

Sustainable Trade Finance and Financing Instruments

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Question

What are the lessons learned from different instruments (within and outside of IFIs) designed to support sustainable trade finance in fragile and complex economies with current account imbalances?

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1. Overview

Trade Finance has been supporting development in fragile and complex developing economies – as well as other (relatively stable and emerging) developing countries.

Particularly, innovative, and sustainable instruments of trade finance (i.e. techniques of injecting liquidities along the trade value chain) have been making the financial sector an integral component of trade growth in several countries. In fragile and complex developing economies, however, access to affordable finance is still one of the most problematic factors recognised by firms as restricting their growth and international trading practices. Closing this gap in trade financing can improve productivity, competitiveness and create jobs – all of which stimulate sustainable development (Gonzalez, 2014).

However, the current COVID-19 pandemic and the associated global economic crisis is causing considerable upsets in trade and trade finance. The experiences of trade finance disruptions during the 2008/09 Global Financial Crisis (GFC) as well as challenges faced by countries with current account crises may offer some useful lessons for the ongoing COVID-19 induced crisis – although the current crisis has no comparable modern precedent. Past studies have shown that periods of major regional and global economic crisis (e.g. the GFC) make fragile economies particularly vulnerable to disruptions in trade linkages and trade finance (see Allen and Giovannetti, 2011; Berman and Martin, 2012).¹

In light of the current crisis, there is an urgent need for the international community (donors, multilateral development banks, governments, etc.) to help alleviate the constraints faced by banks in developing countries (particularly those with economic and state fragility) – to enable them in scaling up trade financing. Often, the productive capacity of firms in developing countries is growing faster than the capacity of local banks to finance their activities. In order to remain competitive in trade, firms must have access to greater financial markets which can give them the choice of suitable financial instruments for growth, whether that is a loan or capital. This will help them to make the required investments in their quality and standards infrastructure, modernise logistics, invest in human resources and technology, finance research and development for innovation. The availability of adequate financing makes it possible for these firms to upgrade themselves to the required level and integrate into global value chains. Being a part of global production and distribution network leads to considerable developmental opportunities to businesses and a wide range of economic actors involved in the process (Gonzalez, 2014).

Some examples of the biggest trade finance providers to fragile and developing economies (i.e. International Financial Institutions (IFIs))² and their financing instruments, which tend to be relatively well documented, include the following (see also Section 5 of this report).

¹ Several studies have noted that the GFC has affected the capacity of businesses to finance international trade (see IDS, 2009; Hossain, 2009; Berman and Martin, 2009; Humphrey, 2009; Gregory et al., 2010).

² Several Multilateral Development Banks (MDBs), including the Asian Development Bank (ADB), the African Development Bank (AfDB), the European Bank for Reconstruction and Development (EBRD), the IDB Invest (which is a member of the Inter-American Development Bank IDB Group), the International Finance Corporation (IFC), and the International Islamic Trade Finance Corporation (ITFC), carry out large-scale trade finance programmes, that provide trade financing instruments to facilitate cross-border trade in emerging and developing economies (ICC, 2018).

- **African Development Bank (AfDB)** runs a trade finance programme (worth USD 100 annually) that assists developing economies and fragile/complex states in Africa. It provides partial payment guarantees to local banks and foreign exchange liquidity to soft commodity aggregators. The programme also sometimes supports non-private sector financial institutions and government agencies in these countries. Apart from the conventional partial payment guarantees, AfDB is designing innovative single trade finance transaction guarantees to underwrite 100% of trade risk. Further, AfDB employs financing instruments that rapidly respond to countries in crisis (e.g. fragile economies). Together with other finance institutions, AfDB also works on co-sharing of risk, provision of joint short-term liquidity facilities and capacity-building support to local banks, and trade finance related surveys and research initiatives.
- **Asian Development Bank (ADB)** has a trade finance programme which supports the banking system in developing countries of the Asia-pacific region. The programme helps to facilitate the provision of trade financing particularly to Small and Medium Enterprises (SMEs). The programme plays a pivotal role in helping to mobilise financial resources from the private sector as well as through the provision of guarantees and loans to local financial institutions.
- **The Inter-American Development Bank (IDB)** runs a trade finance facilitation programme in developing (and some economically/politically fragile) countries of the Latin America and the Caribbean region. Through trade finance funds, the IDB mobilises equity investors to finance trade in countries of the region. It also offers trade guarantees and loans to financial intermediaries in the region. Inclusivity and sustainable trade financing are key components of IDB's trade finance instruments.
- **The International Finance Corporation (IFC)**, which is part of the World Bank Group, operates a global trade finance programme – which helps to connect trade institutions in developing countries with international banks. As such, the corporation helps in facilitating trade financing for firms in developing (and some economically/politically fragile) countries – these being in different parts of the globe. One main area of investment for the IFC is in fighting climate change and one key instrument is its 'Climate Smart Trade' – which promotes the trade/use of clean and efficient energy technology.
- **The International Islamic Trade Finance Corporation (ITFC)** provides trade finance to several countries (some of them with economically/politically fragility) in the Middle East and North Africa region, Asia, and sub-Saharan Africa regions (i.e. to member countries of the Organisation of Islamic Cooperation). ITFC's trade finance has facilitated trade in petroleum products, agriculture, and minerals. The trade financing programmes in the agricultural sectors of economically fragile low-income countries have additionally focused on enhancing food security for farmers. The trade financing operations in The Gambia and Senegal have, for instance, resulted in enhanced food security, poverty reduction, export growth, higher foreign exchange earning – and overall contributed to their socio-economic development. ITFC is also moving from a traditional transaction-based financing to an innovative integrated programme approach – where trade finance and trade-related capacity building are combined.

Outside the IFIs, trade financing in developing and fragile economies relies on local banks and government agencies (e.g. Export Credit Insurance agencies). It is also important to note that these financial institutions in fragile economies are themselves often financed by IFIs to provide trade financing loans and credits (see also Section 6 of this report).

- **Local financial institutions (e.g. banks) provide a variety of (sometimes innovative) trade financing instruments to local businesses.** Some of the key trade financing instruments may include letters of credit, credit to buyers or suppliers, pre- and post-shipment financing, avalised bill, export credit insurance, trade insurance for exchange rate risks, and forfeiting.
- Trade financing instruments involving businesses from fragile economies may also include **simple and special arrangements directly between sellers and buyers** (bypassing traditional financial transactions) – such as Countertrade.
- **There is also a recent trade financing instrument that is based on a ‘disruptive’ ‘Fintechs’ model.** These are non-bank financial institutions which use sophisticated technologies to undertake, what are essentially traditional banking activities. Fintechs often rely on ‘big data’ and ‘cloud’ technologies to provide innovative trade financing and micro-lending services to businesses in fragile economies – which are often underbanked and underfinanced due to their higher risk and lack of adequate financial information.

Nevertheless, it is worth noting that there is some limitation in the evidence base (e.g. academic studies) around instruments of trade finance in fragile and complex economies. Although the literature on trade finance (and the underlying instruments of trade financing) is well developed, there is far less academic evidence from fragile states on the topic. Owing to the scarcity of evidence, this rapid evidence review looks at different types of available relevant literature – including reports issued by different development agencies, international financial institutions and some academic publications.

2. Sustainable trade finance: definition and recent trends

The International Chamber of Commerce (ICC)³ – which is the world’s largest trade/business association – **defines ‘sustainable trade finance’ as “finance which supports goods or services produced in a manner that minimises adverse environmental or social impacts or risks, or that promotes environmental protection or social benefit”** (ICC, 2018. P 152). In its 2015 Charter for Sustainable Development, the ICC set forth guidelines to achieve sustainable development in a business context, described as “a process whereby companies seek to manage their financial, societal (including governance) and environmental risks, obligations and opportunities. This is commonly referred to as a triple bottom line approach where business connects to healthy and balanced economic, societal and environmental systems. In order to do so businesses must be aware of the principles of sustainable development [...] and consider their impacts on the environment in which they operate” (ICC, 2015, p 4).

The ICC’s Charter for Sustainable Development stresses the need for implementing the approach of sustainable trade (and sustainable trade financing) with distributors, service providers, and other relevant partners, and cooperating with all actors in the global value chain to realise accountable behaviour across the whole product or service life cycle. ICC’s working group has defined ‘Sustainable Trade’ as “the business and activities of buying and selling

³ The ICC is the largest, most diverse business organization in the world. The ICC has hundreds of thousands of member companies from more than 100 countries. See <https://www.investopedia.com/terms/i/international-chamber-of-commerce-icc.asp>

commodities, goods and services that meet environmental, social and economic criteria capable of benefitting all actors involved and minimising adverse impact while fostering sustainable global development” – while implementing this method to the context of traditional trade and supply chain finance products (ICC, 2018, p. 152).

According to a recent ICC report (see ICC, 2018), several factors are pushing the trade financing industry in a more ‘sustainable’ path. First, consumers are more cognizant of and worried about the environmental and social footprint of the goods they purchase. They have the ability to vote with their wallets. Businesses are reacting to this by pledging to sourcing sustainably manufactured goods and forcing verification from certification systems that check for environmental and social impacts.⁴ Second, banks (e.g. those which supply trade finance to fragile states and other developing countries) do not wish to have their image to be tainted,⁵ or to risk bigger losses, owing to the unsustainable procedures of firms in their supply chain.⁶ Third, More local, national and international authorities recognise the need to fight and adapt to the impact of climate change, support the Paris Agreement and implement the UN Sustainable Development Goals. The Climate-Related Financial Disclosure Task Force of the Financial Stability Board illustrates the need for business to be transparent about the material risks of climate change. The High-Level Expert Group on Sustainable Finance of the European Commission also outlines a framework for a financial system which makes sustainability considerations part of its decision making process (ICC, 2018).⁷

Banks and IFIs that ignore major long-term changes in demand – or finance transactions that are associated with things such as the use of child labour, devastation of tropical forests, or extreme use of water or pesticides – face losing business and putting their profits at risk. In the meantime, financial institutions that currently push ‘responsible practices’ into supply chains could also further enhance their efforts. Banks that adopt sustainable trade and supply chain finance could reduce the credit and reputational risks linked to lending to customers that have not yet applied proper controls to their operations and supply chains. Banks that follow ‘responsible’ and ‘sustainable’ practices could even profit from new competitive advantages, as they eventually become market leaders. This is important for securing new business from corporate customers that are already devoted to sustainable and responsible

⁴ Since 2011, there has been a fivefold increase in the amount of global soy production verified by the Round Table on Responsible Soy. According to the Better Cotton Initiative (ICC, 2018), the land supporting sustainably cultivated bananas has expanded threefold in the same period; and certified sustainable cotton production has grown nearly nine-fold over the past decade.

⁵ An Indonesian palm oil producer is no longer an eligible supplier to major importers after being suspended by a certification authority, i.e. the Roundtable on Sustainable Palm Oil. A Latin American cocoa plantation company had also its operations stopped, trading suspended, and debt and equity de-listed. It is now become insolvent (ICC, 2018).

⁶ For example, the Commerzbank’s reputational risk department checks on average more than 5,000 transactions, loans, and relationships a year against strict criteria for social, environmental, and governance (ESG). Those risks go far beyond bad marketing. The threat of protest or litigation is also growing as regulation and social advocacy expand. Bank customers who are unable to manage such risks are susceptible to regulatory fines, damage liability or loss (ICC, 2018).

⁷ Government restrictions on the importation of conflict minerals, unlawfully harvested timber and the use of forced or child labour and related requirements for disclosure add to the need for greater transparency on how goods are financed and produced. With transaction banks increasingly under the microscope, regulations are likely to get significantly harder, and penalties for non - compliance are greater (ICC, 2018).

production and sourcing. It is equally important for investors and retail customers, who are more fixated on the social and environmental history of banks. The trade finance industry will start producing real value when banks integrate sustainability principles into their business practices. The initial step is for banks to communicate with their customers regarding whether their business present social and environmental concerns and how they can alleviate these risks (ICC, 2018).

3. Lessons from trade finance activities in fragile and complex developing economies

3.1 Gaps in trade finance in fragile economies

Trade financing is a crucial instrument to facilitate the trade of goods and services and it enables firms and value chains in fragile and developing countries to sell their products on international markets. Annual trade flows of about 80% of world's merchandise depends on trade financing. Furthermore, trade finance is usually a lot safer (with a default rate below 1%) when compared to other banking services and instruments (Gonzalez, 2018).

Nonetheless, there is a considerable and enduring gap between the demand and supply of trade financing. This gap is estimated by the Asian Development Bank to be worth USD1.5 trillion. Trade financing challenges are mainly faced by the Micro, Small, And Medium-Sized Enterprises (MSMEs) in low-income (and fragile) countries as well as those in emerging economies. This significant financing gap leads to diminished international trade and lower economic growth. The Asian Development Bank reports that a 10% rise in access to trade financing is linked to a 1% rise in employment by firms. Governments of developed countries (i.e. donors) as well as leaders of fragile and developing countries have pledged to enhance the trade financing ecosystem, for example, through the 2015 "Addis Ababa Action Agenda" (AAAA) on Financing for Development. The key explanations for the trade financing gap include lack of quality bankable transactions, problems around banking regulations, and requirements for collateral and information management (Gonzalez, 2018).

Circumstantial evidence implies that banks are hesitant to lend to MSMEs in fragile economies (and other developing countries) due to low profitability and hurdles in evaluating firms that do not have clear financial records. Multilateral development banks are broadening their trade finance programmes to allow more MSMEs from fragile countries to linkup with international value chains. For instance, the International Finance Corporation has brought together buyers, sellers, and international banks providing financial guarantees. This has helped in filling the gap that usually prevails in fragile and developing countries for interim financing between suppliers and buyers in global value chains (Gonzalez, 2018).

Furthermore, women-run businesses in fragile and complex economies face tougher challenges in accessing trade finance. Financial institutions reject about 2.5 times more applications from female entrepreneurs than male, even if women entrepreneurs have been regularly shown to be more financially efficient. The trade financing and facilitation work done by the International Trade Centre (ITC) in countries such as Kenya (together with local financial institutions) shows that the gap can be bridged through actions on both demand and supply. Though MSMEs are the instruments of growth and job creation in fragile countries (as well as in developing countries in general), inadequate access to trade finance is holding them down from

capturing the opportunities offered by international markets. At the moment, international organisations, technology providers and governments are working with banks, institutional investors and regulators to close the trade finance gap (Gonzalez, 2018; also see section 5).

3.2 Role of IFIs in trade finance in fragile economies

The roles of IFIs and multilateral development banks has been critical to the provision of sufficient levels of trade finance to fragile and developing economies (and businesses run by marginalised groups) and this is currently at the centre of the global discourse on ‘economic inclusiveness’. While fragile and developing countries benefit from IFI’s facilitation of trade-based inclusiveness, the IFIs themselves benefit from the commercial opportunities in developing economies (particularly in emerging markets) and the positive reputation they gain for their development work in fragile economies (Ash, 2017).

IFIs partner as much with local financial institutions in fragile and developing markets, as they do with international institutions in facilitating access to trade finance. Providers of trade finance (including private banks) within fragile economies have an opportunity to engage more with IFIs, especially in the context of compliance-based de-risking that is critical to enabling trade. Trade financiers (external or local) may provide their support for increased assistance and expansion of IFIs trade finance programmes, either directly via transactional engagement, or by an advocacy work with senior leaderships at multilateral institutions. Advocacy on the gains and value of IFIs’ assistance for fragile states and developing economies can help advance the growth of these programmes, and contribute directly to enhanced global capacity in providing trade finance in some of the most complex and challenging markets in the world (Ash, 2017).

Note: Section 5 provides useful examples and lessons on the roles of IFIs (such as the African Development Bank, Asian Development Bank, Inter-American Development Bank, World Bank Group’s International Financial Corporation, and International Islamic Trade Finance Corporation) regarding trade financing to developing countries in different parts of the world.

4. Trade finance in crisis-ridden fragile economies

4.1 Trade finance and current account imbalances

The current account of a country represents its trade balance with the rest of the world (i.e. imports and exports of goods and services), together with net income and direct payments. As such, the current account also shows the international transfers of capital. Thus, unsurprisingly, **trade financing can be linked to the state of current accounts.** For instance, Beja (2006), who studied capital flight from Southeast Asia, noted that a large trade (or current account) balance would mean bigger trade financing – implying greater (official) capital movement. A good trade balance could also lead to reduced demand for external funds (i.e., external borrowing) as revenues from trade are now available for trade financing.

In linking trade finance with the state of current accounts, WTO (2007) noted that every supply chain transaction starts its life as a trade transaction and closes as a cash transaction in a current account with a bank. In between the trade and the cash, however, there are multiple handovers – which range from the warehouse operator to the shipping companies. Banks managing the trade and cash parts of the transactions are in a fortunate position of integrating the stream of information throughout a product life cycle.

ICC (2014) noted that a **substantial current account imbalance in fragile and developing countries (e.g. in the form of trade imbalances) could adversely impact their ability to trade** (or properly finance their trade) in an ever-increasingly competitive global market. For example, a report by Pakistan's National Committee of the International Chamber of Commerce (see ICC Pakistan, 2019) noted that use of unsustainable energy sources (such as coal- and LNG-fired plants) is increasing Pakistan's dependence on expensive fossil fuel imports, placing the country's current account deficit under growing pressure, lowering energy security, and adding to the nation's import burden – and, notably, creating further difficulties in trade financing. The report also indicated that an unsustainable trade financing (of fossil fuel imports) will put a growing strain on inflation and interest rates – generating a lasting challenge to economic growth.

Araujo et al. (2017), conversely, note that **trade financing may not necessarily be moving in the same direction as the overall state of an economy, e.g. the state of current accounts of these countries.**⁸ Low-income (or fragile) developing economies characteristically depend more on bank flows and trade finance, while in emerging economies cross-border flows take more the shape of tradable securities that have asset prices. These are procyclical and could lead to a rebalancing of portfolios (Araujo et al., 2017; Lane, 2015).

Chandrasekhar (2018) stressed that **there is a need for a safe (and sustainable) trade finance framework in fragile and developing countries – especially since trade (and economic) volatility has amplified considerably in recent decades. This, he argues, is due to the liberalisation of capital controls and the ensuing rise in cross-border flows of capital.** Capital flows are now pushed not by current account financing demands of the host country (e.g. fragile countries), but by the enthusiasm of foreign investors (e.g. financiers in developed economies) for equity and bonds offered in host country markets and that are open for investment by foreign capital. Because the volume of inflows and outflows is decided mainly by the supply side (i.e. by the appetite of foreign investors) and not by the financing demands of host developing countries, there is an inherent unpredictability about the amount of net cross-border flows. In addition, the underlying uncertainty is even bigger because these financing decisions are usually determined by external factors (e.g. an increase in US interest rates) that are far outside the host developing country.

4.2 Trade finance and economic crises

International trade relies heavily on the trade credit that is offered to businesses and about 90% of trade is usually financed by short-term credit. During the 2008/09 global financial crisis, trade finance was considerably slashed (i.e. as banks started to limit their credit risk exposure), coinciding with an approximate decline in world trade of around 10–15% (Auboin, 2009). Subsequently, there was a dual pressure on fragile countries – with dwindling trade financing credit and lower export earnings (Allen and Giovannetti, 2011).

Fragile countries could be affected differently during crisis – when compared to other (relatively stable and emerging) developing countries. Especially, exporters in fragile and complex low-income countries may finance themselves differently from exporters in other

⁸ Araujo et al. (2017) argue that the kinds of financing instruments available to international investors could be a factor that explains why financial flows in low-income (or fragile and complex) developing countries are less-procyclical.

developing countries (and in developed countries). This is mainly because i) the financial system is under-developed and highly risky in fragile economies and ii) firms do not have adequate self-finance and iii) small exporting firms in developing countries usually rely on letters of credit provided by credit institutions in destination countries. Nevertheless, letters of credit require confidence (which is understandably low during financial crisis) as well as the accessibility of liquidity to provide finance and insurance for payment to the exporters – which is also low in times global economic crises (Allen and Giovannetti, 2011).⁹

Low financing prospects have been shown to have historically inhibited the exports of fragile (and other) developing countries (see Berman and Martin, 2009). During a financial crisis, the authors emphasise, uncertainty is high, and trust and financial liquidity are low. In these conditions, banks and firms in the importer country first slash their exposure and credit to countries which are more at risk (e.g. fragile economies). This would adversely affect trade financing via disruptions to issuance of letters of credit, i.e. where the importer pays the exporting firm in advance (see section 6). For instance, World Bank's Global Monitoring Report of 2009 (see World Bank, 2009) noted that trade finance was vital to sustaining the multilateral trading system – highlighting that up to 20% of the USD15.8 trillion world merchandise trade in 2008 was based on secured documentary transactions, such as a letter of credit (LCs) (see section 5 and 6 for more on trade financing instruments).

The experience from the late 2000s global financial crisis has shown that as financial crises spread, the demand for LCs, insurance, and guarantees rises since exporters want to be certain that importers will be able to pay them on schedule (World Bank, 2009; Allen and Giovannetti, 2011). The excessive unpredictability linked to economic crises and the need for considerable risk assessments is likely to lead to bigger cost of trade finance for importers, exporters, and financial intermediaries. Moreover, exporters may themselves become incapable of repaying their debts, and this could provoke a vicious circle. Berman and Martin (2009) claim that, in the past, fragile economies (such as those in the Sub-Saharan Africa (SSA) region) were hit harsher and longer than other groups of countries – due to recessions and financial crises in the countries to which they were exporting (e.g. advanced economies).

5. Innovative instruments of sustainable trade finance: Evidence from IFCs

5.1 African Development Bank (AfDB)

Activities around trade financing in fragile and/or developing economies:

AfDB's trade finance programme was launched in February 2013 to lower the trade finance gap in African countries (including several fragile and complex developing economies in the region). The programme is big and is estimated at USD 100 billion annually. It offers partial payment guarantees to participating banks (Risk Participation Agreement – RPA). It also provides foreign exchange liquidity support to local banks and soft commodity aggregators

⁹ The international trade literature has (in recent years) offered evidence on the positive role of financial development on exports at a macroeconomic level (see Manova, 2013 and Beck, 2002; Allen and Giovannetti, 2011). This positive effect may partially emanate from the existence of fixed costs that have to be paid by firms to enter foreign markets. These costs also make financial constraints more stringent (Allen and Giovannetti, 2011).

or corporates. Private sector financial institutions (including regional development banks) and commodity corporates that are operational in any of the 54 African countries can benefit from the programme. State-owned agencies that fulfil certain requirements are also eligible for support (ICC, 2017).

The programme has delivered considerable support for the import and export of essential commodities and intermediary goods that are critical to the socio-economic development of fragile and developing countries (e.g. agriculture, forestry, fishing, and manufacturing, mining, and petroleum products). From August 2013 to December 2016, the AfDB supported more than 1,300 trade transactions – comprising of 85 financial institutions in at least 20 African economies, for a cumulative trade value of more than USD 5 billion. Of this amount, intra-African trade accounted for more than USD 1 billion, that is, representing 20 % of the total trade supported. Most of the support was in the form of portfolio guarantees. Roughly 50% of the transactions are attributable to SMEs (ICC, 2017).

Innovations in trade financing in fragile and/or developing economies:

In reply to the increasing market demand, the AfDB is also looking into the potential of providing novel instruments of single trade finance transaction guarantees (i.e. direct guarantees) to underwrite 100% of issuing bank payment risk. This financing instrument will supplement the existing RPA instrument that solely offers a partial risk guarantee. Direct guarantees would be extremely useful to international confirming banks that have strategic aspirations to expand their trade finance business on the continent but do not currently possess well-founded local correspondent banking relationships. Just as important is the need to encourage the use of alternative innovative and sustainable trade finance instruments across the continent. In this vein, AfDB is exploring the prospect of offering supply chain finance facilities to various banks, among various financing instruments. In a time where multilateral development banks and IFIs try to leverage their balance sheets to ‘do more with less’, AfDB notes that the development bank will continue to chase collaborative opportunities with other sister institutions that are active in trade finance on the continent – in areas such as co-sharing of risk, supply of joint short-term liquidity facilities, and support of capacity-building to local banks and co-sponsorship of thematic trade finance linked surveys and research endeavours, among others (ICC, 2017).

The AfDB has been responding rather quickly to crisis-prone developing countries on the African continent, many of which often have a heightened level of economic and political/security fragility. In 2016, for example, the AfDB authorised USD 960 million of trade finance facilities in the form of guarantees, short-term liquidity, and equity. This consisted of the payment of country membership subscriptions (equity) to the Africa Trade Insurance Agency (ATI) for Benin, Cote d'Ivoire, Ethiopia, and Zimbabwe to allow businesses in these countries to gain from ATI's trade credit insurance instruments. The impact of the decrease in the prices of major export commodities in 2015 spilt over to 2016 and continued to adversely affect the foreign exchange reserves of several African economies, thus limiting the availability of foreign currency for international trade financing. Key economies on the continent such as Nigeria and Angola were hard hit. Subsequently, several global banks became wary and curbed trade finance lines (both confirmation and liquidity) to banks in these countries (and other/fragile countries in the region). To mitigate the adverse effects of these changes, the AfDB acted fast to provide counter-cyclical trade finance loans to financial institutions in several countries in the region in 2016. For instance, in Nigeria, 3-year short-term trade loans were offered to banks – USD 300 to

First Bank of Nigeria, USD 50 million to FSDH Merchant Bank Limited and USD 310 to Ecobank Group. These trade loans were for use by subsidiary banks, including Ecobank Nigeria. AfDB's support in trade financing was crucial in allowing these banks to settle outstanding trade obligations and expedite the import-export of vital commodities (ICC, 2017).

The AfDB is also supplementing its traditional and innovative trade financing instruments with provisions of technical assistance (i.e. capacity building) to local banks in fragile and developing economies of the region. In AfDB's 2016 'Trade Finance in Africa' survey, when banks were asked about what the major obstacles to the growth of their trade finance business were, banks cited insufficient staff capacity as one of the key constraints. This gap in capacity adds to the sluggish rollout of several non-traditional trade finance instruments such as supply chain finance and other structured trade solutions. AfDB is, consequently, investigating numerous forms of partnerships to offer trade finance e-learning training remedies for local banks in Africa (ICC, 2017).

5.2 Asian Development Bank (ADB)

Activities around trade financing in fragile and/or developing economies:

ADB's Trade Finance Programme (TFP) supports the development of the banking sector in developing economies, mainly in the Asia-Pacific (including some fragile states in the region). ADB's TFP aided over 1,500 SMEs in 2016. This figure is especially valuable to ADB, as SMEs are known to be a foremost source of job creation. Furthermore, ADB's annual survey, 'Trade Finance Gaps, Growth, and jobs Survey', validates that SMEs are most affected by the lack of trade finance provision. ADB's TFP will also continue to offer as much backing as possible to SMEs via its expanding Supply Chain Finance Programme (SCFP) (ICC, 2017).

The spreading of useful information on TFP to eligible countries and partner banks has created a tangible developmental impact. ADB's TFP conducts regular discussions with banks and insurance institutions, including their risk management departments, to offer useful information that aids these agencies in moving into frontier (i.e. underdeveloped and fragile) markets or maintain and improve limits to support trade financing. The TFP's comprehensive due diligence and risk monitoring procedures, together with its routine presence in its countries of operation, reinforce its capacity to offer useful information. ADB's TFP also offers training and seminars on trade finance and banking. In 2016, for instance, ADB undertook several training seminars in Nepal, Cambodia, Myanmar (twice that year in a country with high institutional and social fragility),¹⁰ Mongolia, Uzbekistan, and the Philippines. TFP has also been conducting annual regional conferences on trade finance in Central Asia, which has witnessed successful attendance by banks in over eight countries of the region (ICC, 2017).

ADB's TFP fills the market gaps in the region for trade finance instruments by delivering guarantees and loans, but more crucially by mobilising larger private sector resources to fill those gaps. In 2013, for instance, over 50% of ADB's TFP activities characterised co-financing and risk-sharing with private sector entities. Crowding-in the private sector has a considerable development effect. By delivering (partial) guarantees to private sector, banks in

¹⁰ <http://pubdocs.worldbank.org/en/333071582771136385/Classification-of-Fragile-and-Conflict-Affected-Situations.pdf>

developed markets (i.e. financial institutions with the necessary funds but that are wary of risks in fragile markets), the TFP facilitates the way for global private financial institutions and investors to move into frontier/fragile markets. As such, TFP is working to diminish the market gap in trade finance in the most difficult markets, both via its direct support and through the mobilisation of private resources into challenging markets and fragile economies. This helps to generate long-term relationships (credit lines) between banks in developed countries and those in fragile and developing economies. With these novel relationships, greater financial links are generated to support trade, job creation and economic growth in the region (ICC, 2017).

Innovations in trade financing in fragile and/or developing economies:

ADB's TFP has rolled out a novel trade finance product in 2017 called the Funded Risk Participation Agreement (FRPA) – where TFP provides disbursements to partner financial institutions against a basket of underlying trade transactions. The trade finance funds will be utilised to take part, on a 50/50 risk share arrangement, in 'issuing bank' risk linked to funded trade transactions (e.g., trade loans, discounting). When the underlying transactions are settled, the funds may be recycled for new transactions (ICC, 2017).

5.3 Inter-American Development Bank (IDB)

Activities around trade financing in fragile and/or developing economies:

IDB's Trade Finance Facilitation Programme (TFFP) supports developing country banks in the Latin America and the Caribbean (LAC) region – among which are some countries with economic and state/political fragility – to access international trade finance markets through guarantees, loans, advisory services, and knowledge products. The programme, which was established in 2005, seeks to stimulate development and economic growth in the region by intensifying and diversifying the sources of trade finance available for LAC banks and guaranteeing liquidity in periods of market volatility. As such, the TFFP seeks to expand and bolster trade finance support available for LAC importers and exporters via their banks and in assisting the region's integration in international and intraregional supply chains (ICC, 2017).

As a part of the 'beyondBanking' strategy, the TFFP supports its several customer countries (including some fragile economies) through technical cooperation, knowledge creation and the 'access2Markets' financial product line. The 'access2Markets' product line offers financial products that enable banks and funds to gain access to new capital sources and to expand their foreign trade portfolio, while promoting an efficient exchange of goods and services. These financial products consist of (i) loans to trade finance funds, which mobilise equity investors to directly finance LAC importing/exporting companies and (ii) TFFP trade guarantees and loans to LAC financial intermediaries. One of the fundamental pillars of IDB's novel business strategy is the launch of a new set of legal documents, which are market-friendly (i.e. they meet the market requirements) and improve IDB's processing efficiency. This enables

the TFFP to increase its transaction volumes which in turn, is beneficial to all involved banks and their importing and exporting customers (ICC, 2014).¹¹

IDB sees access to inclusive and sustainable trade finance as an essential part of its overall ‘beyondBanking’ strategy. ‘beyondBanking’ reassures financial intermediaries to go beyond their traditional role as lender and risk manager and to endorse a business model that balances financial and social returns – and, thus, fosters an environmentally friendly, inclusive, transparent and commercially-viable local financial sector. ‘beyondBanking’ acknowledges financial intermediaries as cost-effective networks to get to end-borrowers – especially those SMEs that reside in high impact sectors such as trade. In this respect, the IDB launched its Small Banks Initiative in 2007. This was aimed at integrating a group of smaller financial intermediaries, mostly focused on MSMEs into the TFFP and to effectively increase their ability to access trade financing. Together with the integration component, the initiative also envisions a capacity-building component, providing technical assistance to these smaller financial intermediaries and to enhance their international trade subdivisions – making sure that they become active participants as members of the IDB’s TFFP network (ICC, 2014).¹²

Innovations in trade financing in fragile and/or developing economies:

Aside from the TFFP, the IDB is also considering growing the scope of its support to LAC trade via diverse and innovative financing products. This, for example, comprises (ICC, 2014; 2017):

- I. **Provision of trade finance funds:** The IDB backs trade finance funds which consist of third-party equity and long-term funding offered directly to LAC exporting businesses. IDB assists trade finance funds to reach critical mass and connect with a wider universe of exporters that have insufficient trade financing from traditional sources (e.g. local banks) by applying structured trade finance procedures, created to supplement traditional trade finance banking services and enhance the competitiveness of financing options for exporters and importers in the region. The IDB has also been creating projects that are funded via an impact fund (registered on the U.S. Securities and Exchange Commission (SEC)) which will mobilise institutional and retail investors to boost trade finance in the region. With this effort, IDB, in conjunction with the fund, is turning out to be an innovator in the mainstreaming of trade finance impact investing in the LAC region.
- II. **Provision of medium and long-term credit to banks:** In its continuous exploration for novel and sustainable ways of assisting the development of businesses in the LAC region (i.e. through internationalization and trade), the IDB is also assisting innovative projects that can add to lowering the trade finance gap, fostering foreign investment, and

¹¹ Within this new business strategy, TFFP trade lending to financial intermediaries in the LAC is gaining relative importance. TFFP trade loans are portfolio-based loans to finance eligible trade transactions that allow greater transaction tenors (e.g. up to three years) and greater mobilisation of the funding resources available to LAC banks and their importing and exporting customers through co-financing and syndicated structures. These loans, apart from providing liquidity, cover the gap in the medium-term trade finance market that Multilateral Development Banks (MDBs) or commercial banks presently do not participate in (ICC, 2014).

¹² Particular to the TFFP, IDB’s commitment to developmental impact is proven by: (i) the share of individual trade transactions from small and vulnerable economies financed (48% since the program’s inception), (ii) the number of individual trade transactions for amounts under USD 500,000 (61% of the total since the program’s start), and (iii) the volume of ‘south-to-south’ trade financed (23% of the total TFFP trade volume in 2013) (ICC, 2014).

enhancing access to finance for LAC businesses. One such example relates to the SME Internationalization Financing Partnership that was signed in 2013 with BAC International Bank (Panama) and its subsidiaries in Nicaragua, Honduras, El Salvador, and Guatemala. The partnership extended credit financing to SMEs in their corresponding countries, with up to 50 % of the proceeds aimed at assisting the internationalisation of SMEs.

- III. **Undertaking capital markets operations:** The IDB is also seeking to grow its product offering in the capital markets domain, through the provision of financial intermediaries with financing structures that meet their requirements, while supporting LAC businesses, and realising a high developmental impact. For example, the IDB approved a USD150 million long-term financing for Banco Industrial (BI) in Guatemala via a Diversified Payment Rights Programme (DPR) to boost access to financing for MSMEs in the country. IDB financing is secured by USD denominated payment obligations for the benefit of BI. The funds arise from commercial transactions, remittances, and foreign currency transactions. Trade-related transactions constituted 83% of the total flows in 2014. The DPR Programme structure offers solid risk improvements, granting longer tenor financing (e.g. up to 12 years) and improved pricing.

5.4 International Finance Corporation (IFC): World Bank Group

Activities around trade financing in fragile and/or developing economies:

The IFC introduced the Global Trade Finance Programme (GTFP) in 2004 as an international bank network linking developing country market institutions with international banks. The aim was to facilitate trade (e.g. offer trade finance) and generate fresh opportunities for firms to take part in global value chains. After GTFP's success, IFC has launched other initiatives, such as the Global Trade Liquidity Programme (GTLP) and Critical Commodities Finance Programme (CCFP), to expand the access to trade and commodity finance in developing economies (ICC, 2017).

To fight climate change and encourage the use of clean energy and energy-efficient technology in developing countries, IFC's Climate Smart Trade introduced special incentives for GTFP guarantees on qualifying goods in 2013. Since its launch, the programme has assisted developing country importers and exporters across the world, financing the trade in climate-change-related goods. In Nigeria¹³, for instance, a three-year EUR 4.3 million guarantee has assisted to fund the construction, testing, commissioning, and supervision of the Kashimbila hydroelectric dam (ICC, 2014).

Innovations in trade financing in fragile and/or developing economies:

Building on the effective model of Climate Smart Trade, IFC and the Banking Environment Initiative have launched the Sustainable Shipment Letter of Credit. This is a novel financing

¹³ Although Nigeria is an emerging economy and does not fall into the category of 'fragile states' (i.e. countries with high institutional and social fragility), it has been in a "conflict-affected situation" in its recent history. See <http://pubdocs.worldbank.org/en/333071582771136385/Classification-of-Fragile-and-Conflict-Affected-Situations.pdf>

solution to broaden the trade of 'sustainably sourced' products and promote the growth of sustainable global supply chains. This innovative instrument allows for preferential treatment for trade in agricultural goods that fulfil globally accepted sustainability requirements. Palm oil with a 'Roundtable on Sustainable Palm Oil' (RSPO) certificate was the first product eligible for this programme, and more commodities are being incorporated (ICC, 2014).

Other value chains in which IFC has so far been able to offer capital relief to banks and raise extra funding are agriculture and refined fuels – products that are essential to economic development of the poorest, fragile and most vulnerable countries in the world. IFC's risk mitigation instruments have provided relief to banks since 2012. This is for their exposures to corporates via structured commodity finance programmes as well as targeted supplier finance and warehouse finance programmes. In countries such as Mali, Senegal, and Tanzania, farmers (and agricultural processors and traders) are gaining from over USD 500 million in warehouse finance lines – which have been used to unlock the value of their products and more effectively manage their cash flows. IFC has also enhanced its expertise in structured commodity finance with its projects in Ethiopia and Mauritania. Further, through a notable and innovative two-year, USD 300 million revolving facility, the IFC has helped to fully secure the import of crude oil to Cote d'Ivoire (ICC, 2014).

5.5 International Islamic Trade Finance Corporation (ITFC)

Activities around trade financing in fragile and/or developing economies:

ITFC offers trade finance to member countries of the Islamic Development Bank Group and Organisation of Islamic Cooperation (OIC). This includes several developing (and fragile) countries – mainly in Middle East and North Africa (MENA), Asia, and sub-Saharan Africa.¹⁴ Furthermore, the ITFC at times offer its trade finance services to non-member countries (i.e. outside the 57 current OIC member states).¹⁵

Most of the approved projects financed ventures in the crude and petroleum products sector, followed by agriculture, minerals, and chemicals. The region that has obtained the most finance is Asia, followed by MENA and sub-Saharan Africa. Of the total commitments by instrument, 70% were sovereign, while 20% were guaranteed by the bank (ICC, 2017).

A big portion of ITFC's trade finance portfolio in sub-Saharan Africa is allotted to the agricultural sector, which has a significant impact on improving food security for farmers. In fact, agriculture holds the largest share (54%) of ITFC's trade financing portfolio for the region. It is worth noting that even though agriculture financing is mainly for cash crops (specifically, cotton and groundnuts), it nevertheless helps improve food security as farmers use a portion of the agricultural inputs to cultivate their food crops (ICC, 2017).

ITFC's trade financing, for example, supports the groundnut subsector in Senegal and the Gambia since groundnut products are important to the economies and livelihoods of

¹⁴ Few European (i.e. Albania) and Latin American countries (i.e. Suriname and Guyana) are also members of the Islamic Development Bank Group and Organisation of Islamic Cooperation.

¹⁵ <https://www.oic-oci.org/states/?lan=en>

Senegal and The Gambia. As a basic food crop, groundnut is playing a central role with regard to poverty reduction and food security because it provides a source of income for over 1.1 million small-scale farmers in the two countries. It also makes a contribution to livestock feeding and export revenues. Further, groundnut crop cultivation, processing, and trade all have an effect on the socio-economic development of the two countries. According to the findings of a joint study conducted by ITFC and ITC in 2011, (in terms of its impact to foreign exchange earnings and the lessening of trade deficits) groundnut products averaged around 27% of total Gambian exports and less than 5% of Senegalese exports. Local value addition via small- and medium-scale processing is deemed vital for both i) the development of the national industrial base and ii) an increase in the value of exports in both countries. With that perspective, ITFC financed the subsector in both Senegal and the Gambia. Given that the state is engaged in the marketing of groundnut in the two countries (i.e. with state-owned enterprises), ITFC partners with the governments to fund the subsector (ICC, 2017).

ITFC's involvement in trade financing for the groundnut subsector in Senegal and the Gambia (with a total aggregate of about USD 200 million) supported the export of groundnuts to numerous international destinations, especially in Europe and Asia. A significant effect of ITFC financing of the groundnut subsector in the two countries is that it removed the credit buying of nuts by the Groundnut Company. Previously, farmers sold their nuts for Promissory Notes issued by the Groundnut Company. However, there had been various instances where farmers supplied their groundnuts but only got paid several months after the sale of their groundnuts. These practices were pressuring farmers to find an alternative means of selling their nuts for cash. Nevertheless, this was creating substantial difficulty to the farming communities since groundnut cultivation was their sole source of income for most of these farmers (ICC, 2017).

Innovations in trade financing in fragile and/or developing economies:

A crucial innovation and change in trade financing at ITFC is the transition from a 'transaction-based' strategy to an 'integrated programming'. particularly, ITFC is moving to programmes that integrate the Corporation's two core instruments of intervention – i.e., 'trade finance' and trade related 'capacity building'. **The overall aim of the integrated programme approach is to improve the overall developmental impact of the ITFC response to trade financing issues.** These programmes will be directly linked to the achievement of the three main strategic goals of ITFC, which are: i) expanding intra-OIC trade; ii) supporting the process of diversification of the economies of member countries; and iii) global growth in Islamic finance (ICC, 2017).

6. Other trade finance instruments provided by non-IFIs

6.1 Bank supplied trade finance

Trade Finance services and instruments offered by banks to importers and exporters may include opening letters of credit; accepting and confirming letters of credit, and discounting letters of credit; provision of working capital loans or overdraft; and issuing performance, bid and advance payment bonds. Such trade financing services and instruments are usually denominated in hard currencies, excluding working capital loan or overdraft (see Contessi and Nicola, 2012; Auboin and Meier-Ewert, 2003).

Letters of credit

One of the most commonly used ways exporters in developing (and fragile) countries use trade finance is via documentary credit, which depends on commercial letters of credit. With this financing instrument, the issuing bank states its obligation to pay the beneficiary (exporter) a specific amount of money at the request of the buyer (importer) – if the seller is in compliance with the terms and conditions in the sale contract between the buyer and the seller. Conversely, this financing instrument permits the importer to use his cash flow for alternate purposes instead of paying the exporter for a specific period. Meanwhile, the letter of credit guarantees that the exporter will be paid on time. This trade financing instrument is especially fitting for international contracts that are challenging to enforce and riskier than domestic contracts since the creditworthiness of the foreign counterparty is difficult to assess (Contessi and Nicola, 2012; Auboin and Meier-Ewert, 2003).

Credit to buyer or supplier

Credit (to buyer or seller) counters the off-balance-sheet trade financing offered by documentary credit and characterizes the more traditional form of bank lending. It may take place in the shape of working capital provisions, overdraft facilities or term loan facilities (Contessi and Nicola, 2012). To help an exporter, a bank in the exporting country might offer a loan to a foreign buyer to pay for the purchase of the export items. This procedure gives the buyer a longer time to pay the seller under the contract, that is Buyer's Credit (Auboin and Meier-Ewert, 2003). In other instances, the exporting company (and not a bank) may provide credit directly to the buyer in the importing country (e.g. a fragile economy), to give the buyer time to pay the seller under the contract, i.e. Supplier's Credit (Auboin and Meier-Ewert, 2003).

Pre- and Post-shipping Financing

With these types of trade financing instruments, a bank may provide short-term loans, discount letters of credit or offer advance payment bonds for the exporter. This will help to make sure that the exporter has adequate working capital for the time prior to shipment of the exports and that the exporter can bridge the period between shipping the goods and obtaining payment from the importer of his goods (Auboin and Meier-Ewert, 2003).

Avalised bill

Some exporters also depend on 'bill avalisation' for their trade financing. In this case, the buyer's bank guarantees payment to the seller – in the event that the buyer will not pay (Contessi and Nicola, 2012).

Other instances of documentary credit include advance payment guarantees, customs bonds (these instruments enable the delay of tax payments up until the goods are sold), and customs bonds for provisional transit – which relinquish payment of duties if goods are imported with the purpose of being exported (Contessi and Nicola, 2012).

6.2 Fintechs supplied trade finance (novel trade finance market)

Fintechs are non-bank institutions that use innovative and advanced technologies to provide traditional banking services. Expanded regulatory measures for banks in recent years (e.g. Basel III, Basel II) have made it difficult to do banking in certain jurisdictions that have stricter compliance rules about transparency, consumer protection, and capital requirements. Further, providing financial support to SMEs (particularly to those in developing/fragile countries) necessitates specialised risk-assessment and evaluation models that banks are not always willing or able to adopt. At times, however, new alliances between Fintechs and banks have been created. The ICC noted in its 'Global Survey on Trade Finance 2017' report, that Fintechs count key financial institutions amongst their shareholders (OECD, 2017; Tralac, 2017).

Fintechs make use of big data and cloud-based technology to provide innovative (and proven) financing services – e.g. in trade finance, marketplace lending, micro-lending, and 'robo-investment platforms.' Most of these start-ups have still not been subject to the same regulatory inspection and constraints – thus, giving them an edge over conventional banks. Regulators are in the initial stages of catching up with these financing models. Blockchain is another emerging and transformative financing model. It is a digital ledger of trade-related financial transactions that can be traceable at any point in time – and is communicated among participants with the necessary access rights. Whilst traditional trade finance obliges each participant to keep their administration and databases, Blockchain integrates the financial information on transactions in a single digital document. Payments can be scrutinized by both parties, and banks can look at the original contract, in addition to the order placed among companies. As such, banks can authenticate both the validity and state of fulfilment at any time (OECD, 2017; Tralac, 2017).

6.3 Other types of trade financing

In fragile and complex low-income countries (i.e. where the role of banks is relatively low), companies may also use other instruments to finance their transactions, i.e. without the need for the intermediary role of banks or even the new Fintech trade finance instruments. These may include i) bills of exchange, through which a seller can get an undertaking from the buyer to pay at a specified future date, as well as ii) promissory notes, in which a buyer agrees to pay at a future date, but which provide less legal cover than bills of exchange (Auboin and Meier-Ewert, 2003).

Countertrade

Countertrade instruments are arrangements used in situations and countries where there is a scarcity of foreign exchange reserves or liquid assets (e.g. in fragile and complex economies). That is, in circumstances that make the normal exchange of goods for money difficult. Under these arrangements, buyers and sellers concur that goods will be traded between them at a fixed value without requiring the use of cash or credit terms. As an alternative, barter-exchange, counter-purchase or buyback promise will be utilized (Contessi and Nicola, 2012; Auboin and Meier-Ewert, 2003).

Export Credit Insurance: government institutions

There are several circumstances in which alternative financing instruments are offered to exporters by host governments and government-related institutions. As such, these types of supports should be considered part of trade finance. One of these institutions are 'Export Credit Insurance Agencies', which are otherwise known as 'Investment Insurance Agencies'. These agencies act as financial intermediaries between the exporters and their national governments. They provide financial and insurance services to protect trade partners from different types of risk. The risks may vary from currency fluctuations to political riots and other scenarios of considerable political distress (i.e. events that are common in fragile states and are disruptive to economic activities). These agencies may offer short (e.g. for up to 180 days) or long (e.g. for up to three years) term insurance to exporters. They offer the exporters with the credit they require to cover costs linked to production and transportation. Central banks of some countries offer refinancing schemes through which they discount the commercial bills of exporters at favourable rates. These refinancing schemes of the central banks work in a similar way to 'forfeiting' (see next sub-section). In other countries, specialised financial agencies, such as Export-Import Banks, particularly focus on fulfilling the trade financing needs of exporters' and importers' (Contessi and Nicola, 2012).

Forfeiting

With forfeiting, the exporter remits guaranteed debt from a sale on credit to a third party (i.e. financial firm) which upfront pays the face value of debt (minus a discount) to the seller in cash. Therefore, the seller is no longer responsible for any default of the importer when the debt comes to maturity. Thus, the discount is basically the price the exporter is willing to pay to transfer the risk of default to the financial firm (Contessi and Nicola, 2012). That is, the exporter sells receivables with no recourse at a discounted rate to a specialised house and the receivables, thus, becoming tradable financial instruments or securities (Auboin and Meier-Ewert, 2003).

Trade insurance: for exchange rate risks

Other trade financing instruments play the role of insurance against the risks associated with international and domestic trade, primarily price fluctuations, or currency fluctuations. Instances of such contracts are options, forward contracts, futures, swaps, and spot contracts. These instruments provide the exporter and the importer the potential to insure against the losses linked to the risk of exchange-rate or price fluctuations – which are all too common to businesses in fragile and developing economies (Contessi and Nicola, 2012).

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