, both of these factors increase the cost of providing trade finance.
100% credit conversion factor (CCF)	The CCF reflects the likelihood that an off-balance sheet loan will become an on-balance sheet item. A 100% CCF essentially assumes that the loan will not be repaid at all. Since trade contingents have been shown to be extremely low risk, raising the amount of capital that must be kept against a trade loan, as the 100% CCF requires, will significantly raise the cost of providing such credit[31].
50% liquidity coverage ratio (LCR) for corporate trade finance transactions	Under a 50% LCR, banks must maintain 50% of expected inflows in liquid assets as a buffer against default. This means that only 50% of maturing corporate trade finance transactions are recognized as inflows, or in other words, that banks should assume that only 50% of corporate trade finance exposures will be repaid, considerably overstating the risk profile of trade finance products and therefore raising the cost of providing such facilities.

In the most recent International Chamber of Commerce (ICC) Global Survey on Trade Finance, 65% of respondents said that the implementation of Basel III regulations is to some extent or to a large extent affecting the cost of funds and liquidity for trade finance, with 57% of respondents believing that Basel III will have a negative to very negative impact on their trade finance business[32]. Also, in a recent survey of international banks conducted by the Asian Development Bank, nearly 80% of the respondents stated that Basel regulatory requirements play a significant role in limiting trade finance[33]. Furthermore, the survey also revealed that if Basel III were to be fully implemented, then the respondent banks would reduce their support for trade finance by 13%, on average, with over 35% of respondents indicating that they would reduce their trade finance support by 20% or more. Such a

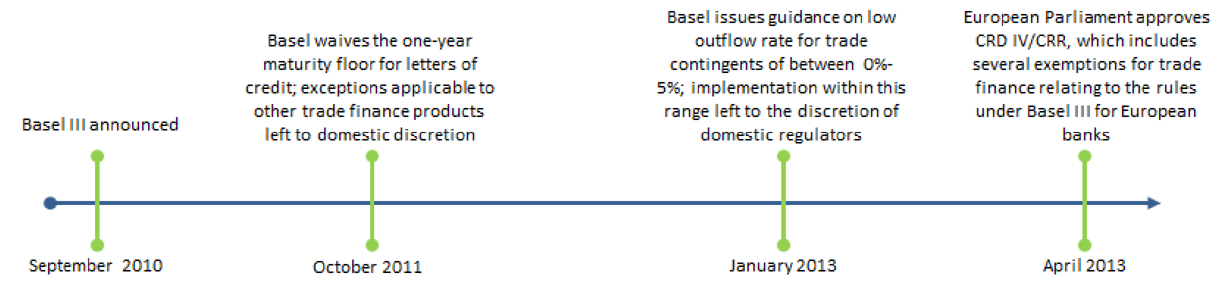
[31] Financial institutions typically keep trade contingents, such as letters of credit and shipping guarantees, as off-balance sheet items. A contingent liability is a potential loss that may occur at some point in the future. Such contingents become on-balance sheet items when, for instance, there is a high probability of non-payment.
[32] International Chamber of Commerce (ICC) Banking Commission (2013b).
[33] Asian Development Bank (2013a).

reduction in lending for trade finance could have a significant impact on the real economy given the linkages between trade finance, trade, and economic growth.

Regulators appear to be taking heed of the warnings that the prudential regulations under Basel III will have unintended consequences on the provision of trade finance, having made several changes to its treatment under the regulatory framework (Diagram 2). In October 2011, the Basel Committee on Banking Supervision waived the one-year maturity floor for certain trade finance transactions, namely letters of credit, stating that it was "inappropriate for short-term self-liquidating trade finance instruments given their average tenor of well below one year"[34]. As discussed above, relaxing this rule as it applies to letters of credit will surely limit the increase in the cost of providing trade finance under the Basel III regulations. However, although the Committee also considered the 100% credit conversion factor as it applies to trade finance facilities, it decided against changing this rule for calculating the leverage ratio.

The most notable development to date with respect to the treatment of trade finance under the Basel III standards occurred in April 2013 when the European Parliament approved the Capital Requirements Directive IV, or the Capital Reserve Requirements (CRD IV/CRR). This directive for European banks includes several important exemptions in the implementation of the Basel III rules with respect to trade finance products that were expected to have a negative impact on the provision of trade finance. The exemptions under CRD IV/CRR include waiving the one-year maturity floor for all trade finance instruments (not only letters of credit), an adjustment of the liquidity coverage ratio to recognize 100% inflows for corporate payments for trade finance products, and a move back to a 20% credit conversion factor for low or medium risk trade finance contingents.

Diagram 2. Treatment of Trade Finance under Basel III: Timeline of Developments



Although Basel III is a standard set of regulations, it is also voluntary and this can lead to inconsistencies in its implementation across jurisdictions. As such, trade finance for non-European banks will still be subject to the regulations under Basel III unless their local regulators also adopt similar exemption measures as Europe has recently done. In fact, the exemptions recently approved in Europe do not apply to local branches of European banks operating in, for example, Asian markets, where they will still be subject to the local regulations. Most importantly for APEC members, the recent decision in Europe to exempt trade finance from many of the Basel III regulations for European banks could potentially lead to regulatory arbitrage if other jurisdictions do not follow suit. Simply put, it will be less expensive for European banks to provide trade finance given their exemption from the Basel III regulations than it will be for other international banks, including Asian and North American banks. This will put banks in the APEC region at a disadvantage in providing trade

[34] Bank for International Settlements (2011).

finance as it will be relatively more expensive for them to do so than it will be for European banks.

Other recently introduced regulations, such as Know Your Customer (KYC) and Anti-Money Laundering (AML), also impact the provision of trade finance. These protocols are meant to prevent money laundering, fraud, identity theft, as well as financing for illegal activities. However, requiring such due diligence by providers of financial services raises the cost of compliance and ultimately the cost of lending. This is of particular concern for SMEs given their typically smaller loan amounts and often opaque financial statements. In addition, these guidelines are not harmonized so regulations vary from jurisdiction to jurisdiction, often requiring an understanding of the standards as they are implemented in each jurisdiction, and potentially leading to inconsistencies in the implementation of the regulations. Based on its most recent trade finance survey of bank representatives around the world, the ICC found that 66% of respondents stated that KYC hampers trade finance transactions to some extent[35]. In fact, 35% of respondents considered closing correspondent relationships due to rising compliance costs.

[35] International Chamber of Commerce (2013b).

5. OUTLOOK FOR TRADE FINANCE AND THE ROLE FOR APEC

Available data on some trade finance products as well as global banking surveys on the provision of trade finance suggests that the overall market for trade finance has improved since the 2008 Global Financial Crisis (GFC), although the recovery has been patchy. In the context of fragile financial markets and continued uncertainty in the global economy, a sustained and strong recovery of trade finance to support global trade and economic activity faces a number of challenges. In particular, there are two medium-term risks that could potentially have a large and negative impact on the provision of trade finance across the APEC region: (1) a reduction in the amount of global liquidity that has helped to keep credit available and its cost low; and (2) the introduction of regulatory standards that will raise the cost of lending and potentially change the lending behaviour of banks.

Since the 2008 GFC, many economies have held monetary policy rates at historical lows and many central banks in advanced economies have pursued large-scale expansionary monetary policies, helping to ease credit conditions globally[36]. For example, the average price for letters of credit in emerging economies fell from 150-250 basis points in 2009 to 70-150 basis points in 2010[37]. Any changes to the current international setting would therefore have an impact on the availability of credit and on the cost of borrowing, most likely impacting trade finance. In fact, recent discussion about the possibility of a reduction in the U.S. Federal Reserve’s asset purchase program has again seen a tightening of liquidity conditions. For instance, the yield on 10-year Treasury bonds rose 80 basis points between the end of May and the first week of September of this year. Liquidity conditions in developing and emerging economies have also become constrained as reflected in the IIF's Emerging Markets Bank Lending Conditions Index dropping below 50 in the second quarter of 2013.

Furthermore, the introduction of new and enhanced prudential regulations will have significant consequences on the banking sector. Whilst such regulations are certainly important to ensure stability in the financial sector, it is also vital that regulators fully understand how the standards will impact lending behaviour in their economies. Given the linkages between trade and employment and economic growth, it is essential that the financing to support trading activities is not impacted by regulations meant to strengthen the banking sector so that the market for trade finance remains robust. In particular, APEC members should ensure that banks in the region are not at a disadvantage since recently approved exemptions to Basel III could give European banks a regulatory advantage in providing trade finance.

In the context of reduced liquidity, continued European bank deleveraging, and the potentially large structural changes in the financial sector to cope with new regulations, trade finance could be negatively impacted, despite its low risk nature. With firms engaged in international trade strongly dependent on trade finance, disruptions in this market can be damaging to global trade and ultimately to global economic growth. However, despite the medium-term risks to the provision of trade finance, APEC members are overwhelmingly positive on the outlook for trade finance. The APEC 2013 Trade Finance Survey reveals that 11 of 18 respondents (61%) expect the trade finance situation to improve through the end of

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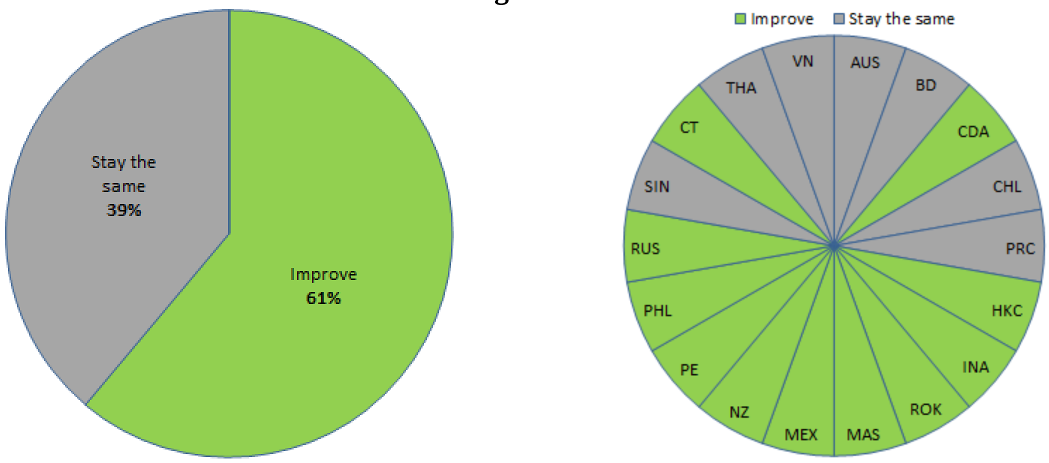
[36] For an in-depth analysis of the impact of these monetary policies on the APEC region, please see the APEC Policy Support Unit’s “APEC Economic Trends Analysis”, April 2013 and October 2013 editions.
[37] International Chamber of Commerce (2011).

2014, with the remainder expecting it to stay about the same (Figure 22). This also represents a slight improvement on the sentiment shortly after the start of the 2008 GFC when 59% of the respondents to the APEC 2009 Trade Finance Survey felt that the situation would improve over the following six months, while 6% thought that it would worsen.

Figure 22. Outlook for Trade Finance through 2014



Source: APEC 2013 Trade Finance Survey.

Based on the findings presented in this paper, the PSU has the following policy recommendations for APEC members and for APEC as a whole:

1. Given its susceptibility to changing economic conditions, APEC should continue to monitor the volume of trade finance in the region as well as whether there are any issues in the ability of businesses to access trade finance, including those that are perhaps specific to certain industries or sectors.
2. APEC members should continue to promote and facilitate access to trade finance for SMEs in the region, especially in light of the medium-term risks to the availability and cost of credit. In addition, in order to help build capacity in the export credit agencies of the developing economies, APEC should also be a forum for members to engage in the sharing of best practices.
3. Regulators in the APEC region should take note of how the implementation of the Basel III standards will affect the provision of trade finance in their economies. Given the regulatory advantage that European banks could have in providing trade finance as a result of Europe’s implementation of the standards, APEC could perhaps take a coordinated approach to ensuring that banks in the region are not at a disadvantage in their provision of trade finance.
4. Given its increasing use in international trade transactions, policy makers should implement policies that help to facilitate access to open account trade finance for both exporters and importers. This is especially pertinent given the deceleration in global imports that occurred during the first few months of this year, and which is expected to persist in the near future, since reduced import demand may prompt more buyers to insist that exporters offer open account payment methods.
5. Some APEC members have expressed interest in developing trade finance instruments (e.g., letters of credit) as an asset class. Further research could be undertaken in this area to assess the feasibility of embarking on such an initiative in the APEC region.

ANNEX 1: APEC 2013 TRADE FINANCE SURVEY

Question 1(a): Please provide annual data from 2000 to 2012 on the volume of trade finance in your economy (in nominal local currency or in USD). If possible, please provide disaggregated data based on the source of trade finance (i.e., public, private, bilateral, multilateral). (Please submit the data as a separate attachment in Excel or Word format.)

Question 1(b): <u>If unable to provide data for Question 1(a)</u>, then please estimate whether the volume of trade finance in your economy is currently consistent with the level prior to the 2008 Global Financial Crisis (i.e., the 2003-2007 average)?

☐ Below pre-crisis level
☐ Around pre-crisis level
☐ Above pre-crisis level

Question 2(a): What has been the role of European banks in providing trade finance in your economy (as a share of the total supply of trade finance over the period 2003-2007)?

☐ Less than 10%
☐ Between 10%-30%
☐ Between 30%-50%
☐ Between 50%-70%
☐ Over 70%

Question 2(b): Has the retrenchment in European banks reduced their share of the total supply of trade finance in your economy since 2010? If so, to what extent?

☐ Not at all
☐ Slightly reduced (by less than 10%)
☐ Moderately reduced (by 10% to 30%)
☐ Substantially reduced (by more than 30%)

Question 2(c): Have other international banks (e.g., Asian banks), multilateral development banks, and/or domestic banks increased their share of the total supply of trade finance in your economy since 2010? If so, to what extent?

☐ Not at all
☐ Slightly increased (by less than 10%)
☐ Moderately increased (by 10% to 30%)
☐ Substantially increased (by more than 30%)

If applicable, please specify which types of banks have increased their share of the total supply of trade finance in your economy (e.g., other international banks such as Asian or North American, multilateral, domestic): ________________

Question 3: Has your economy implemented any new/enhanced measures to facilitate trade finance since 2009? (Respondents can tick more than one box.)

☐ None at all
☐ Export credit insurance
☐ Working capital guarantee

☐ Export credit
☐ Import loans
☐ Buyer's credit
☐ Forfaiting
☐ Others; please specify: _______________

Question 4(a): In your view, what are the main impediments for SMEs to access trade finance in your economy? (Respondents can tick more than one box.)

☐ No significant impediments
☐ General liquidity shortage in the economy
☐ Increased risk aversion of financial institutions towards smaller companies
☐ Higher perceived counterparty risks of banks
☐ Higher cost of capital of banks
☐ Increased capital requirement of banks
☐ Others; please specify: _______________

Question 4(b): What are the existing measures that your economy has in place to facilitate trade finance to SMEs? (Respondents can tick more than one box.)

☐ None at all
☐ Export credit insurance
☐ Working capital guarantee
☐ Export credit
☐ Import loans
☐ Buyer's credit
☐ Forfaiting
☐ Others; please specify: _______________

Question 5: Regarding the publicly-provided trade finance facility in your economy (e.g., export credit agency), please provide annual data from 2000 to 2012 for the following: (Please submit the data as a separate attachment in Excel or Word format.)

- Number of requests
- Number of approved projects
- Amount funded (in nominal local currency or in USD)
- Rate of default

Question 6: How does your economy foresee the trade financing situation developing through the end of 2014?

☐ Improving
☐ Deteriorating
☐ Staying about the same

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