



# Trade Finance Infrastructure Development Handbook for Economies in Transition



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*The shaded areas of the map are ESCAP Members and Associate members.*

# Trade Finance Infrastructure Development Handbook for Economies in Transition



**United Nations**  
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**International Trade Centre**  
UNCTAD/WTO

# Trade Finance Infrastructure Development Handbook for Economies in Transition

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## Foreword

This *Handbook* is one of the products developed under a three-year project funded through the United Nations Development Account and aimed at building the capacity of selected ESCAP member countries with economies in transition in the area of trade and investment, with a view to enabling them to respond more effectively to the challenges and opportunities emerging from the globalization process.

As part of this project, a series of eight national training workshops on trade finance infrastructure development were held in Central Asia, the South Caucasus and Mongolia. Most of the training material developed for these workshops is summarized in this *Handbook* and an accompanying CD-ROM.

The *Handbook* is targeted mainly at officials from ministries in charge of trade who need to acquire a basic understanding of trade finance and the importance of trade finance infrastructure development. Information provided in the *Handbook* may help to strengthen the trade finance aspects of national trade development strategies and to foster a better understanding of the issues and mechanisms that may need to be discussed with officials in charge of financial sector regulation and supervision.

On the other hand, the *Handbook* may also provide a platform for financial system regulators to better understand the point of view of trade officials and traders and their needs. Selected chapters may also be of interest to officials from ministries or agencies in charge of information and communication technology with the main responsibilities of developing e-commerce, online banking and e-payment systems.

The first a chapter provides a general introduction to trade finance and trade finance infrastructure development, and an overview of trade finance methods and instruments is given in chapter II. Legal issues and conventions related to the main trade finance instruments are discussed in chapter III, and chapter IV is dedicated to structured trade and commodity finance. The relationship between trade finance and the macroeconomic environment is examined in chapter V and the importance of institutions for trade finance development is highlighted in chapters VI. Issues related to international payment systems and e-trade finance development are addressed in chapters VII and VIII. The *Handbook* concludes with a proposed trade finance infrastructure development framework based on ITC trade finance pointers methodology and inspired by the ESCAP Trade Facilitation Framework.

This *Handbook* is the result of close collaboration between ESCAP and a number of international organizations that provided relevant expertise and knowledge. Mr. Lee Yow Jinn, ESCAP consultant and Senior Adviser at the International Trade Institute of Singapore contributed most of the two introductory chapters as well as the chapters on payment system development and e-trade finance. Mr. Carlo Cattani, Senior Trade Finance Adviser, and Mr. George Mills, Consultant, both from the International Trade Centre UNCTAD/WTO contributed most of the material presented in chapters III and IV. Mr. Lamon Rutten

and Ms. Frida Youssef, both from the Division on International Trade in Goods and Services, and Commodities of the United Nations Conference on Trade and Development, contributed the chapter on structured trade and commodity financing. Finally, Mr. Yann Duval, ESCAP Trade and Investment Division, provided overall coordination and guidance for the preparation of the *Handbook* and contributed chapter VI.

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## LIST OF ABBREVIATIONS

ACU	Asian Clearing Union
ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
ASEAN	Association of Southeast Asian Nations
B2B	business-to-business
CIS	Commonwealth of Independent States
D/A	documents against acceptance
D/P	documents against payment
EBRD	European Bank for Reconstruction and Development
ECGF	export credit and guarantee facility
ECI	export credit insurance
EDC	enterprise development corporation
EDI	electronic data interchange
EFTPOS	electronic fund transfer at point of sale
ESCAP	Economic and Social Commission for Asia and the Pacific
EXIM Bank	export-import bank
FDI	Foreign direct investment
FIDIC	International Federation of Consulting Engineers
GDP	gross domestic product
GNI	gross national income
ICC	International Chamber of Commerce
ICT	information and communication technology
IMF	International Monetary Fund
IOB	Internet-only bank
ISDA	International Swaps and Derivatives Association
ISP	International Standby Practices
ITC	International Trade Centre UNCTAD/WTO
L/C	letter of credit
LIBOR	London Inter-Bank Offer Rate
MAS	Monetary Authority of Singapore
PKI	public key infrastructure

x

SME	small and medium-sized enterprise
SOE	state owned enterprise
STCF	structured trade and commodity financing
STE	state trading enterprise
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TFIS	trade finance institutional structure
TPO	trade promotion organization
UCP	Uniform Customs and Practice for Documentary Credits
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNIDROIT	International Institute for the Unification of Private Law
URC	Uniform Rules for Collection
URCB	Uniform Rules for Contract Bonds
URDG	Uniform Rules for Demand Guarantees
WTO	World Trade Organization

## I. AN INTRODUCTION TO TRADE FINANCE

### A. Introduction

International trade, the cross-border exchange of goods and services, is now widely acknowledged as an important engine of growth in most developing and transition economies. The recent ministerial meetings of WTO have further demonstrated the importance of international trade and investment flows, with many developing economies joining hands to vigorously defend their interests in this area. While countries need to actively engage in negotiations with others to create a favourable international environment, each must also ensure that its *domestic environment* is favourable to trade development.

Whether the domestic environment is favourable can ultimately be measured by the economic cost of importing or exporting specific goods and services into or from the domestic market. In most economies, major transaction cost factors would include transportation and financing (including insurance) as well as red tape. Unpredictable and/or uncompetitive transportation, financing or procedural and documentation costs can all be formidable barriers to trade for SMEs.

The financing of trade and investment has long been identified as one of the most challenging issues faced by new enterprises and SMEs in developing or transition economies. The issue of financing is particularly important, as financing is needed not only during the export process itself, but also for the production of the goods and services to be exported, which may include imports of raw material or intermediate goods. Lack of financing at any time during the production and/or the export process will result in a failed transaction.

### B. Trade finance and trade development strategy

To understand the significance of trade finance, it is important to view it in the context of an overall trade development strategy whose purpose is to develop and expand sustainable trade flows to support the country's economic development.

Figure 1.1. Trade development strategy

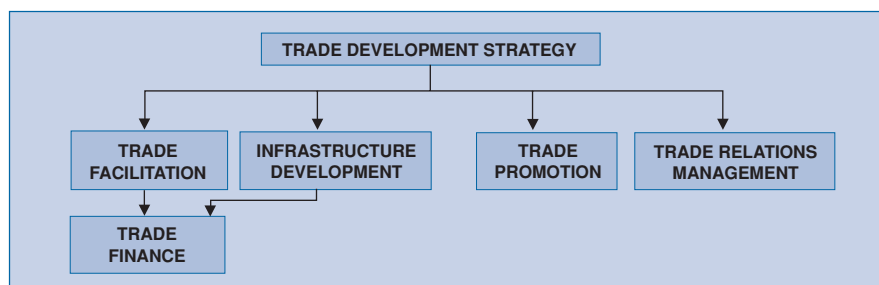


Figure 1.1 suggests that a comprehensive trade development strategy includes four main components, with trade finance issues being addressed as part of trade facilitation and infrastructure development. Key elements of the strategy are discussed below.

#### *Trade relations management*

International trade relations management involves developing cordial trade relations with other countries to safeguard a country's trade interests and to ensure market access for its products and services. It also involves responding to restrictions placed on products by importing countries. Trade negotiations may be conducted at three levels, namely bilateral, regional (e.g., ASEAN free trade area, AFTA) and multilateral (i.e., WTO).

#### *Trade promotion*

Trade promotion consists of programmes and activities to promote and develop trade with other countries. It includes measures to help establish and improve a country's or a firm's participation in trade fairs, trade missions and publicity campaigns, as well as providing information and advice on overseas market prospects, contacts and access. More generally, it covers the way in which a country assists its exporters to enter markets overseas, to expand their presence in those markets and to make their products competitive.

#### *Infrastructure development*

Infrastructure development is necessary to enable the handling of larger trade volumes and to increase the diversification of traded goods and services. It includes the provision of basic utilities, such as power and water, but also the development of warehousing, transportation, shipping and information technology infrastructures, and the establishment of related administrative bodies and systems. Efficient and effective banking and payment systems are important elements of the trade infrastructure.

#### *Trade facilitation*

Trade facilitation, often referred to as the "plumbing" of international trade, focuses on the efficient implementation of trade rules and regulations.<sup>1</sup> In its narrowest sense, trade facilitation may be defined as the systematic rationalization of procedures and documentation for international trade. In its wider sense, however, it covers all the regulatory measures that affect the flow of imports and exports. The main objective of trade facilitation is to minimize the transaction costs and complexity of international trade for businesses, while maintaining efficient and effective levels of government control.

Trade facilitation contributes to overall trade development strategy by optimizing the use of the trade infrastructure and complements trade promotion efforts by improving the country's image as an efficient trading centre. It also enhances the development and

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<sup>1</sup> ESCAP, *Trade Facilitation Handbook for the Greater Mekong Subregion* (United Nations publication, sales No. E.03.II.F.5), 2002 (available online at [www.unescap.org](http://www.unescap.org)).

management of trade relations by making trade regulations and procedures more transparent and consistent with international conventions and standards.

### *Trade finance*

Trade finance refers to the financing of imports and exports, one of the major challenges facing businesses that endeavour to compete in global markets. Facilitating access to trade finance requires the development of a trade finance infrastructure, defined in this *Handbook* as the institutions, laws, regulations and other systems related to the following three activities:

- (a) Provision of capital to firms that are engaging in international trade transactions;
- (b) Provision of support services to manage the risk involved in these transactions;
- (c) Provision of international payment mechanisms.

The absence of an adequate trade finance infrastructure is, in effect, equivalent to a barrier to trade. Therefore, Governments whose economic growth strategy involves trade development may consider supporting the development of an efficient trade finance infrastructure as part of their trade facilitation action plans, i.e., one that is able to provide traders with a variety of trade finance tools and instruments at competitive prices.

## **C. Importance and benefits of trade finance**

Trade accounts for about one half of the gross national income of developing countries and financing that trade has become increasingly important to a country's development prospects. Trade finance, provided by commercial banks, export credit agencies, multilateral development banks, suppliers and purchasers, has grown by about 11 per cent annually over the last two decades. Because trade finance eases creditor's risk, as it is tied to the traded goods, it may be seen as a way for poor countries to gain broader access to financial markets.<sup>2</sup>

However, the primary benefit of improved access to trade finance is to facilitate and expand trade, by providing traders with appropriate instruments to support their trading activities. The benefits of trade finance to traders can be broadly classified into three areas:

### *Reduced capital outlay*

Trade finance provides companies with the necessary capital and liquidity and helps them to better manage their cash flow, allowing them to expand and grow.

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<sup>2</sup> Dailami et al., "Harnessing cyclical gains for development", in World Bank, *Global Development Finance* (Washington, D.C., World Bank, 2004).

### *Reduced risks*

Apart from capital, traders would also need support systems to help them manage risks associated with international trade transactions. The development of a sound and secure trade finance infrastructure will increase the number of options available to traders to reduce or eliminate risks associated with non-payment or payment delays, fluctuation in exchange rates, changes in trade and financial regulations and political unrest, among others.

### *Increased competitiveness*

Terms of payment are increasingly used as competitive tools during contract negotiation. Buyers would generally favour a contract that provides certainty and attractive credit terms. Traders with access to a wide array of trade finance tools and instruments are better equipped.

Numerous trade finance methods and instruments exist to support traders throughout the trade cycle. An overview of these methods and instruments is provided in chapter II, while legal issues related to their use are discussed in chapter III. Chapter IV provides additional information on structured commodity and trade financing techniques.

## **D. Trade finance infrastructure development**

The availability and affordability of the above-mentioned trade finance tools and instruments to domestic traders will depend on the level of development of the trade finance infrastructure, as defined earlier. Two important issues related to trade finance infrastructure development are (a) the development of a favourable macroeconomic and legal environment for trade finance and (b) the development of institutions to support or provide trade finance.

### *Trade finance and the macroeconomic environment*

Because trade finance tools and instruments are primarily offered by or through financial institutions, the level of development of the trade finance infrastructure is closely linked with that of the overall financial sector. It can therefore be expected that a stable macroeconomic environment will be an important factor in the development of trade finance, along with an open economic policy.

Some of the factors that affect the development and availability of trade finance are discussed in chapter V, which includes a methodology that may be used by Governments as a simple way to assess and monitor over time how favourable the macroeconomic and legal environment is for trade finance. This methodology, conceptualized by ITC and pilot-tested in Central Asia and other transition economies in cooperation with ESCAP in 2004, may assist countries in identifying the weaknesses of their trade finance infrastructure and the potential impediments to trade finance development.



### *Institutions for trade finance development*

To participate efficiently in international trade, a country needs sound monetary and banking policies, transparent fiscal and financial regimes, and functioning capital and insurance markets. To increase physical capacity, a country also needs a legal and regulatory framework that encourages domestic and foreign investment. But is that enough for the development of trade finance? Should trade finance be left to private sector financial institutions or is there a role for public institutions in actively supporting the provision of trade finance services, particularly to SMEs?

Chapter VI proposes a model trade finance institutional structure based on the various models that have developed in some of the fast-growing export-oriented developing countries of the ESCAP region. It contains recommendations taking into account the particularities associated with newly independent States and transition economies.

### *Payment system development*

An international transaction is not complete until payment has been received. Cross-border payment systems form an integral part of the overall banking and financial system and are an essential part of the trade finance infrastructure.

A payment system is a set of institutions, laws, regulations and other mechanisms needed for a buyer to make a payment and a seller to receive that payment. An effective payment system should be designed to meet the financial needs of buyers and sellers. For importers and exporters, this means that the payment system must be capable of providing for accurate, secure, efficient and affordable international payments.

Chapter VII describes the different elements that together constitute a payment infrastructure, focusing on international payment system issues and highlighting the importance of legislation as well as regional cooperation.

### *E-trade finance infrastructure development*

Recent advances in ICT now allow trade transactions and payments to be managed over a secure Internet protocol. To reduce procurement costs and turn-around time, most multinational companies are already using the Internet to source internationally their raw material and maintenance, repair and operations (MRO) items. Banks and other financial institutions as well are increasingly relying on the Internet to provide their customers with banking services, from basic online banking to e-payment and online credit applications. Most international payments are now made electronically.

Internet-based trade finance products and services are also growing and private consortiums have been created to provide traders with more complete (integrated) trade finance and logistics solutions. Chapter VIII describes the various components, models and potential benefits of e-banking and e-trade finance systems and services, highlighting the many challenges associated with their development.

## E. Trade finance and international organizations

A number of international and regional organizations are directly or indirectly involved in trade finance infrastructure development in Asian and Pacific transition economies. At the global level, BIS, ICC, IMF, ITC, UNCTAD, UNCITRAL, and the World Bank are among the most important organizations (this is, however, a non-exhaustive list). At the regional level, ADB, EBRD and ESCAP have all been involved in trade finance infrastructure development. A brief overview of each of these institutions and their role appears below.

### *At the global level*

#### (i) Bank for International Settlement

BIS is an international organization that fosters cooperation among central banks and other agencies in pursuit of monetary and financial stability. One of the major components of BIS is the Basel Committee on Banking Supervision.

The Basel Committee recently issued a revised framework for international convergence of capital measurement and capital standards, commonly known as Basel II. This framework is a revision of the 1988 Basel Accord aimed at further strengthening the soundness and stability of the international banking system. Basel II has implications for trade finance as it stipulates a set of requirements in the area of capital adequacy and credit risk exposure that banks should fulfill. (Website: [www.bis.org](http://www.bis.org))

#### (ii) International Chamber of Commerce

ICC plays a very important role in the development of international rules and practices for trade finance. Two of the major contributions of ICC to global trade finance infrastructure development include:

- ICC Uniform Customs and Practice for Documentary Credits (UCP 500) are the rules that banks apply to finance billions of dollars' worth of world trade every year;
- ICC Incoterms are standard international trade definitions used in most, if not all, contracts that involve cross-border shipments and payments.

ICC model contracts also make it easier for small companies that cannot afford an in-house legal department to engage in international trade. (Website: [www.iccwbo.org](http://www.iccwbo.org))

#### (iii) International Monetary Fund

IMF was established to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide countries with temporary financial assistance to help ease balance of payments adjustments. IMF also provides technical assistance with a view to enhancing the effectiveness of economic policy and financial policy through capacity-building and policy design.

While the central focus of IMF is on the international monetary and financial system, it works closely with WTO to provide a sound system for global trade and payments. Some trade-related areas in which IMF is involved include current and prospective WTO agreements on financial services and investment, trade debt and finance, and preventing disruptions to trade finance during financial crises. (Website: [www.imf.org](http://www.imf.org))

#### (iv) International Trade Centre UNCTAD/WTO

ITC is the technical cooperation agency of UNCTAD and WTO for operational, enterprise-oriented aspects of trade development. ITC has a dedicated trade finance programme focusing on facilitating access to finance for SMEs that export from developing and transition countries.

ITC provides technical assistance aimed at strengthening schemes and mechanisms offered by financial institutions in both the private and public sectors in the fields of export finance, short-term trade credit and trade credit insurance and guarantees. The technical assistance is also aimed at building up the capacity of entrepreneurs and credit officers for dealing with credit and financial risk management. (Website: [www.intracen.org](http://www.intracen.org))

#### (v) United Nations Conference on Trade and Development

UNCTAD provides information, analysis and technical assistance in a wide range of trade-related areas. The UNCTAD Division on International Trade in Goods and Services and Commodities is active in technical assistance and capacity-building in the area of agricultural and commodity trade finance, while its Division for Services Infrastructure for Development and Trade Efficiency covers e-trade finance issues. (Website: [www.unctad.org](http://www.unctad.org))

#### (vi) United Nations Commission on International Trade Law

UNCITRAL is responsible for a number of conventions and model laws directly or indirectly related to trade finance. Relevant UNCITRAL instruments are discussed in chapter III. (Website: [www.uncitral.org](http://www.uncitral.org))

### Box 1.1. The Islamic Development Bank

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in December 1973. The Bank was created to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of Islamic law.

The Bank helped to establish the Islamic Corporation for Insurance of Investments and Export Credit (ICIEC) as a half-owned subsidiary in 1994. ICIEC offers insurance products for investments and export credit that are compatible with Islamic requirements. The current membership of the Bank consists of 55 countries, including many economies in transition.

*Source:* [www.isdb.org](http://www.isdb.org); [www.iciec.com](http://www.iciec.com)

### (vii) World Bank

The World Bank is another specialized agency of the United Nations and one of the world's largest providers of development assistance. The "World Bank" is the name that has come to be used for the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). Together, these organizations provide developing countries with low-interest loans, interest-free credit and grants.

In addition to IBRD and IDA, three other organizations make up the World Bank Group. The International Finance Corporation (IFC) promotes private sector investment by supporting high-risk sectors and countries. The Multilateral Investment Guarantee Agency (MIGA) offers political risk insurance (guarantees) to those who invest in and lend to developing countries. The International Centre for Settlement of Investment Disputes (ICSID) settles investment disputes between foreign investors and their host countries.

Aside from financing large infrastructure projects in developing countries, the World Bank Group supports large-scale reforms that often have a direct impact on trade finance development and availability. The research and analytical activities of the World Bank also cover trade finance issues. (Website: [www.worldbank.org](http://www.worldbank.org))

### *At the regional level*

#### (i) Asian Development Bank

ADB is a multilateral development finance institution dedicated to reducing poverty in Asia and the Pacific. Established in 1966, ADB has 63 members, including most of the countries of Central Asia as well as one country from the South Caucasus (Azerbaijan). The type of technical assistance that ADB may provide for SME trade finance development is illustrated in box 1.2. (Website: [www.adb.org](http://www.adb.org))

#### (ii) European Bank for Reconstruction and Development

EBRD was established in 1991 to support the newly independent States of the former Soviet Union. Today, EBRD invests in emerging market economies and democracies in 27 countries from Central Europe to Central Asia and provides them with technical assistance. The largest single investor in Central Europe and Central Asia, it mobilizes significant FDI beyond its own financing.

The EBRD Trade Facilitation Programme promotes foreign trade with Central and Eastern Europe and CIS. The Programme provides guarantees for international confirming banks, eliminating the political and commercial payment risks of transactions undertaken by issuing banks in the countries where EBRD operates. The Programme can guarantee any genuine trade transaction associated with exports or imports involving the countries in which EBRD operates. Over 70 issuing banks in the EBRD region of operations participate in the Programme together with about 440 confirming banks throughout the world. (Website: [www.ebrd.org](http://www.ebrd.org))

**Box 1.2. ADB programmes for SME trade finance development in Pakistan**

The ADB SME Sector Development Programme (SDP) for Pakistan identified the lack of access to finance as one of the inhibitors to SME development. The existing prudential regulations of the State Bank of Pakistan require financial information and physical collateral for lending. This results in bank lending policies and processes that effectively preclude SME access to finance. Banks have yet to realize the full potential of the SME market from a commercial perspective and lack the skills to develop profitable financial services for SMEs.

The assistance of ADB involved the following:

- (a) Supporting the State Bank in preparing SME-neutral prudential regulations;
- (b) Strengthening the support infrastructure and improving the coverage of credit information;
- (c) Restructuring the SME Bank so that it can play an important and effective role in serving SMEs;
- (d) Improving access to risk capital.

In addition to the SME Sector Development Programme, ADB has assisted the Government in facilitating SME access to trade finance under the SME Trade Enhancement Finance Programme which has four components, including:

- (a) A \$150 million revolving Foreign Currency Export Finance Facility;
- (b) A Partial Risk Guarantee facility for letters of credit confirmation;
- (c) An equity investment of up to \$2 million in the Pakistan Export Finance Guarantee Agency to provide an alternative to traditional collateral instruments.

**(iii) Economic and Social Commission for Asia and the Pacific**

ESCAP is the regional branch of the United Nations in Asia and the Pacific. The Trade and Investment Division of ESCAP implements a concerted mix of research and operational activities to assist developing countries and economies in transition in the development of their trade and investment policies, in close cooperation with WTO, UNCTAD, ITC and other relevant agencies.

One of the key roles of ESCAP is to promote regional cooperation. As such, it facilitated the creation of ADB, the Asian Clearing Union and the Asian Reinsurance Corporation. (Website: [www.unescap.org](http://www.unescap.org); [www.asianclearingunion.org](http://www.asianclearingunion.org); [www.asianrecorp.com](http://www.asianrecorp.com))

### Box 1.3. The Asian Clearing Union

The Asian Clearing Union (ACU) is one of several clearing houses/payment arrangements operating in various regions of the world. It currently has eight participating members: Bangladesh, Bhutan, India, Iran (Islamic Republic of), Myanmar, Nepal, Pakistan and Sri Lanka. Its objectives are to facilitate payments among member countries for eligible transactions, thereby economizing on the use of foreign exchange reserves and transfer costs, as well as promoting trade among the participating countries.

ACU was formed in 1975 with the assistance of ESCAP. Its specific objectives are the following:

- (a) To provide a facility to settle on, a multilateral basis, payments for current international transactions among the participants;
- (b) To promote the use of participants' currencies in current transactions between their respective territories and thereby effect savings in the use of participants' exchange reserves;
- (c) To promote monetary cooperation among participants and closer relations among their banking systems and thereby contribute to the expansion of trade and economic activity among the countries of the ESCAP region;
- (d) To provide for currency arrangements among participants so as to make Asian monetary units available to them temporarily.

The Asian monetary unit is the "currency" ACU. The accounts of ACU are held in this currency, the value of which is currently equivalent to that of the United States dollar.

ACU has been successful since the start of its operations, none of its members ever having defaulted.

*Source:* [www.asianclearingunion.org](http://www.asianclearingunion.org)

## F. For further reading

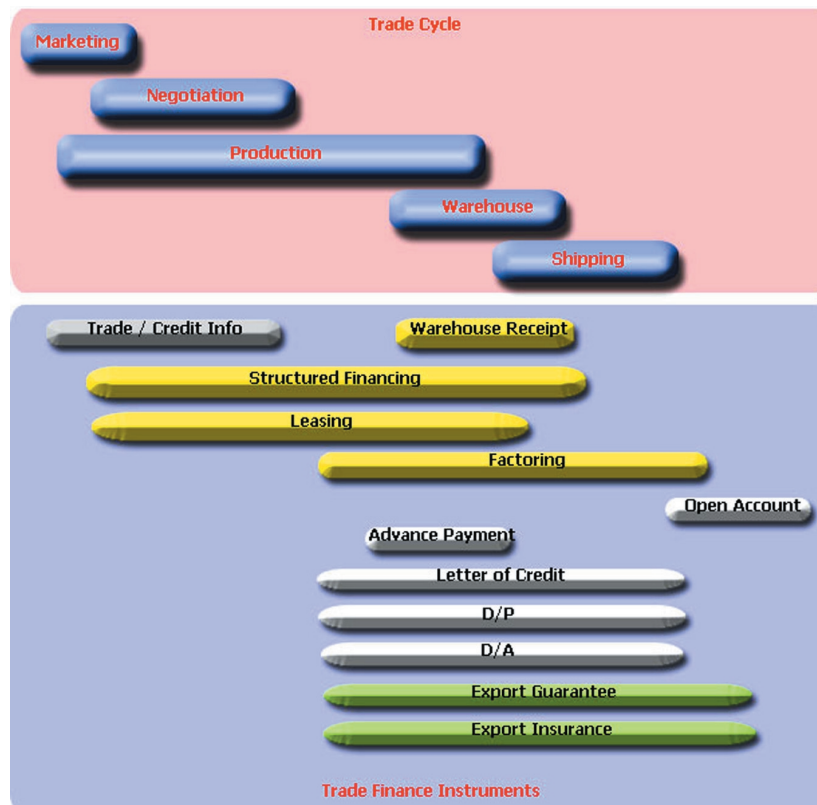
- United Nations Online Network in Public Administration and Finance, "Financing development projects: public-private partnerships and a new perspective on financing options", statement by Myoung-Ho Shin, Vice-President (Region West) at the OECD/DAC Tidewater Meeting, Penha Longa, Portugal, 24-26 June 2001 (available online at <http://unpan1.un.org>).
- WTO, *Special Studies 2: Electronic Commerce and The Role of the WTO*, 1998 (available online at [www.wto.org](http://www.wto.org)).
- WTO, "WTO provisions relevant to the relationship between trade and finance and trade and debt" (WT/WGTDF/W/3), Note by the secretariat, 21 June 2002 (available online at [www.wto.org](http://www.wto.org)).
- Mansoor Dailami, "Harnessing cyclical gains for development", in World Bank, *Global Development Finance* (Washington, D.C., World Bank, 2004) (available online at [www.worldbank.org](http://www.worldbank.org)).

## II. Trade finance methods and instruments: an overview

### A. Introduction

In international trade, overseas buyers rarely want to pay cash in advance for imported goods and services. Consequently, exporters have to provide credit and secure short-term financing until they receive payment. As shown in figure 2.1, numerous trade finance methods and instruments have developed to meet the needs of traders throughout the trade cycle.

**Figure 2.1. Trade cycle and trade finance methods and instruments**



Trade finance methods and instruments can be broadly classified into three categories:

- Methods and instruments to raise capital (in yellow in figure 2.1)
- Methods and instruments to mitigate risks (in green in figure 2.1)
- Methods and instrument to effect payment (in light grey in figure 2.1)

Selected methods and instruments in each category are briefly described below.

## **B. Methods and instruments to raise capital**

Companies often need financing to market, promote and manufacture their products and services. The financing needs of companies involved in international trade transactions are usually categorized as follows:

- (a) Pre-shipment financing: this is financing for the period prior to the shipment of goods, to support pre-export activities, such as wages and overhead costs. It is especially needed when inputs for production must be imported. It also provides additional working capital for the exporter. Pre-shipment financing is especially important to smaller enterprises because the international sales cycle is usually longer than the domestic sales cycle. Pre-shipment financing instruments can take the form of short-term loans, overdrafts or cash credits;
- (b) Post-shipment financing: This is financing for the period following the shipment of goods. The competitiveness of exporters often depends on their ability to provide buyers with attractive credit terms. Post-shipment financing thus ensures adequate liquidity until the purchaser receives the products and the exporter receives payment. Post-shipment financing is usually short-term.

Pre- and post-shipment financing may come in the form of secured or unsecured loans or lines of credit from banks or financial institutions. Common methods used to obtain such financing are explained below.

### *Factoring, export receivables financing or advance against documentary bills*

The exporter who sells goods to an overseas buyer on credit terms requests his bank to make an advance based on such documents as a bill of exchange, a bill of lading or a simple invoice. The lending bank generally advances from 50 to 100 per cent of the invoice value, depending on the perceived risk.

### *Inventory financing*

An inventory of raw material or intermediate or finished products is used to secure a loan. Inventory financing is commonly used to finance trade in commodities, since commodity producers and traders typically hold substantial inventories. Inventory and warehouse receipt financing are discussed in more details in chapter IV in the context of structured commodity finance.

### *Leasing*

Some banks and financial institutions provide leasing as a medium- to long-term means of financing. Leasing is generally of interest to manufacturing companies that need to import equipment or machinery to produce goods for export. The company procures the equipment and pays a monthly rental fee to a leasing company (or bank), which owns



the equipment. Leasing thus allows an exporter to acquire capital goods for export production without having to make a large one-time cash outlay.

### Structured financing

Structured financing often refers to schemes whereby the lender extends a loan to the borrower by securitizing the current assets of the borrower over which the lender has control. These assets, including streams of expected cash inflows, serve as collateral for the loan. Structured financing techniques can be used for short-term financing as well as capital investment in countries where traditional financing is not available (or too onerous). However, structured financing deals are specific to each transaction or operation being financed and thus require a level of financial expertise rarely available in emerging economies. Structured financing is discussed in greater detail in chapter IV.

## C. Methods and instruments to manage risks

As mentioned in chapter I, companies dealing with international trade have to manage their risks. These risks may be classified into four categories: economic or commercial risks, exchange rate risks, transportation risks and political risks. Figure 2.2 shows some examples of the various types of risks and the methods that may be used to mitigate or reduce them.

Figure 2.2. Risks in international trade and mitigation methods

Risk Category	Economic (commercial) risks related to the trading partner	Exchange rate risk	Transportation risk	Political risks		
				Foreign policy	Domestic policy	Economic policy
Examples	<p>Importer is not willing or unable to pay</p> <p>Importer does not accept merchandise</p> <p>Exporter does not deliver on time or products agreed</p>	<p>Floating exchange rates: variations in exchange rates</p> <p>Fixed exchange rates: risk of devaluation</p>	<p>Damaged or loss of goods</p>	<p>War</p> <p>Embargo</p> <p>Restrictions</p>	<p>Revolt</p> <p>Civil War</p>	<p>Prohibition to transfer foreign exchange</p> <p>Currency declared non-convertible</p>
Methods to mitigate risks	<p>Private insurance or public export credit agencies</p> <p>Letter of Credit</p> <p>Bank guarantees</p>	<p>Bank provide hedging facilities; public exchange risk insurance</p>	<p>Private insurance</p>	<p>Export credit agencies or private insurance</p>		

Source: WTO, "Trade, Finance and Financial Crises", Special Studies 3.

Some of the common financial instruments that importers and exporters can use to manage their risks are introduced below.

### *Forfaiting*

Forfaiting is a term generally used to define the purchase or sale of rights and obligations arising from the delivery and acceptance of goods and services due at some future date and without recourse to any previous holder of the obligations. It is a form of supplier credit, which means that the supplier offers credit terms to the buyer and then sells the debt to a bank without recourse. This allows the seller to reduce his exchange rate risk and to eliminate most non-payment risks.

### *Hedging*

Exporters and importers can manage foreign exchange risk by hedging. Hedging a particular currency exposure means offsetting a currency position by another so that whatever is lost or gained on the original currency exposure is offset by a corresponding foreign exchange gain or loss on the currency hedge. Hedging can reduce the volatility of a company's cash flows because the company's payments and receipts are not forced to fluctuate in accordance with currency movements. The two most common hedging methods are forward and future contracts.

#### (i) Forward contracts

A forward contract is a contract made today for delivery of an asset at a specified time in the future and at a price or exchange rate agreed upon today. The price is therefore fixed and will not be affected by currency fluctuation.

Alternatively, a company can arrange a forward contract with its bank. This involves entering into a contract with a bank today under which the bank undertakes to exchange the foreign currency received from the company at an agreed exchanged rate. The agreed exchanged rate is usually the forward rate of the bank for a predetermined time frame (for example, six months).

#### (ii) Futures contracts

A futures contract is similar to a forward contract, but it is traded on organized exchanges with standardized terms (in contrast, forward contracts are traded over-the-counter and are customized one-off transactions between a buyer and a seller). Intermediate gains or losses on a futures contract are posted each day during the life of the contract.

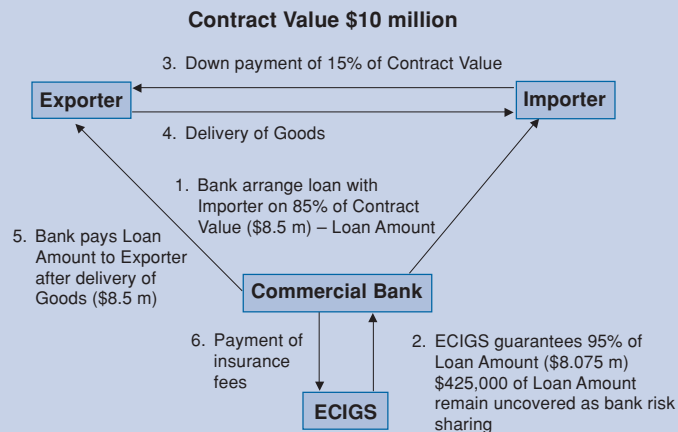
One of the major international financial futures exchanges is Euronext ([www.euronext.com](http://www.euronext.com)). Governments in emerging economies are also creating commodity futures exchanges to help producers and traders to manage their price risk and facilitate the price discovery process (the Agricultural Futures Exchange of Thailand is an example. For more information, see [www.afet.or.th](http://www.afet.or.th)).

*Export credit insurance*

An exporter may protect himself by purchasing ECI against non-payment for his trade receivables arising from either commercial or non-commercial risks. Depending on the type of ECI they select, exporters may protect themselves from risks associated with the non-acceptance of goods by the buyer, the failure of the buyer to pay the debt, the failure of foreign banks to honor documentary credits, as well as risks associated with war, riots and civil commotion, bans on foreign exchange transfers and currency devaluation. However, ECI does not usually cover risks normally covered by marine, fire and other types of insurance offered by traditional commercial insurance companies. ECI may be offered by both private insurance companies and government-backed export credit agencies (see chapter V, on trade finance institutions).

**Box 2.1. Export transaction with credit guarantee: An example**

In this example, the exporter has successfully negotiated a contract worth US\$ 10 million with an overseas buyer. However, the buyer has requested a 180-day credit. The exporter is not able to cope with the lack of cash flow or the risks of extending credit for the contract. His bank is also not willing to lend such a large amount without a guarantee.



The bank agrees, however, to arrange for a loan with the importer for 85 per cent of the total contract value (step 1), if the Export Credit Insurance and Guarantee Service (ECIGS, generally backed by the Government) provides a guarantee for 95 per cent of the loan value (step 2). This guarantee ensures that the bank will receive 95 per cent of the loan value in case the buyer does not repay the loan.

Once the loan and guarantee are in place, the importer pays the exporter 15 per cent of the contract value (step 3). After delivery of the goods (step 4), the exporter claims the outstanding 85 per cent of the contract value from the bank. The bank remits the remaining 85 per cent of the contract value to the exporter after deducting the fee payable to ECIGS (step 6).

### *Export credit guarantee*

Export credit guarantees are instruments to safeguard export-financing banks from losses that may occur from providing funds to exporters. While export credit insurance protects exporters, guarantees protect the banks offering the loans. They do not involve the actual provision of funds, but the exporters' access to financing is facilitated (see box 2.1).

An export credit guarantee is typically provided by a public institution or government agency to a commercial bank. Such a guarantee will allow exporters to secure pre-shipment financing or post-shipment financing from a bank more easily. Even in situations where trade financing is commercially available, banks may look unfavourably upon companies without sufficient track records. Therefore, providing the banking system with financial guarantees for purveying export credit is an important element in helping local companies to export. The agency providing this service has to carefully assess the risk associated with supporting the exporter as well as the buyer.

## **D. Terms of payment**

When negotiating a contract, supplier and buyer will have to agree on the terms of payment. Generally, there are four types of payment terms: payment in advance, open account, documentary collections and letters of credit.

### *Payment in advance*

Payment in advance, or advance payment, refers to a situation in which the seller requests payment from the buyer before he will ship the goods. The seller only ships out the goods to the buyer after receiving the payment. The settlement method used is likely to be SWIFT payment, telegraphic transfer or bank draft.

#### **Box 2.2. Some best practices for advance payment**

##### **Seller:**

- Give the buyer clear payment instructions, including mode of payment (for example, by SWIFT).
- Avoid accepting bank drafts (cheques) or company cheques.
- If you are asked to issue an advance payment guarantee, instruct your bank to make the guarantee "inoperative" until you receive the payment.

##### **Buyer:**

- Avoid this arrangement. Try offering a letter of credit instead.
- Insist on an advance payment guarantee. This will allow you to recover the payment if the seller fails to fulfill his part of the contract.

### *Open account*

In an open account transaction, the seller ships the goods together with the necessary documents to the buyer before the payment is made and without any form of guarantee. When the goods have been dispatched, the seller also sends the buyer an invoice asking for payment within the agreed credit terms, for example, 60 days from the invoice date.

#### **Box 2.3. Some best practices for open accounts**

##### **Seller:**

- Do not agree to an open account when the buyer is new to you or you are unable to determine the risk or the reliability of the buyer.
- Keep in mind that your goods are delivered before payment; therefore, make sure that you supply your goods or services in accordance with the contract terms, thus avoiding disputes and non-payment.
- Insist on an electronic transfer (cleared funds) instead of a bank draft or cheque (uncleared funds).

##### **Buyer:**

- Make sure that the goods or services are satisfactory before you effect payment.
- Make sure that payment is made in accordance with the agreed credit terms to avoid damaging your trading relationship with the supplier.
- Make sure to pay according to the settlement instructions.

### *Documentary collections*

Documentary collection offers some protection to the seller. It is more secure than shipping on an open account basis but less secure than using a letter of credit or an advance payment. With a documentary collection, the seller asks his or her bank to obtain the payment from the buyer (through the buyer's bank) in exchange for related shipping documents.

As shown in figure 2.3, the documents are released to the buyer on the basis of documents against payment (D/P) or documents against acceptance (D/A) terms. With D/P, the buyer is given the documents (step 8) when a payment is made to the bank (step 7). In the case of D/A, a bill of exchange accompanies the collection order. A bill of exchange is a written order addressed by the seller to the buyer, asking the buyer to pay a certain amount of money on a specified date. By accepting the bill of exchange, the buyer agrees to pay on that date. The documents are released to the buyer when he or she accepts the bill, in which case the buyer's bank holds the bill until it matures (ends) and the buyer pays the seller.

#### Box 2.4. Some best practices for collections

##### Seller:

- Make sure that you are satisfied with the buyer and country risks before agreeing to this method.
- Make sure that you supply your goods and services in accordance with the contract terms in order to avoid disputes.
- Make sure that your collection instructions are clear and match the terms of the contract exactly.

##### Buyer:

- When you are asked to pay or accept the bill of exchange, make sure that the terms are exactly as you agreed in the contract.
- If possible, make sure that the goods or services are satisfactory before you instruct your bank to pay or before you accept the bill of exchange.
- Make sure that you have received the correct documents needed to obtain the goods. Once you are satisfied that everything is in order, respond promptly when asked to pay or accept the bill of exchange.

#### *Letters of credit*

Otherwise known as a documentary credit or a commercial letter of credit, the L/C is one of the most commonly used methods of payment in international trade. An L/C offers the seller the security of knowing that he will be paid while offering the buyer the assurance that payment will only be made when his bank is presented with documents that keep to the terms of the L/C.

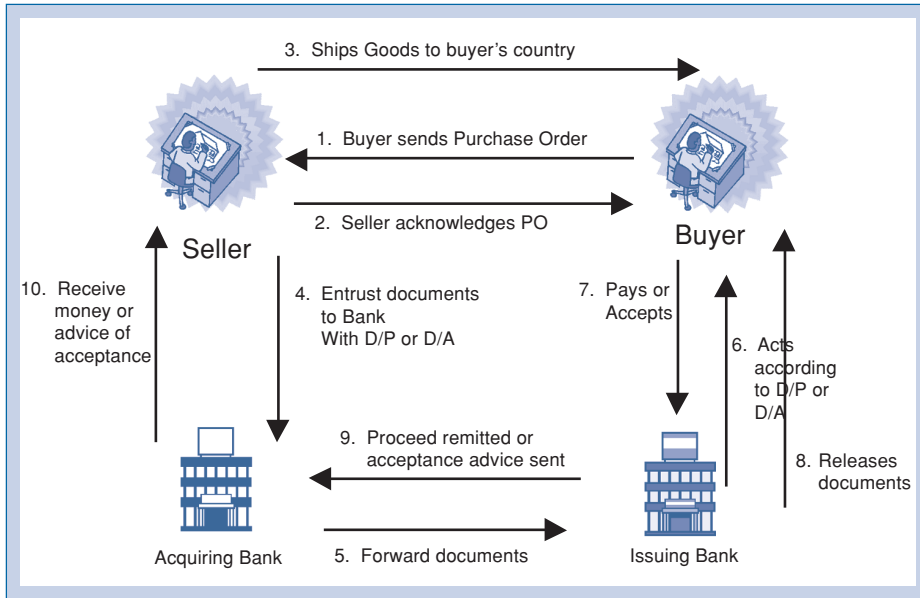
When both the buyer and seller agree on using the L/C as a mode of payment, the buyer first obtains the L/C from his bank. This is different from documentary collection, where the seller initiates the process with his bank.

As shown in figure 2.4, the buyer applies for the L/C from his bank in step 4. Once approved, the L/C is forwarded to the advising bank (step 5). The advising bank, which acts on behalf of the seller, has to confirm whether the L/C is in order. Once this is confirmed, the seller releases the shipping documents (step 8). The issuing bank releases the payment once the buyer has confirmed the collection of the goods.

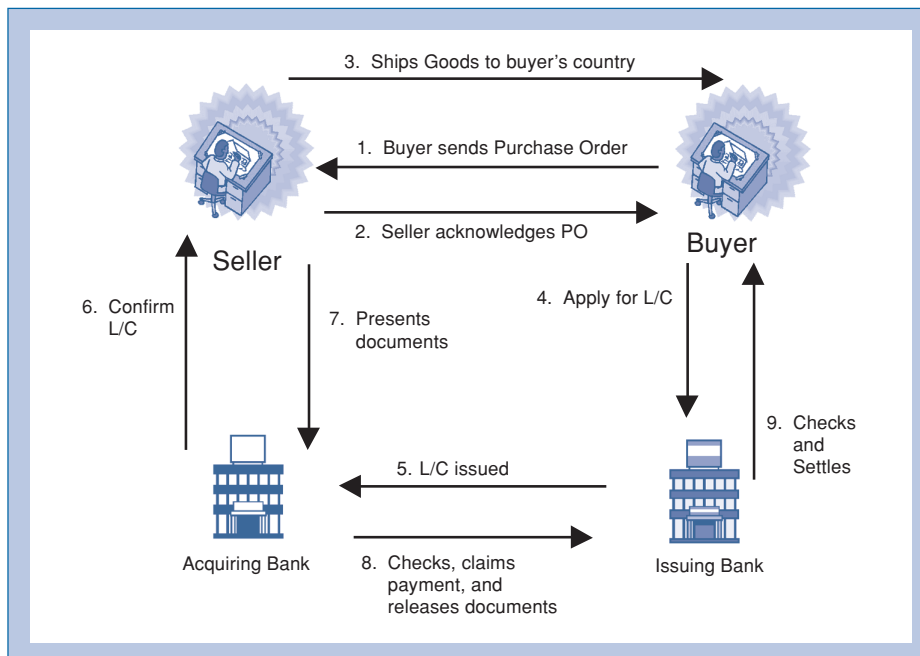
#### *Terms of payment and associated risks*

Each of the four payment methods described above carries associated risks and offers a different level of protection to importers and exporters. For example, a payment method that is considered risk-free for the exporter (e.g., advance payment) is considered very risky for the importer. Figure 2.5 ranks the payment terms based on the level of risk they entail for exporters and importers.

**Figure 2.3. Documentary collection process**



**Figure 2.4. Letters of credit**



**Box 2.5. Some best practices for letters of credit****Seller:**

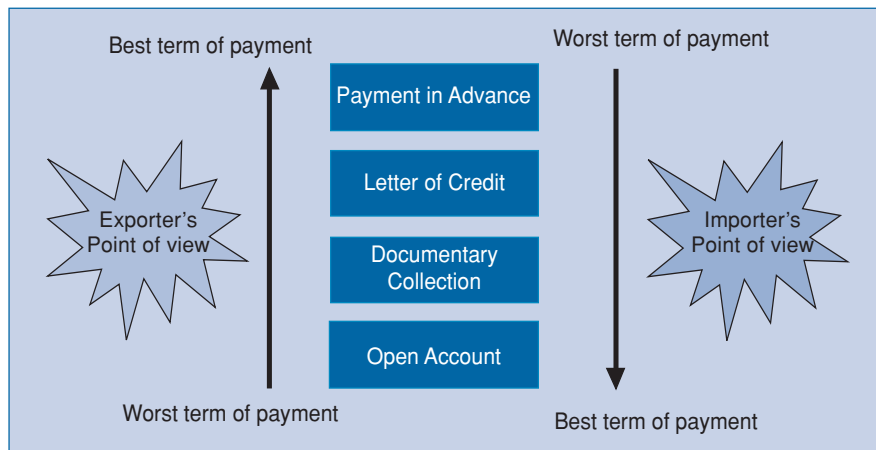
- Make sure that a local bank has authenticated the letter of credit. If you receive a letter of credit directly from a foreign bank, forward it to your bank to have its details verified and have it authorized.
- Examine the letter of credit carefully and make sure that it keeps to the terms of the sales contract.
- Make sure that you can present all the documents named.
- Be extremely careful in preparing your documents. Remember that the guarantee is conditional and the bank will effect payment solely on the basis of the documents. If your documents do not keep to the terms of the letter of credit, you lose your guarantee of payment.
- If the political or economic situation in the buyer's country worries you, you should not ship the goods. Asking a reputable bank to confirm the letter of credit may reduce the economic and political risk.

**Buyer:**

- Check with your bank in good time and make sure that you have enough credit with your bank.
- Be careful in completing your application and make sure that your guarantee is issued according to the contract terms. The shipment will not take place until the seller is satisfied, so aim to have the guarantee issued in good time and avoid the time and cost of amendments.
- Use the opportunity to negotiate extended credit terms, if possible.
- Make sure that you call for all the necessary documents so that the goods pass to you smoothly.
- Insist on terms that you think are important to protect your interest, such as latest shipment dates or other such terms.

As shown in figure 2.5, L/C and documentary collections (D/P or D/A) offer the best compromise in managing the risks undertaken by exporters and importers.



**Figure 2.5. Comparison between various terms of payment**

### E. For further reading

- “An introduction to trade finance”, ESCAP, *Trade Facilitation Handbook for the Greater Mekong Subregion* (United Nations publication, sales No. E.03.II.F.5), 2002 (available online at [www.unescap.org](http://www.unescap.org)).
- A well-developed domestic financial system can go a long way towards facilitating trade by making trade financing easier. The issue of mobilizing domestic finance for development is addressed in the report of the Regional Expert Group Meeting on Mobilizing Domestic Finance for Development, a joint ESCAP-ADB workshop (available online at <http://www.un.org/esa/ffd/escap-rpt2001.pdf>).
- The International Trade Centre (ITC), a joint initiative of UNCTAD and WTO, is a source of practical guides and manuals on international trade finance issues (see [www.intracen.org/tfs/docs/overview.htm](http://www.intracen.org/tfs/docs/overview.htm)).
- Daniele Giovannucci, Panos Varangis and Don Larson, *Warehouse Receipts: Facilitating Credit and Commodity Markets*, World Bank.
- WTO, *Special Studies 3: Trade, Finance and Financial Crises*, 1999 (available online at [www.wto.org](http://www.wto.org)).
- Daniele Giovannucci, *Basic Trade Finance Tools: Payment Methods in International Trade*, World Bank.

### III. Trade finance methods and instruments: legal issues and conventions

#### A. Introduction

As discussed in chapter II, a variety of instruments and methods exist to help traders secure credit internationally with competitive rates, mitigate the risks stemming from international transactions and ensure payment for goods and services. The availability and effectiveness of these tools, however, is often based on relatively complex but important legal considerations.

This chapter therefore provides a legal perspective on many of the trade finance methods and instruments introduced in the previous chapter, highlighting key legal issues and pointing to international rules and conventions that may be used to address them.<sup>3</sup>

#### B. Trade credit legal issues

In general, trade credit can be used to finance payments for both domestic and international commercial transactions. Short-term credit is used to pay for the goods and services necessary for business transactions. Goods covered in this category of transaction include raw materials and consumable goods used in the production process as well as the processed goods themselves. Long-term credit is used for general corporate financing purposes or to allocate payment for goods to be used over long periods of time, most commonly for industrial production purposes.

##### *Commercial credit*

The time period granted by the supplier between the delivery of the goods and the receipt of payment is the most common form of non-banking credit, generally called commercial credit. It is a facility based on a prior agreement between the purchaser and the supplier. It is the simplest method and the quickest to set up, and often the least expensive for the purchaser as well.

Based on mutual trust between the parties, commercial credit does not require any official document or the involvement of a third-party financier. Instead of paying by cheque or credit transfer upon receiving the goods, the purchaser may, subject to the agreement, issue a promissory note, which is a commitment to make a forward payment. When the supplier does not know the purchaser well, he may require payment by means of a bill of exchange from his client.

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<sup>3</sup> A more detailed discussion of the legal issues presented in the present chapter may be found in an ITC publication entitled *Trade Finance: A Legal Guide for Cross-Border Transactions* (ITC, 2003) (see [www.intracen.org/tfs](http://www.intracen.org/tfs)).

### *Invoice discounting*

Invoice discounting is a funding operation available to companies that provide a product or services on credit terms to their customers. The advantage of discounting lies in the fact that the supplier has a choice regarding the bills of exchange that he wants to discount, which allows both flexibility and speed in the transaction. On the other hand, there is an element of cost involved in this solution: the discount rate.

There are two kinds of invoice discounting: confidential invoice discounting, which is provided for established, profitable companies with a strong balance sheet; and disclosed invoice discounting, which is provided for companies whose balance sheets are not very strong.

### *Short-term banking facilities*

Instead of, or in addition to, obtaining commercial credits or discountable receivables, the supplier may decide that he needs a more regular external source of financing to pay for goods and services. The most common type of financing that answers this concern is the bank overdraft.

In theory, overdrafts are repayable on demand or after notice is given, but often they are allowed to run on indefinitely, subject to a periodic review. An advance is reduced or repaid whenever the account is credited with deposits and recreated when new checks are drawn upon it, interest being paid only on the amount outstanding. Security for reimbursement is nearly always required, as are documents establishing the identity and legal capacity of the account holder.

## **C. Documentary credit legal issues**

Documentary credit is a bilateral contract between a bank and a supplier in which the former undertakes to pay the latter when the documents specified in the credit are presented. A documentary credit is not only a means of effecting payment; it can also serve as a credit instrument.

The ICC UCP 500 form the basis for the processing of documentary credits. They are a practical and comprehensive set of 49 rules that address the major issues in documentary credit usage. They also reflect the major legal decisions on documentary credits handed down by the courts in the last 10 years.

The UCPs, which are well established internationally, are regularly revised to take into account the evolution of the commercial techniques and practices that they aim to regulate. The current UCP version, UCP 500, entered into force on 1 January 1994. The next revision of UCP, UCP 600 is expected at the end of 2005. UCP exist in several language versions, with the English version being paramount in any case of conflicting interpretations in another language. The UCP need to be expressly incorporated in the documentary credits that they claim to administer. In the absence of such an incorporation,

a judge or an arbitrator ruling on a dispute involving a documentary credit could refuse to apply the UCP, unless he deems them to be of established usage in the branch concerned and hence considers that the parties ought to have been aware of them and that they were implicitly intended to be incorporated in the documentary credit.

### Box 3.1. Areas not covered by the UCP 500

While the UCP cover many aspects of documentary credit, it is important to remember that they do not cover the following:

- Documentary credits that do not refer to the UCP and those which expressly exclude them;
- The underlying relationship between the supplier and the purchaser, as well as the relationship between the purchaser and his bank for the issuance of the credit (commissions, fees, reimbursement, securities, etc.);
- The parties' legal capacity, which is governed by the national law of each party;
- Fraud, the evidence and consequences of which are governed by the law applicable to the documentary credit;
- The judicial remedy that a party could use to prevent the payment of a documentary credit;
- Back-to-back documentary credits;
- Prepayment of documentary credits.

*Source:* International Trade Centre: Trade Finance: A Legal Guide for Cross-border Transactions (chapter V) Trade Law and Trade Finance Series (2003).

Once incorporated into a documentary credit, the UCP are an integral part of the contract. By nature, documentary credits are an independent payment mechanism, separate from the contracts of sales or other agreements on which they may be based (see UCP 500, article 3a). Under a documentary credit transaction, the parties involved deal with the documents rather than the goods, services and/or other items to which the documents may relate ( see UCP 500, article 4).

Alongside the UCP 500, local legislation governing documentary credits also remains important.

## D. Documentary collection legal issues

Documentary collection is a useful method of payment offering a relatively high level of security in international commerce, but not as high as a documentary credit.

The Uniform Rules for Collection (URC 522) form the basis for the processing of documentary collections. They govern the essential rights and obligations of the parties to the agreement. The current URC 522 guidelines, published by ICC, have been in force since 1 January 1996 and are extremely well established internationally.

As with Incoterms, the application of URC depends on the will of the parties. Therefore, the URC must be incorporated in collection instructions given by the client and relayed to every bank in the documentary chain. Without prompt incorporation, a judge or an arbitrator deciding on a dispute concerning a collection might refuse to apply these rules, unless he authoritatively decides to consider them as an established usage that both parties are supposed to know. The parties to a documentary collection typically include the exporter, the remitting bank (the principal's bank), the collecting bank (located in the purchaser's country), the presenting bank (the bank that presents the documents to the purchaser to collect the payment) and the purchaser.

## E. Leasing legal issues

Leasing is a way of financing assets. It consists of one party (the lessor) who acquires assets from one or more suppliers on the instruction of another party (the lessee). A typical lease comprises two separate agreements: a supply agreement between the supplier and the lessor, and a leasing agreement between the lessor and the lessee.

Leasing agreements may be governed by different laws, depending on the particular segment of the lease operation at issue:

- Supply agreement: law of the supplier's place of business
- Lease agreement: law of the lessor's place of business
- Securities: law of the place where the collateral is located
- Bankruptcy: law of the principal place of business of each of the parties.

Because the legal risks associated with a leasing operation are higher when the parties involved are based in different countries and because most countries have diverging laws with regard to leasing operations, UNIDROIT<sup>4</sup> drafted the Convention on International Financial Leasing (Ottawa, 28 May 1988),<sup>5</sup> a convention that formulates uniform rules on international financial leasing.

Its status as an international treaty allows the Convention, once ratified, to supersede a country's other laws. This allows for a greater level of uniformity between legal systems.

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<sup>4</sup> The International Institute for the Unification of Private Law (UNIDROIT) is an intergovernmental organization that acts, in the manner of UNCITRAL, for the unification of law at the legislative level and at the contractual level. It has a website at [www.unidroit.org](http://www.unidroit.org).

<sup>5</sup> *Acts and Proceedings of the Diplomatic Conference for the adoption of the draft Unidroit Conventions on International Factoring and International Financial Leasing*, Ottawa, 9-28 May 1988, vol. I.

## F. Legal issues related to the assignment of receivables, factoring and forfaiting

An assignment of receivable is a contract by which the assigning creditor transfers to his assignee his receivable on the assigned debtor. The assignment of receivables is therefore a tripartite relationship of the parties involved; the assignor, the assignee and the debtor. However, this relationship is based on separate legal grounds.

As far as the assignor-assignee relationship is concerned, the assignor assigns his receivable on the debtor to the assignee, pursuant to a contract called an assignment. If the contract is valid, its effect is to place the assignee in position identical to that of the assignor regarding the assigned receivable.

The validity of a contract of assignment lies on the following criteria: the assignor's capacity, the subject matter of the contract of assignment and the free assignability of receivables. If valid, a contract of assignment has the following effects: it transfers the receivables and all accessories to the assignee; the debt of the assignor towards the assignee survives; and the assignor may be compelled to guarantee the payment of the receivable, depending on the applicable law.

Concerning the assignee-debtor relationship, the change of creditor does not alter the obligations of the assigned debtor. The latter retains the same obligations and the same rights towards the assignee.

Should the assignment of receivables imply one or more foreign elements, the assignee will have to verify the extent of his right under several legal systems. Given, on the one hand, the differences between national laws in their approaches to the conditions of validity of assignments and, on the other hand, the assignability of a large number of receivables through a unique, all-inclusive contract of assignment, the risks that companies take when resorting to the assignment of receivables on a large scale are understandably significant.

For this reason, the United Nations Convention on the Assignment of Receivables in International Trade (New York, 12 December 2001)<sup>6</sup> was adopted under the aegis of UNCITRAL. It details a substantial choice of legal regimes to facilitate cross-border transactions involving the assignment of receivables. It notably addresses regulations governing the validity of such receivables, as well as the rights and obligations of contracting parties.

### *Factoring*

Factoring is an operation by which a "supplier" transmits its short-term account receivables to a specialized entity, "the factor", which agrees to manage those receivables for a fee and to recover them on behalf of the supplier, or to discount them with or without

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<sup>6</sup> General Assembly resolution 56/81, annex.

recourse against the supplier. In the latter case, the factor will be the only one to bear the risk of non-payment at maturity.

As in the case of the assignment of receivables, factoring consists of a three-party transaction but is based on the sales contract between the supplier and his purchaser, the factoring contract between the supplier and the factor, and the recovery of the purchaser's receivable at maturity.

If the parties have not chosen a single law to rule all their relationships, various elements of the transaction involving several legal systems are required to interact.

The following are examples of these legal elements:

- (a) The law of the factor's place of business governing the factoring contract;
- (b) The law of the factor's place of business governing the inter-factor contract;
- (c) The law of each guarantor's place of business if the factor claims payment under the available guarantees;
- (d) The law of the debtor's place of business governing the assessment of the effectiveness of the assignment made to the factor against the supplier's creditors;
- (e) The law of the place of bankruptcy of each of the proceeding parties.

The UNIDROIT Convention on International Factoring (Ottawa, 28 May 1988)<sup>7</sup> was adopted to resolve the above legal complexities. This instrument contains a set of substantive rules applying directly to factoring contracts without the prior need to go through the process of determining the applicable law and searching for relevant provisions in that law. The Convention applies when the receivables assigned pursuant to a factoring agreement refer to a contract of international trade in which supplier and debtor both have their place of business in different countries and when these two countries as well as the country of the factor's place of business are contracting States, or both the contract of sale and the factoring contract are governed by the law of a contracting State.

The Convention may be excluded either by the parties to the factoring contract or by the parties to the contract of sale, provided that the exclusion is made as a whole. A factoring contract may cover future receivables that are not specifically individualized, as long as they can be identified as being covered by the factoring contract when they come into existence.

The assignment of receivables by the supplier is valid despite any stipulation of non-assignability in the contract between the supplier and the debtor, except if the country in which the debtor has his place of business made a reservation to this provision at the time that it ratified the Convention.

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<sup>7</sup> Acts and Proceedings of the Diplomatic Conference for the adoption of the draft Unidroit Conventions on International Factoring and International Financial Leasing, Ottawa, 9-28 May 1988, vol. I.

The Convention requires, however, that the assignment of receivables to the factor be notified in writing to the debtors. In the absence of notification, a debtor may validly discharge his debt by paying the supplier, despite the knowledge he might otherwise have of the factoring contract. The transfer of accessories to the receivables is not automatic; there must be a provision to this effect in the factoring contract. The debtor is entitled to assert against the factor all defences he is entitled to raise against the supplier.

### *Forfaiting*

Forfaiting is an operation by which an exporter assigns a receivable, i.e., a future payment expected from a buyer based on a sales contract or from a bank as the proceeds of the documentary credit, to a third party (assignee). A key rule in forfaiting is to know the assignor, his activity and, in particular, the commercial transactions from which the assigned receivable stems. It is preferable that the assigned receivable be materialized by a negotiable instrument.

Detecting fraud is another important aspect of forfaiting. As a response to this concern, forfaiting agreements may provide recourse against the assignor limited to fraud. While the discount commission may be reduced owing to the unavailability of such a limited recourse, it allows the forfaitor to neutralize a risk that would otherwise be difficult to avoid.

## **G. Legal issues related to financial risk management instruments**

Companies involved in the export-import business are confronted with a wide range of risks. Risk evaluation is especially difficult when one is dealing with unfamiliar countries and new business partners. Guaranties are therefore necessary to give exporters security and minimize any possible risks.

While the most common sanction for breaching of the terms of a credit contract is termination, financiers nearly always require an efficient security that would increase their chances of obtaining reimbursement and yet remain simple and quick enough to yield cash in case of default. There are two kinds of securities depending on the asset to be covered:

- (a) *Ad personam* guarantees, which consist in adding a third party's commitment to that of the borrower:
- (b) Security over goods, which consist in granting a preferential right over one or several specific items among the borrower's assets or those of a third party guarantor.



### *Ad personam guarantees*

*Ad personam* guarantees fall into two mutually exclusive categories: (a) enterprises that are accessory to the guaranteed obligation, typically a suretyship; and (b) businesses that are independent of the guaranteed obligation, mainly independent guarantees.

To address the problems that stem from the various legal rules applied to guarantees and to offer a reasonable compromise between the different interests of all parties involved, two international bodies have adopted instruments aimed at standardizing these rules.

ICC first adopted and published the Uniform Rules for Demand Guaranties (URDG 458) in 1992. These rules, which have a contractual nature (they need to be incorporated into a contract to be applicable), apply only to independent guarantees and counter-guarantees. They provide rules for, inter alia, the various transactional aspects of independent guarantees, including the demand for payment, the performance of the guarantor's undertaking, the scope of the latter's liability and the transferability of the guarantee.

The contractual nature of URDG 458 prevents them from effectively addressing practices and issues that pertain to the public policies of the States involved, such as those related to fraud or national regulations. Such regulations could, for example, nullify the expiry date stated in a guarantee. In order to address these issues, UNCITRAL adopted the Convention on Independent Guarantees and Standby Letters of Credit in 1995.<sup>8</sup> Rather than competing with each other, the UNCITRAL Convention and the ICC URDG 458 are complementary.

### *Standby letters of credit*

A standby letter of credit is a crossbreed: on the one hand, it is a form of documentary credit; on the other hand, it has the functions of an independent guarantee subject to its own terms.

Standby letters of credit have traditionally been issued with a reference to UCP. However, specific practices in standby letters of credit, such as extend or pay demands, have not been provided in UCP. That is why specific rules for standby letters of credit have been drafted, which have led to the adoption of the International Standby Practices (ISP) under the aegis of ICC in 1998 (publication No. 590). To be applicable, ISP have to be incorporated by reference in the standby. Where the same standby refers to ISP and to other rules, ISP shall supersede them.

The issuance of a standby under ISP implicitly entails an agreement between the parties as to the irrevocability, independence and exclusively documentary nature of the standby without the need to specifically so indicate (article 1.06). Amendments to a standby shall become effective only after it has been entirely accepted by the beneficiary.

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<sup>8</sup> General Assembly resolution 50/48, annex.

A standby letter of credit may be transferred as long as its terms so specify. In this case, it may be transferred more than once. ISP also contains many other useful provisions dealing with personal or corporate succession of the beneficiary, expiration, reimbursement by the principal, syndication and subparticipation. In practice, however, standbys are generally still subject to UCP 500.

#### *Security over goods*

If a debtor or a guarantor has already granted security rights over his assets to existing creditors, a new creditor's claim against him may prove unsuccessful.

Pledges are the main example of such securities. They provide the pledgee with a priority right over the value of the pledged goods. Moreover, the pledge automatically follows the pledged goods if they are sold by the grantor to someone else. Thus, the pledgee is certain to supersede the rights that the grantor's other creditors may have as concerns the value of the pledged goods.

Nevertheless, one must consider that a pledgee's rights may be weakened when a grantor is bankrupt. In such a case, depending on the legal system, a pledgee is not certain to keep first-rank priority over the pledged goods. This is all the more true when several bankruptcy proceedings are commenced at the same time in each of the countries where the bankrupt debtor has an activity or asset.

In addition, the strict legal provisions that govern a pledge may turn it into an instrument too rigid for international trade transactions, which often deal with goods that are not specifically individualized and identified. Furthermore, if conveyance of possession is difficult to reconcile with the grantor's commercial or industrial activity, possession may show itself to be just as cumbersome for the pledgee. In 1993, ICC published the Uniform Rules for Contract Bonds (URCB 524), which are a set of rules designed to secure uniform practice in the operation and enforcement of bonds.

## **H. Legal issues related to international payment terms and modalities**

Payment in international trade reveals a set of legal issues that vary according to the way payment is made, its terms, the process used and the source and the identity of the payer. Two notions need to be distinguished when dealing with payment: the terms of payment and the modalities of payment.

#### *Terms of payment*

Once goods to be delivered have been agreed upon and their price is set in the contract, it is necessary to specify the terms of payment, i.e. the place where the payment has to be made and the date of payment, and possibly the allocation of any additional costs or whether payment is dependent upon delivery.

(i) Place of payment

It is important to determine where payment will take place, if only for the following reasons:

- (a) The court that is competent to rule upon disputes arising in contractual obligations is very likely to be the one where the obligation is performed, meaning, in the case of a payment undertaking, the place of payment;
- (b) The law that is applicable to the form of payment is the law of the jurisdiction where the payment is made, while aspects dealing with the amount, the date and the place where the payment should be made are determined by the law applicable to the contract;
- (c) The option in the contract of using a currency other than that of the place of payment depends on the law of the place of payment.

Where no exchange controls apply, parties are usually free to agree on a place for payment. If the parties do not provide in their contract for such a place, then the law applicable to the contract will determine where payment must be made. Parties to a contract are free to choose where payment should be made. Once the parties have agreed on a place for payment, their choice becomes binding not only on them but also on their assignees.

In the absence of an explicit or implied agreement by the parties, a judge or an arbitrator would invoke the law governing the contract to determine the place of payment. In that regard, France, Belgium, Luxemburg and Germany opt in favour of the place of business of the debtor unless the contract specifies otherwise. In contrast, it is the creditor's place of business that is favoured by law in Greece, Hungary, Italy, the Netherlands, Switzerland, the United Kingdom of Great Britain and Northern Ireland and the United States of America.

The United Nations Convention on Contracts for the International Sale of Goods<sup>9</sup> (Vienna, 11 April 1980) provides that the price is payable at the supplier's place of business (article 57). The *UNIDROIT Principles of International Commercial Contracts* (1994) also opt in favour of payments being made at the supplier's place of business.

(ii) Time of payment

As far as the time of payment is concerned, two aspects need to be considered: (a) the time by which the payment must be made in relation to the delivery of goods and services; and (b) once the purchaser has made payment, the time when such payment is considered made and the purchaser is considered to have discharged his obligation.

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<sup>9</sup> United Nations, *Treaty Series*, vol. 1489, No. 25567.

These issues are purely a matter of contract. The parties may decide that the payment shall be made in all or in part before the delivery of the goods, upon delivery or at the end of an agreed period.

As regards the time when the purchaser's obligation to make payment can be considered to have been validly performed, most jurisdictions consider that the debtor is discharged of his obligation only when his creditor does indeed receive the complete payment agreed in the contract. The *UNIDROIT Principles of International Commercial Contracts* (2004) (which, once again, only apply to a contract if they have been expressly incorporated therein or if the parties have chosen to submit their contract to "general principles of law" or "trade customs") adopt a somewhat different solution since they provide that a debtor has discharged his payment duty "when the transfer to the obligee's financial institution becomes effective".

#### (iii) Extent of payment

While the purchaser's obligations should normally be considered as having been discharged once the price agreed in the contract is paid, international trade contracts often involve additional payments as well, including insurance premiums for the goods, customs duties, taxes, transportation charges and inspection fees. It is important that the parties agree in advance on the responsibility for these costs. In the absence of an explicit agreement, a judge or an arbitrator will have to infer from the circumstances of a case the implied will of the parties.

The ICC Incoterms, which are the most commonly used compendium of commercial terms related to sales of goods contracts in international trade, are aimed at avoiding the long and costly process of negotiating and drafting the most common terms in international sales contracts. Parties to a contract can incorporate Incoterms simply by reference. Incoterms mainly deal with the responsibility for obtaining export and import licences, liability for the fees relating to the contracts of carriage and insurance, transfer of risks, place of delivery and liability for fees relating to inspections before the loading of goods.

#### *Modalities of payment*

The modalities of payment refer to the way actual payment is to be made. The parties may agree on the amount and the currency as well as the form of payment: cash, check, negotiable instrument, or a credit or postal transfer. Alternatively, the parties may agree that payment should be made by countertrade of goods, completed if necessary by monetary payment.

#### (i) Monetary payments

When parties to a contract agree on a monetary payment, that payment is usually made through a credit transfer that will cross from one country to another. Indeed, payment by credit transfer is by far the most commonly used means of monetary settlement and the preferred vehicle for the majority of payments in international trade. There are various reasons for this: on the one hand, the process is fast because it can be done

### Box 3.2. Risk transfer and Incoterms 1990

The correct use of Incoterms goes a long way towards providing the legal certainty upon which mutual confidence between business partners must be based. Using Incoterms to negotiate the time and location of risk transfer from the seller to the buyer can help prevent disputes. The following 13 Incoterms are ranked in order from minimum to maximum risk to the seller:

1. EXW Ex Works (named place)
2. FCA Free Carrier (named place)
3. FAS Free Alongside Ship (named port of shipment)
4. FOB Free On Board (named port of shipment)
5. CFR Cost and Freight (named port of destination)
6. CIF Cost, Insurance and Freight (named port of destination)
7. CPT Carriage Paid To (named port of destination)
8. CIP Carriage and Insurance Paid To (named port of destination)
9. DAF Delivered at Frontier (named point)
10. DES Delivered Ex Ship (named port of destination)
11. DEQ Delivered Ex Quay (duty paid) (named port of destination)
12. DDU Delivered Duty Unpaid (named point)
13. DDP Delivered Duty Paid (named point)

Complete definitions of these and other Incoterms may be found at [www.iccwbo.org](http://www.iccwbo.org).

electronically. On the other, the absence of any requirement for paper support or cash handling makes it the most convenient method. Furthermore, the competence of banks in handling the millions of international credit transfers that are processed every day is a reinforced guarantee of security and efficiency.

In 1992, UNCITRAL the Model Law on International Credit Transfers<sup>10</sup> (15 May 1992), which was designed to meet the challenge of the fundamental evolutionary process of paper transfer orders being replaced by electronic orders. The model law applies only to cross-border credit transfers. It deals with the obligations of the parties and with the consequences of incidents that may occur during the transfer and its processing.

<sup>10</sup> Official Records of the General Assembly, Forty-seventh session, Supplement No. 17 (A/47/17), annex I.

In 1988, UNCITRAL adopted the United Nations Convention on International Bills of Exchange and International Promissory Notes<sup>11</sup> a modern, comprehensive set of legal rules that govern new international instruments for optional use by parties to international commercial transactions. It was designed to overcome the major disparities and uncertainties that currently exist in relation to instruments used for international payments. The Convention applies if the parties use a particular form of a negotiable instrument indicating that the instrument is subject to the UNCITRAL Convention.

Without pre-existing business relationships establishing the minimum level of confidence necessary to accept ancillary risks, and if no appropriate securities for performance can be obtained, the supplier and the purchaser may agree to the involvement of a third party, usually a bank. That bank would guarantee the performance of the transaction by pledging its financial credit (Cf. Documentary collection (RUE 522) and documentary credit (RUU 500)).

Parties to an international contract can agree on a currency of account that is different from the currency of payment. The former is a currency unit chosen by the parties in their contract to compute the amount of the obligation, while the latter is the only currency by which the debtor may validly discharge himself of his payment obligation. In other words, a currency of account allows the calculation of the value of the subject matter of the obligation; it is a unit of measurement.

#### (ii) Payment by countertrade

For various reasons, the parties to an international contract may resort to countertrade as instrument of payment. Countertrade allows the importer to offer other goods or services to the exporter in payment for the imported products. The value of the delivery by the importer is then equivalent to the value of the exporter's delivery. The most frequently used countertrade techniques include barter, clearing agreements, buybacks and counterpurchases.

Barter, in particular, consists of trade in goods or services and, in principle, requires no monetary payment. For a barter to be successful, the parties must ensure that specific conditions are met. The goods that are the object of the countertrade delivery have to be clearly specified, particularly as to their quality standard, origin, value and type of packaging. The availability of the countertrade goods must be verified and shipment to the main exporter must be quickly arranged. The parties should also provide pre-shipment or post-arrival quality and quantity inspections, choose the appropriate Incoterms to specify the reciprocal obligations and the transmission of risks, determine in advance the price of the countertrade goods and make sure that all necessary import and export licences have been obtained. Where possible, performance guarantees issued by banks covering the reciprocal deliveries should also be obtained.

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<sup>11</sup> General Assembly resolution 43/165, annex.

## I. Conclusion

Differences between countries in terms of customs, practices, case law and national legislation run counter to the need for speed and security in trade financing. This has led to the drafting of uniform rules of contractual nature (i.e., directly addressed to businesses), such as the ICC Incoterms, the Uniform Customs and Practice for Documentary Credits (UCP 500), FIDIC Standard Contracts for Construction and Engineering, ISDA Master Agreement for Derivatives, and arbitration rules of various arbitration institutions.

These international rules, standards and practices play an increasingly important role in facilitating trade and ensuring the effectiveness of trade finance instruments. Traders and national regulators in emerging economies should take advantage of these existing legal instruments in conducting and promoting trade, respectively.

## J. For further reading

- ITC, *Trade Finance: A Legal Guide for Cross-Border Transactions* (ITC, 2003) (see [www.intracen.org/tfs](http://www.intracen.org/tfs)).
- European Bank for Reconstruction and Development, *Law in Transition 2005: Courts and Judges* (available online at [www.ebrd.org](http://www.ebrd.org)). Part of the EBRD “Law in transition” series, this publication includes an assessment of the effectiveness of commercial laws in selected Central Asian and Caucasus countries.
- ESCAP, *Harmonized Development of Legal and Regulatory Systems for E-Commerce in Asia and the Pacific*, ESCAP Studies in Trade and Investment series, No. 54, 2004 (ST/ESCAP/2348) (available online at [www.unescap.org](http://www.unescap.org)). This publication includes a chapter on e-commerce legal issues in transition economies of Central Asia and the South Caucasus, as well as a case study on the development of the e-commerce legal system in Viet Nam.

## **IV. Structured trade and commodity financing**

### **A. Introduction**

Until the onset of the Latin American financial crisis in the mid-1980s, banks involved in international commodity finance relied on balance sheet analysis and government guarantees for ascertaining the creditworthiness of lenders. Security was at times enhanced by tangible assets, such as real estate, offered as collateral. However, these traditional tools were no longer sufficient to deal with increasing economic and political risks, particularly in emerging markets. Indeed, as a number of national trade finance surveys conducted by ESCAP in cooperation with ITC have shown, it is not uncommon for banks in economies in transition to require as collateral physical assets estimated at 150 per cent of the value of the loan.

With the consolidation of the commodity industry, only a small number of large creditworthy traders are actively involved in trade, in addition to an increasing number of niche players that are difficult to finance. Most of the traders have large credit requirements (compared with their own equity), short track records, a modest capital base and limited access to government guarantees. Given the high default rate of commodity traders (both large and small), banks have become hesitant to meet their financing needs on an unsecured basis. Hence, the evolution of a range of innovative, structured commodity financing techniques to mitigate the risk of losses and assess the potential losses associated with financing commercial transactions.

Globalization and privatization are other factors behind this demand for structured finance. With many commodity trading activities moving out of the hands of State-owned and government-controlled marketing bodies and into the hands of private companies, previous sales to government entities, backed by State-bank letters of credit, have been replaced by private sector trade, financed by commercial banks.

### **B. What is structured trade and commodity financing?**

STCF revolves around identifying and mitigating the risks associated with transactions. This is achieved by structuring financing so that potential risks (structural and performance) are either mitigated or externalized to parties better able to bear them, and in a manner that ensures automatic reimbursement of advances from underlying transaction assets. A key element when structuring a deal is examining the role of the various parties in the funding and reimbursement chain, with a view to ascertaining how each can impact the transaction positively.

Because of the risks that commodity markets entail and commodity price volatility, the majority of enterprises involved in commodity production, processing or trade are considered by banks as posing "difficult" credit risks: can they provide any guarantee or



collateral? Will they repay loans on time, and if not, can banks enforce their rights? The risks inherent in structuring commodity finance deals, can be mitigated in several ways. For example, security can be taken on collateral and/or trade receivables, in addition to such safeguards as commodity price hedging and insurance (e.g., country risk insurance to cover the risk of an export ban), which can be built into the financing structure.

At the heart of structured financing is the goal of meeting the needs of the borrower (in terms of maturity, pledge requirements, repayment schedule, etc.) and of the credit provider (in terms of country risks limits, provisioning requirements, etc.). It is quite a challenging task in view of their opposing, and often conflicting, commercial interests.

There are no standardized structured commodity trade finance deals, since one essential principle of STCF is the tailoring of a structure to the needs and circumstances of all parties involved, provided that perceived or real risks are mitigated. However, it is possible to single out three generic models: export receivables-backed financing, inventory/warehouse receipt financing and pre-payment financing.

### **C. Export receivables-backed financing**

This model entails the provision of pre-export loans or advance payment facilities to an exporter, with repayment being obtained from the exporter's receivables resulting from the sale of the pre-financed exported commodities.

Under this model, banks take the following combined measures:

- (a) Taking security over the physical commodities in the form of a local-law pledge or similar security interest;
- (b) Assigning the receivables generated under the commodity export contracts;
- (c) Establishing an escrow account in a suitable (usually offshore) location into which purchasers of the commodity are directed to pay the assigned export receivables. This creates an automatic reimbursement procedure.

The financing is thus based on the payments to be made by the buyer once the goods are exported. This enables exporters to use future trade flows to raise self-liquidating export-based financing at better cost and tenor. It also enables financiers to externalize country and credit risks by the assignment of export contracts and receivables, and by receiving payment in an offshore escrow account.

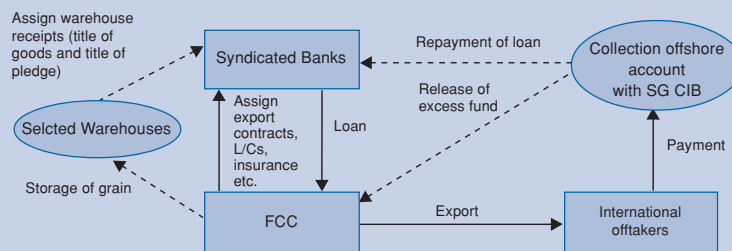
The main risk that needs to be carefully mitigated remains the performance risk of the exporter. This is the risk of the exporter failing to supply the goods as envisaged in the commercial contract. When dealing with a new or uncertain borrower, a bank usually asks for a personal guarantee (rights on the borrower's house for example), or splits the risk by taking goods as a security on the loan and financing up to 80 per cent of the value of the underlying security. Even in such secured loans, however, the bank will first verify that the client has the potential to deliver. In some cases, banks refuse to take any risk on new

clients and deal only on a fully cash basis until trust is established with the new client. However, fraudsters can always find a way to abuse this bank logic.<sup>12</sup>

#### Box 4.1. Pre-export finance for Kazakhstan's Food Contract Corporation

STCF enabled Kazakhstan's Food Contract Corporation to obtain a US\$ 85 million pre-export grant through mandated lead-arranging banks Kazkommertsbank and SG CIB, the corporate investment and banking arm of Société Générale Group. This pre-export finance structure brought in the largest loan ever granted for the agricultural sector in Kazakhstan and is considered to be one of the first direct loans granted by international banks to a Kazakh entity in the soft commodities sector.

Food Contract Corporation is the State-owned agency in charge of the strategic grain reserves of Kazakhstan and also exports grain for commercial purposes. It launched a tender in August 2003 and invited banks to bid for a facility package, seeking a minimum of \$70 million. The arrangers committed themselves to lending up to \$85 million on the basis of a global tenor of 10 months.



The loan was secured by means of the following:

- (a) Pledged local securities:
  - (i) Grain collateral in the form of warehouse receipts. The grain is stored in selected and approved warehouses and warehouse receipts (title of goods and title of pledge) are held and managed by Kazkommertsbank as onshore security agent;

<sup>12</sup> A report prepared in 2003 by the UNCTAD secretariat discusses how fraudsters may use commodity market instruments to trick bankers, commercial counterparties, Governments, regulatory or tax offices and shareholders. See "A primer on new techniques used by the sophisticated financial fraudster with special reference to commodity market instruments" (UNCTAD/DITC/COM/39), 7 March 2003 (available online at [www.wto.org](http://www.wto.org)).

- (ii) Export proceeds (export contracts signed with first-class offtakers with payments through letters of credit opened by international banks) credited on Kazkommertsbank's correspondent banking account with SG CIB and kept until each repayment date.
  - (iii) In order to comply with Kazakh currency control rules, export proceeds are credited to Food Contract Corporation's account in Kazakhstan and debited immediately by Kazkommertsbank to repay the loan. Transfer to/ from Kazakhstan are only for internal bookkeeping at Kazkommertsbank so that transfer risk is mitigated;
- (b) Documentation:
- (i) Contracts to mitigate price fluctuation (such as fixed price forward contract);
  - (ii) Insurance and guarantees, which ensure a high level of cover ratio, protect against storage dispersion and provide a minimum schedule of grain deliveries per month.

This deal was made possible by successful cooperation between (a) Food Contract Corporation, the client, (b) Kazkommertsbank, which brought its knowledge of the local market and its expertise as an onshore security agent, and (c) SG CIB, which brought its underwriting and syndication capacities.

*Source: Trade Finance Magazine.*

## D. Inventory/warehouse receipt financing

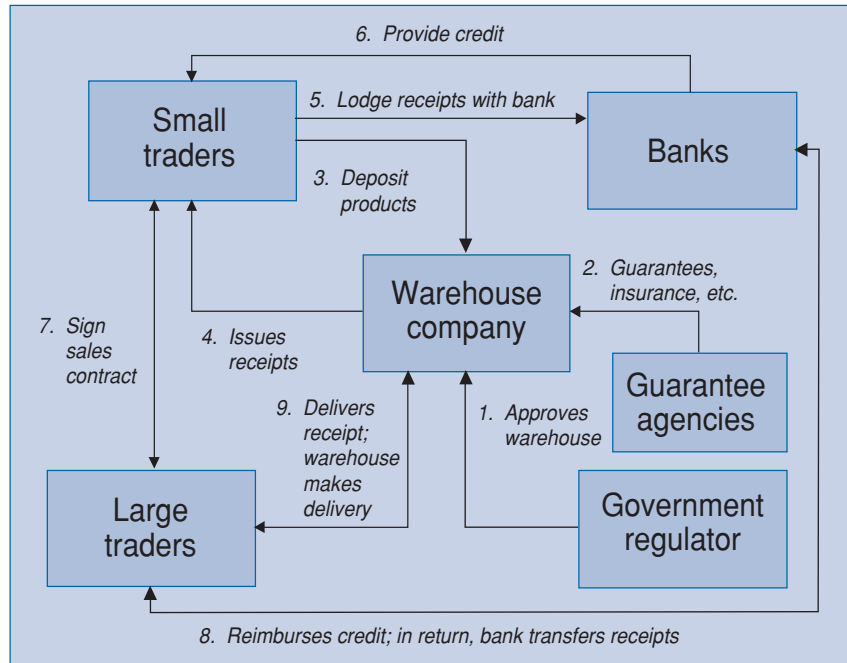
Warehouse receipt financing entails the use of securely stored goods as loan collateral. Secured goods can range from cash crops to processed food, in addition to minerals, metals, hydrocarbons, etc. The receipt issued by the warehouse is accepted by the bank as a fallback guarantee that can be called upon in case of non-payment.

### *Mode of operation*

Rather than relying on the producer's (or exporter's) promise that the goods exist and that the proceeds of their sale will be used to reimburse the credit provider, the goods are placed under the control of an independent third party, the warehouse operator, which, in turn, maintains them in good condition and assures the credit provider that the collateral is secure.<sup>13</sup> Upon receiving the goods, the warehouse operator issues a receipt, the form of which depends on the particular country's legal and regulatory system. The receipt is meant to certify the deposit of goods of a particular quantity, quality and grade, which then forms the basis of financing. The producer can use the receipt as a form of portable collateral to request a loan from a financial institution.

<sup>13</sup> The credit provider himself still needs to ensure that the goods have not been pledged previously and that he has first call on the goods in case of a problem.

Figure 4.1. Warehouse receipt mode of operation



The warehouse operator becomes legally liable for the goods he stores. If these goods are stolen, damaged or destroyed through any fault of his, he and/or his insurance companies have to make up for the value lost (additional insurance can be obtained for catastrophic events).

The use of warehouse receipts as collateral provides the benefit that the commodities are no longer in the possession of the borrower. Should the borrower default, the lender therefore has easy recourse to the commodities. It is also a delayed-sale marketing technique, allowing farmers to take advantage of large seasonal swings in the prices of their produce (without the rush to sell their commodity prematurely or when prices are low) and still obtain cash at harvest time.

Warehouse receipts can also be used to finance storage and transactions as commodities move through the marketing chain from producer to consumer. Banks or trading companies normally feel more confident about advancing funds against commodities that are being stored in a reliable warehouse and have been assigned to the bank or trading company through warehouse receipts. Once goods are in a warehouse, production risk is eliminated, quality can be controlled and transport risk is removed.

### *Types of warehouse receipts*

Warehouse receipts can be *negotiable* or *non-negotiable*. A non-negotiable warehouse receipt is made out to a specific party (a person or an institution). Only this party may authorize the release of goods from the warehouse. He may also transfer or assign the goods to another party, for example a bank. The warehouse company must be so notified by the transferor before the transfer or assignment becomes effective. The non-negotiable warehouse receipt in itself does not convey title and, if it is in the name of, say, an exporter, it cannot be used as possessory collateral; it needs to be issued in the name of, or transferred to, the bank in order for the bank to obtain possessory collateral rather than just a security interest.

The difference is important in that, firstly, if the bank has possessory collateral, it has direct recourse to the warehouse storing the commodities when they are delivered to another party; and secondly, if the borrower files for bankruptcy, it is much easier for the bank to sell the commodities in a speedy manner. However, the surrender of the non-negotiable receipt to the warehouseman is not necessary for the release of all or part of the stored merchandise. All that is needed is a delivery order signed by the party in whose name the receipt is issued or to whom it has been transferred (usually the financing institution) specifying for the warehouseman exactly what types and quantities of goods are to be released to the person named in the order. This makes the use of non-negotiable receipts for short-term trade finance rather easy.

A negotiable warehouse receipt is made out to the order of a named person or to the bearer. It is a negotiable commodity paper that serves as possessory collateral. When the bearer of a properly endorsed receipt surrenders it to the warehouseman, he takes delivery of goods stored against this negotiable receipt. If the commodities stored have been properly graded, the delivery of a negotiable warehouse receipt may replace normal physical delivery.

#### **Box 4.2. Public vs. private warehouses**

##### **Private warehouses**

In a private warehouse, manufacturing and warehousing take place under the same roof, that is, the primary business of the controlling company is not warehousing but manufacturing, wholesaling or retailing, with the warehouse operated as a part of its general business.

##### **Public warehouses**

A public warehouse is operated by a warehouseman, who stores commodities for third parties for a set fee. As the warehouseman does not obtain title to the commodities stored but only retains possession, it is easy to prove that bailment exists.

There are two types of public warehouses:

- (a) A *terminal* warehouse is separate and distinct from the physical plant of the firm or firms owning the goods stored in the warehouse. It is usually a large storage area, e.g., located in a port, which serves many businesses and is owned and operated by an independent warehouse company. Since this type of warehouse is geographically removed from the depositor's place of business, using such a warehouse for collateral purposes may be inconvenient and brings with it a risk of transportation (because of which there are added insurance fees compared with field warehouses);
- (b) A *field* warehouse, on the other hand, is on or near the premises of the firm depositing the commodities. The warehouse belongs to the firm that wants to obtain credit but, in order to obtain credit, an arrangement is set up whereby an independent warehouse operator (collateral manager) leases (part of) the storage facility for a nominal fee and becomes responsible for control of the commodities to be used as collateral. The primary purpose of this kind of a warehouse is to enable the owner of the stored goods to borrow against them and still have the goods close at hand.

In principle, only public warehouses may provide warehouse receipts of use for international trade; with private warehouses, there is no way to know whether the commodities against which the receipts are issued are indeed in the warehouse or whether they have been used several times as collateral. In practice, some trading firms do accept receipts issued by private warehouses as additional security in what, in any case, is a financing relationship largely based on trust.

*Source:* UNCTAD "Potential applications of structured commodity financing techniques for banks in developing countries", study prepared by the UNCTAD secretariat (UNCTAD/ITCD/COM/31).

### *Importance of legislation*

A crucial element for undertaking warehouse receipt transactions is the availability of reliable warehouse operators. Warehouse companies need to be reliable, and the operators need to have the technical and business skills to store the commodities in a safe way, protecting their quality. In some cases, banks may deem it appropriate to set up their own warehousing subsidiaries to carry out a range of collateral management activities.

Probably the major obstacle to warehouse receipt finance is the absence of clear laws (or even any laws or regulations at all) on warehouse receipts and pledges of security. This is often coupled with the difficulty of enforcing rights that are recognized under local regulations.

In many jurisdictions, the taking of a pledge-type security is a difficult and often costly process, both from a legal point of view and also as a result of registration and equivalent governmental fees and duties. The experience of several developing countries that have tried to establish warehouse-receipt systems indicates that, in order to be effective,

warehouse receipts need a recognized basis in law. This guarantees that the ownership established by the receipt is not disputed and the rights, liabilities and duties of each party (warehouse operator, banks, producers, etc.) are clearly defined. In this regard, before extending credit against a warehouse receipt, it is necessary to ensure that there is a valid law to protect the holder of the receipt and that the receipt complies with the law of the State in which it is issued.

In the absence of proper pledge regulations, a way to overcome warehouse receipt obstacles would be through repurchase agreements (repos). In a repo, the bank does not take a pledge over the goods being stored or shipped. Rather, it buys the goods and simultaneously signs a contract for resale before a fixed future date for a pre-arranged price (taking into consideration the cost of funds from the original time of sale to the resale).

Repos are recent, resorted to by a handful of lenders, and can be used not just for goods in storage but also for goods in transport. This model benefits the banks, since they own the goods and can sell them without legal intervention. However, the legal and regulatory environment with respect to bankruptcy and taxation issues is weak in many developing countries, which could undermine the use of repos.

#### *Initiatives for warehouse receipt development*

The international community has seen the real worth of this type of finance and is trying to support it. For instance, EBRD is actively involved in developing legislation and institutions for adequate warehouse licensing, inspection, insurance systems and performance guarantee systems to support the agribusiness sector throughout Central and Eastern Europe and CIS. For example, in 2003, a joint risk-sharing facility of US\$ 100 million was established by EBRD and Banca Romana pentru Dezvoltare-Groupe Société Générale to give agricultural processors and traders across Romania more access to finance. Through the facility, the companies were able to use warehouse commodities as collateral against loans for the 2003-2004 crop season. However, to make this facility a success, EBRD worked extensively with the Government of Romania to amend the existing warehouse receipt law.

Another example of the EBRD innovation is the year-round grain finance that was initiated in Kazakhstan in 2002. The idea was to secure finance for farmers against grain deposits in secure warehouses. EBRD structured the financing scheme, taking into account both the pre- and post-harvest financial needs of farmers. The scheme released money for farmers to buy seed, fertilizer and fuel for machinery and to finance new machinery to produce higher yields. This allowed farmers to plan their planting cycle more effectively, contributing to better harvests and more grain for export. The participation of local banks was essential for a successful outcome, as was the legal framework for the scheme and the training of warehouse inspectors.

## E. Pre-payment financing

This modality is structured as a purchase of goods, with payment made in advance. It allows the buyer (“offtaker”) to raise a loan from a bank and use it to effect pre-payment for the producer/exporter. Such commodities may already be in a third-party warehouse or about to be assembled with the proceeds of the facility.

By making the pre-payment, the buyer obtains title to the commodities under the contract, thus reducing legal/regulatory constraints. The buyer transfers all his rights under the contract to the bank. The bank’s security would lie in the assignment of the pre-paid export contracts, including a charge on the commodity, either in the warehouse or as and when assembled.

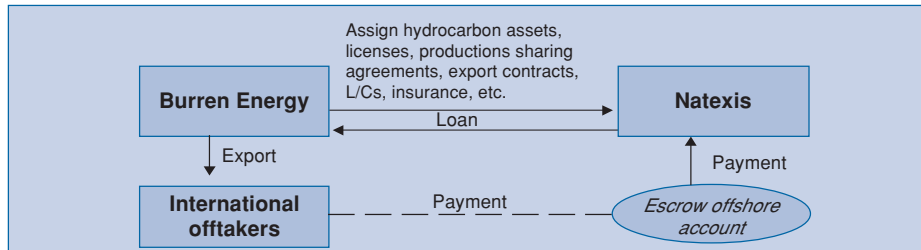
Pre-payment finance is generally limited-recourse finance (repayment can be split, say 20 per cent with full recourse and 80 per cent with limited recourse). In other words, the buyer only has the obligation to repay if the supplier fully meets his commitments under the contract. This means that the bank must closely evaluate the performance risk of the supplier and the legal environment in the country for pre-payments. Will the offtaker really have title? Is this enforceable? Will it have priority over unpaid sellers’ rights and the claims of local tax authorities, employees, warehousemen, etc.? If the beneficiary is not itself the exporter, are the intermediary parties under an obligation to perform? Is a government or central bank consent necessary? Given the likely importance of the warehouseman, the bank will carefully monitor his operations. The bank will also examine possible measures in case it has to take possession of the product (is the product easy to sell? Can it export? Does it have to be sold through public auction?).

In difficult situations, pre-payment structures are often the best solution, as they enable a bank to share key financing risks with the offtaker and reduce the risk of non-payment. In addition, having legal title to the goods, rather than just holding a pledge, would normally give the offtaker direct control over the goods. If, for example, the local company goes into bankruptcy, the commodities being financed will be assigned to the offtaker without the need for lengthy bankruptcy proceedings.

### Box 4.3. Reserve-based lending facility in Turkmenistan

Reserve-based lending (RBL) is a financial product tailored for upstream companies. An RBL facility typically includes a borrowing base mechanism based on the estimates of cash flow streams derived from the oil assets used as collateral. It is a product aimed mainly at medium-sized exploration and production companies in the development stage with a good track record, allowing them to source finance in international bank markets. Instead of classic structured export financing, RBL has a flavour of both project finance and trade finance, where borrowing is linked not just to what a company produces but also to its reserves.





Source: *Trade Finance Magazine*

Turkmenistan is not a country commonly associated with trade finance lending. Few international banks are operating on the ground because some banks have encountered problems with default situations. Structured financing, however, is all about circumventing these difficulties and structuring deals that can meet the financing needs of borrowers. This is exactly what Natexis Banques Populaires has achieved with its innovative RBL facility for Turkmenistan.

With the signing in October 2003, Natexis Banques Populaires structured the first RBL facility in the Caspian Sea region for Burren Energy. The deal was structured on the basis of a borrowing base including not only current production capacity but also future development deriving from the exploitation of the proven hydrocarbon reserves of Burren.

This three-year, US\$ 20 million facility, which is backed by Burren's Turkmen assets, represents an innovative new hybrid product that marries RBL with pure pre-export financing techniques. It is a revolving format adapted to payments over time.

The initial step to assessing the creditworthiness of reserve-based loans is an analysis based on a thorough technical and economic survey of hydrocarbon reserves. The cash flow generated from the future sale of encumbered reserves is the primary, and in most cases the intended, source of repayment.

Therefore, the integrity of engineering data that depicts the future cash stream is critical to the initial lending decision and equally important to assess credit, performance and liquidity quality. The borrowing base calculation model includes not only the current production capacity but also various categories of reserves. It is built around a series of conservative assumptions and allows borrowers to increase the amount of debt they can raise on the basis of the volume of future oil that they pledge.

In addition, security is taken over local oil and gas assets – including the interest in production-sharing agreements and licences. The transaction is also covered by private political risk insurance to mitigate Turkmen risk. Finally, the facility includes an option to more fields, not only in the Caspian region but also elsewhere in the world, triggering a further possible increase in the facility amount.

Pre-payments are advantageous to up-country financing systems in which a financier effectively channels financing for an up-country supplier through a trading company and shares the risks of this financing with their trading company.

## F. Conclusion

The landscape of commodity finance has witnessed radical changes over the last few decades. Companies involved in commodity trade are mainly private, operating under an evolving trade regime shaped by liberalization policies. Borders between banks, investment funds and insurance companies have opened up, and the consolidation of commodity markets, coupled with the introduction of new information technologies, has created new challenges and opportunities for commodity producers and exporters, particularly small and medium-sized ones in developing countries. However, increased opportunities entail increased risks.

STCF is a tool for realizing opportunities while controlling risks. However, the success of STCF depends on the extent to which involved parties (international banks, local banks, importers, exporters, Governments, etc.) are capable of pooling their efforts and knowledge in a coordinated manner. Governments can play a major role in facilitating the use of STCF by providing an enabling environment, particularly in relation to appropriate legal and regulatory reforms for enhancing transparency and reducing uncertainty.

As mentioned above, the establishment of STCF entails several risks that cannot be appreciated by traditional banks. Banks should stretch their activities to include commodity trade financing and to appreciate the particularities of the commodity trade.

However, local banks in developing countries with economies in transition are risk-averse and often lack the required knowledge of STCF. Capacity-building programmes and pilot projects are needed to help local banks to successfully engage in STCF. The possibilities for STCF can also be greatly enhanced if there are strong support institutions, such as warehouse companies, collateral managers and other entities enabling the mitigation of commodity price risks. Strengthening such local support institutions deserves a prominent place in any programme to develop a national trade finance infrastructure.

## G. For further reading

- Expert papers from an UNCTAD expert group meeting on financing commodity-based trade and development held in October 2004 and many other useful documents on risk management and structured finance may be downloaded from the UNCTAD INFO COMM database at: [http://r0.unctad.org/infocomm/comm\\_docs/documents.htm](http://r0.unctad.org/infocomm/comm_docs/documents.htm).
- The ITC *Glossary of Trade Finance Terms* provides definitions for a wide range of trade finance terms in English, French and Spanish. It is available at [www.intracen.org/tfs/docs/glossary/glossary.htm](http://www.intracen.org/tfs/docs/glossary/glossary.htm).

## **V. Trade finance and the macroeconomic environment: pointers**

### **A. Introduction**

In this *Handbook*, the trade finance infrastructure of a country is defined as the institutions, laws, regulations and other systems related to the following three activities: (a) provision of capital to firms that are engaging in international trade transactions; (b) provision of support services to manage the risk involved in these transactions; and (c) provision of international payment mechanisms.

All three activities are typically performed by financial institutions and intermediaries, such as banks, stock exchanges and insurance companies. Therefore, the rapid and successful development of the trade finance infrastructure will be heavily influenced by the development of a dynamic and internationally savvy domestic financial sector.

Factors influencing the development of the financial sector are numerous. Financial sector supervision and regulation play a very important and direct role. Most, if not all, Governments in transition economies are involved in one way or another in financial and banking sector reform. The availability of well-trained bankers and local finance experts is also a key factor, as a modern financial sector cannot develop without appropriate expertise.

However, financial practitioners have long recognized that the overall macroeconomic environment plays an important role in the development of the financial sector and a trade finance infrastructure. ITC has developed a methodology with a view to assisting countries in assessing the level of development of their trade finance infrastructure and pinpointing the potential problem areas that would need to be further investigated.

This chapter starts with a discussion of the determinants of trade finance infrastructure development, followed by an overview of the ITC Trade Finance Pointers (TFP) methodology, which has been tested in cooperation with ESCAP in Central Asia, the South Caucasus and Mongolia over the past two years.

### **B. Determinants of trade finance availability and development**

Countries appear to follow a path similar to that shown in figure 5.1, suggesting that few countries have been able to develop their trade finance sector effectively without first strengthening their macroeconomic environment.

Trade finance infrastructure development in transition economies and other developing countries may therefore require the implementation of macroeconomic or structural policies in addition to sector-specific (i.e., financial or banking sector) reform.

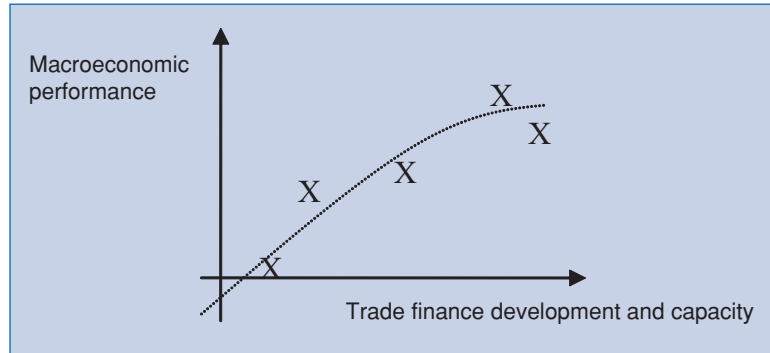
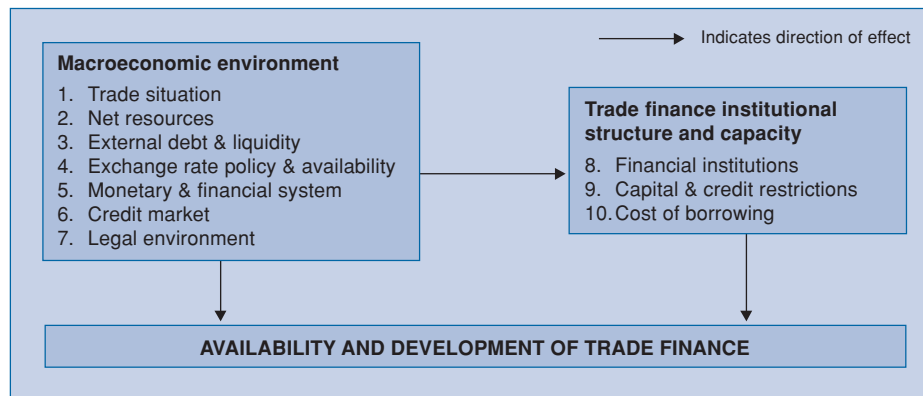
**Figure 5.1. Macroeconomic environment and trade finance**

Figure 5.2 provides a graphical interpretation of the concept, inspired by the TFP methodology mentioned above. The availability and development of trade finance will be indirectly affected by the macroeconomic environment as defined by a country's current trade flows, net resources, external debt and liquidity, etc., but it will be directly affected by its trade finance institutional structure and capacity as inferred from the existing set of financial institutions, capital and credit restrictions and the cost of borrowing. However, as explicitly shown in figure 5.2, the trade finance institutional structure and capacity is itself directly dependent upon the macroeconomic environment.

**Figure 5.2. Ten determinants of trade finance access and availability**

The relevance of each of the 10 proposed determinants of trade finance access and availability is briefly explained below.

#### *Trade situation*

Increased outward orientation and better export performance are favourable for the long-term development of trade finance. The size of trade flows already in existence also provides a strong indication of the expected level of trade finance needs.

#### *Net external resource flows*

Net external resource flows may indicate the availability of funds, with a focus on stability and the future debt burden. The availability of external funds is generally viewed as being favourable to the development and availability of trade finance since these are funds that will be channeled into the economy in the form of investment or consumption. However, when funds are of a transient nature or if the level of external indebtedness becomes too large, then the sustainability of such a financing regime becomes questionable.

Net resource flows consist of long term debt, FDI, portfolio flows and grants. Out of these, FDI is considered more positive than other sources of external finance since it represents investments by foreign entities in the private sector of the economy and is expected to lead to technological transfers and to enhance a country's competitiveness. Furthermore, although FDI is, in effect, a transfer of assets from domestic to foreign ownership, it does not represent a debt in so far as it does not need servicing.<sup>14</sup> Grants are also considered to benefit an economy since they are interest-free and are usually associated with improving or extending public goods and services. In liquid capital markets, portfolio flows can be extremely volatile in nature. For this reason, they are not a stable or reliable source of financing.

#### *External debt and liquidity*

Debt overhang and external liquidity may both have indirect effects on trade finance availability and development. Whereas net resources refers to flows of funds, debt overhang or debt burden refers to the stock of external debt. The higher the level of indebtedness, the higher future debt service payments will be, which is a drain on domestic finance (debt service payments are the annual flows expended to cover both interest payments and principal).

The external liquidity of a country refers to the level of foreign currency that a country holds. A low level of liquidity limits a country's ability to import goods and services. Furthermore, since the monetary stock is composed of international reserves, fluctuations in the latter will influence monetary policy. Since foreign debt is denominated in foreign currency (for example, the United States dollar or the euro), in order to service

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<sup>14</sup> The repatriation of earnings could be considered a form of service payment, although it could be argued that profitability might not have arisen had the investment not been made.

this debt, economic agents may short (sell) the domestic currency and long (buy) the foreign currency. When demand for the foreign currency exceeds reserves, the value of the domestic currency is driven downwards and a financial crisis can ensue.

#### *Exchange rate policy and foreign currency availability*

Trade finance development will be affected by foreign exchange rate arrangements, volatility of exchange rates and business sentiment towards exchange rate policies. International payments also require the existence of foreign exchange reserves, which are influenced by monetary and fiscal policies.

Governments can influence substantially the ease with which international payments are made. For example, placing an anchor on the exchange rate will facilitate international transactions by abstracting from uncertainty regarding exchange rate movements. At the same time, if the anchor, or peg, overvalues a currency, the competitiveness of exporters will be reduced.

Overall, as suggested by the recent financial crises in Asia and South America, flexible arrangements may be more favourable for the long-term development of a trade finance infrastructure. The accumulation and maintenance of significant foreign exchange reserves are also expected to have positive indirect effects on trade finance.

#### *Monetary and financial system*

Monetary and financial system indicators are primarily proxies of the level of banking and financial development. They indicate the extent to which banking transactions are more important than cash transactions and the extent to which the banking system is present in the economy. Traditionally, two indicators are used to assess financial development: financial deepening (the degree of monetization in the economy) and the evolution of real interest rates towards expected equilibrium levels. The simplest measure of financial deepening is to view the level of broad money (quasi money and narrow money) in comparison with GDP.<sup>15</sup> It measures the degree of monetization of the economy. The level of deposits in money banks represents a sign of financial health since the banking system is able to attract savings. This can reasonably be expected to have a positive effect on the availability and development of trade finance.

More interesting is the ratio of broad money to narrow money. Since narrow money reflects cash, it will represent the level of transactions that take place in the economy. As a country makes use of financial intermediaries for transacting, quasi money should rise correspondingly. For this reason, the ratio of quasi money to narrow money may be expected to rise in line with financial deepening and with the increasing availability and use of trade finance instruments.

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<sup>15</sup> Narrow money is cash in circulation, while quasi money included savings deposits.

### *Credit market and ratings*

Government management of public finance can be detrimental to interest rates and can reduce the amount of funds available for trade financing. Indeed, a large government deficit (when revenue does not cover expenses) can be financed by printing money (seignorage is the action of eroding the real domestic value of public debt by raising inflation) or by issuing government bonds. Since tight monetary policy is generally considered to be a high priority, government deficits crowd out the private savings that will finance the deficit, leaving little room for trade financing.

The perception of a country's financial standing from the international market's viewpoint may also have an indirect but very concrete impact on the development and availability of trade finance services. For example, poor sovereign debt ratings issued by Standard and Poor's and Moody's, two international credit rating agencies based in the United States, suggests a high risk of government default on its debt obligations, which has strong exchange rate implications. This makes borrowing by exporters more expensive, since the interest premium will rise, and a subsequent depreciation of the currency would have the effect of raising foreign-denominated debt repayment for private and public enterprises.

### *Legal environment*

A complete legal system is necessary for the development of a variety of trade finance services (e.g., leasing). The legal framework governing enterprises and banks is extremely important in order to ensure that systemic risks are minimized, keeping in mind that liberalization without sufficient prudential regulations can be detrimental to the economy. For businesses, the impartiality and effectiveness of the legal system will determine whether they will be able to follow market forces or be compelled to operate less efficiently. Legal issues and the importance of legislation have already been highlighted in chapters III and IV.

The degree to which the legal environment favours the development and availability of trade finance will be influenced by the quality of commercial laws, the effectiveness and enforcement of bankruptcy laws, the adoption of international rules and standards, and the ability of the legal system to resolve trade disputes in a timely and transparent manner. Measures taken to reduce the cost and time associated with legal requirements, such as registering a loan, preparing and registering the charges and paying the relevant duties, would also facilitate the development of trade finance.

### *Financial institutions*

A trade credit offer is essentially channeled through the banking system. The structure and efficiency of the banking system will therefore significantly influence the availability of trade finance. The efficiency of the system, as measured by the share of non-performing loans in a bank's portfolio of loans, by the spread between deposit and lending rates, and/or by the number of days it takes to transfer money from one institution

to another, will determine the extent to which the needs of exporters and importers may be proactively met by existing institutions. The completeness of the banking sector will also be important, as trade financing is often channeled through specialized banks and credit schemes (guarantees, insurance). However, the level of development of the financial institutions and banking system is dependent on the macroeconomic determinants discussed above.

The importance of trade finance institutions is discussed in more detail in chapter VI.

#### *Capital and credit restrictions*

The existence of government restrictions on capital and market instruments will directly affect the range of trade finance instruments and services available to mitigate risk or secure credit. The degree to which financial intermediaries and enterprises can either draw up financing contracts or deal in financial instruments with or without prohibitive measures imposed by the Government should be examined to ensure that it will not impede trade finance infrastructure development. Legislation on capital controls (one of many tools for conducting monetary policy), which may raise the cost of international transactions, and legislation on foreign direct investment, which is an important source of equity income for resident enterprises, should also be reviewed.

#### *Cost of borrowing*

As explained in chapter I, exporters are often faced with a constraint on financial resources owing to the delay between the time they pay for an order and the time they receive money for that order. The mismatch of time horizons is such that exporters usually turn to financial intermediaries to satisfy their financial needs. The rates of interest for borrowing vary from one country to another and raise the cost of final production while reducing the competitiveness of enterprises.

High borrowing costs, stemming from high interest rates as well as long collection delays, have a direct effect on exporters and the availability and development of trade finance. For example, domestic inter-bank borrowing rates that are high in relation to international rates, such as LIBOR, are likely to prevent the financial sector from providing exporters with affordable credit. The cost of borrowing is ultimately dependent on the macroeconomic environment, as discussed earlier in this section.

### **C. ITC Trade Finance Pointers: an overview<sup>16</sup>**

Trade Finance Pointers (TFP) is an entirely novel and simple data-driven analytical tool designed to help bodies representing the private sector in developing countries, as well as the financial sector and government agencies concerned with trade and private

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<sup>16</sup> The present section is based on an ITC technical paper entitled "Trade finance pointers: methodology, interpretation and theoretical considerations", ITC, 2004 (see [www.intracen.org/tfs](http://www.intracen.org/tfs)).



sector development, to understand where the main constraints to accessing trade finance might lie.

A TFP chart is used to highlight the apparent and comparative strengths or weaknesses in the trade finance macroeconomic environment as well as the trade finance infrastructure of a given country (or a group of countries). A TFP chart is thus a pre-diagnostic tool that greatly facilitates analysis of the causes of a country's (or region's) trade finance structure inadequacies or deficiencies. It may also be used to monitor changes over time and the impact of reforms and changes introduced in the financial sector or measures taken to improve the trade finance macroeconomic environment.

#### *The structure of a TFP chart*

A TFP chart, for any given country or group of countries, is based on a set of up to 52 indicators, as shown in figure 5.3. Each indicator represents or refers to a factor affecting the environment or structure of the country's financial sector. These indicators are aggregated into 10 composite indices reflecting the 10 determinants discussed above.

As such, they may be separated into two groups: a first group representing the trade finance macroeconomic environment and a second representing the trade finance institutional structure and capacity. The composite indices focus on general areas where efforts could be made to bring about reforms or changes that should help improve enterprises' access to trade finance.

The classification of the composite indices as macroeconomic environment and institutional structure and capacity indices also helps to highlight whether the principal trade finance problems of a given country lie mainly in the public sector (e.g., in deficiencies in government policy or the legal or judicial system) or in the financial sector itself (e.g., an incomplete or inadequate range of institutions, instruments or mechanisms).

The TFP methodology, which is based on annual data, enables users to plot the evolution of a country's performance and highlight trends over a number of years, thus testing the effectiveness of measures that may have been introduced to improve accessibility to trade finance.

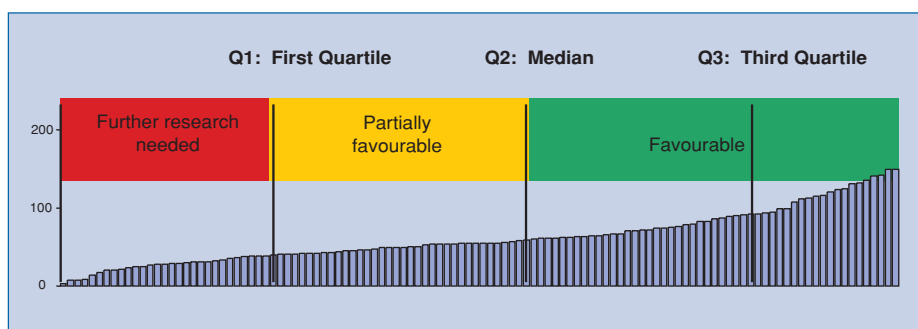
#### *Interpretation of a TFP chart*

For each indicator, the TFP chart gives a value that has been obtained from annual World Bank and IMF statistical series and other sources, including Moody's, Coface and ITC as well as direct observation in the country concerned. Each indicator is compared with the aggregate median and quartile results of all countries with developing and transition economies (a population of 155 countries that make up the list of low, middle and upper-middle income countries as defined by the World Bank). These aggregate results constitute individual indicator benchmarks and determine a country's (or a region's) position in relation to the benchmark. A green-amber-red colour code highlights this relative position. The three possible flags are illustrated below:

- A green flag shows that the indicator value is at least as favourable as the median for the population of 155 developing countries. This indicator result is classified as being “favourable”, i.e., with regard to that particular indicator, the country analysed performs no worse than the median average of the other 154 developing countries;
- Indicator results between the less favourable quartile and the median are classified as being “partially favourable”, i.e., for that particular indicator, a country’s performance is below the median of the other 154 developing countries but above the quartile that represents the less favourable performance.
- If, however, the indicator result is within the least favourable quartile, then the conclusion might be that “further research is needed”, meaning that priority should probably be given to analysing the reasons for the apparently low performance in that area.

Figure 5.4 illustrates how a country is benchmarked using *long-term debt as a percentage of gross national income (GNI)* as an example. If a country’s long-term debt as a percentage of GNI is below the median but within the second quartile of the all-developing-country distribution, the country receives a yellow flag and a score of 2 (out of 3). Similarly, a country that falls within the first quartile of the distribution receives a red flag and a score of 1.

**Figure 5.4. Long-term debt as a percentage of gross national income**



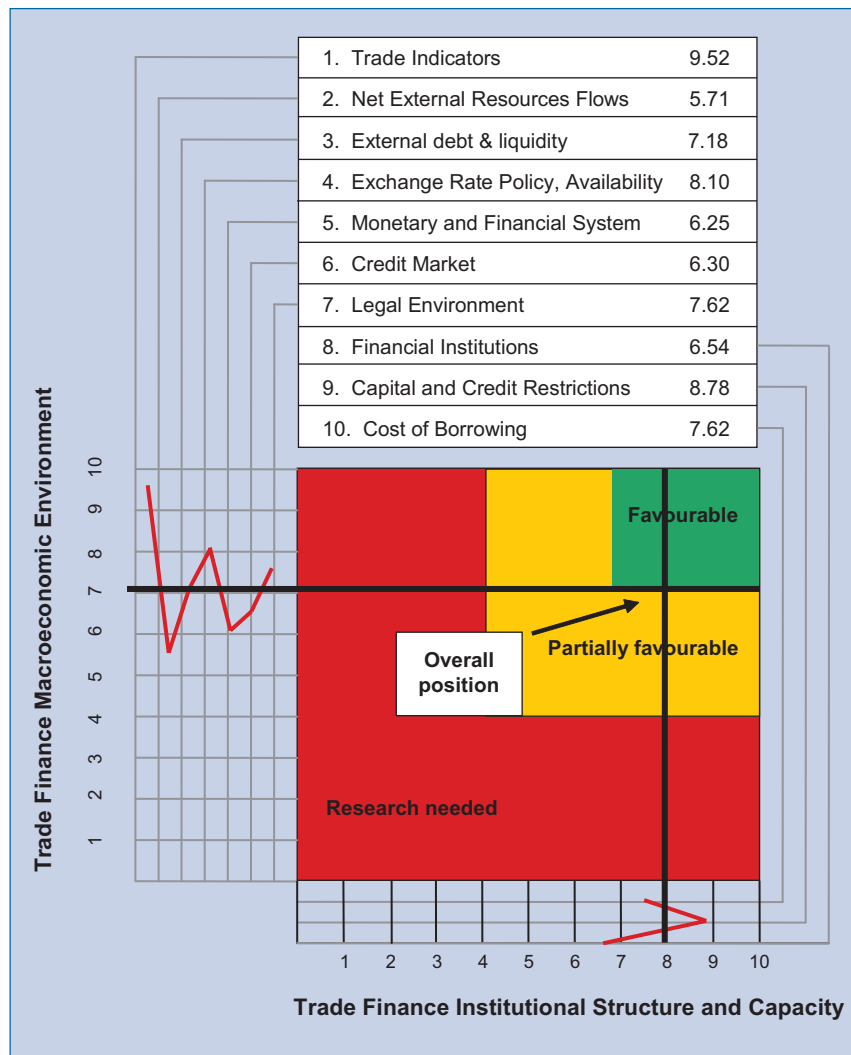
Source: World Bank Indicators, 2002.

The reader can see at a glance how, for any given indicator, a country or a group of countries (e.g., a region, a subregion or a category of countries) compares with the benchmark for the group of 155 developing countries. However, it is very important to emphasize that the chart is not a ranking system and does not attempt to pass judgment: it merely highlights variances. A fuller diagnosis is necessary to determine the causes and significance of the variances and whether remedial action is required.

*From individual indicators to composite indices and the ready-reckoner chart*

As shown in figure 5.3, Kazakhstan receives green flags and scores of 3 (out of 3) for three of the four indicators in the area of trade. A composite index, measuring how favourable the current trade situation is for trade finance development, may then be calculated on the basis of the scores in each of the five indicators (weighted by the relative importance of each of the indicators, as perceived by a consortium of trade finance experts and bankers).

**Figure 5.5. Kazakhstan 2002 ready reckoner chart**



Following the same process, ten composite indices, standardized on a scale of 10, can be calculated and compared, revealing which areas of the macroeconomic environment and the financial system deserve particular attention to improve access to and availability of trade finance.

Ultimately, the composite indices may be used to create a graphic chart similar to that in figure 5.5 to show where the country stands on the trade finance development curve. This is done by plotting the average of the seven macroeconomic indices on the vertical axis and the average of the three institutional structure and capacity indices on the horizontal axis.

## D. Conclusion

For the majority of SMEs in developing countries, ready access to finance is said to be the most severe “bottleneck” for trade. The difficulty that SMEs claim to have in accessing finance is often caused by an incomplete or an inadequate financial environment and infrastructure. In particular, the number of financial intermediaries and specialized financial institutions is often found to be limited, as are the financial instruments offered to exporters and importers.

However, a country’s general legal framework as well as its macroeconomic environment and policies can greatly affect the development of the financial sector and its ability to provide SMEs with adequate and effective trade finance facilities. Factors, such as the debt burden, the external liquidity or the level of monetization in an economy, require substantive government or institutional policy inputs in order to adjust a country’s positioning towards the development of a more favourable trade finance environment.

The ITC Trade Finance Pointers methodology may be adopted by countries with economies in transition to assess their trade finance macroeconomic environment and their trade finance infrastructure and capacity, and to monitor progress in this area.

## E. For further reading

- ITC, “Trade finance pointers: methodology, interpretation and theoretical considerations” (technical paper), 2004 (see [www.intracen.org/tfs](http://www.intracen.org/tfs)).
- Coface: [www.cofacerating.com](http://www.cofacerating.com).
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## Annex

### ITC trade finance survey questionnaire

The ITC trade finance survey is part of the methodology adopted for the Trade Finance Pointers project developed by the Trade Finance Programme at the International Trade Centre UNCTAD/WTO – ITC, in Geneva. A number of sources are consulted in collecting data for the 52 indicators that make up the TFP for each country covered: World Bank and IMF publications, ITC publications, and the ITC Trade Finance Surveys. Therefore, this survey serves as a fact finding exercise that aims to obtain objective information to be used to prepare the TFP indicators. For further information on the TFP project or on the Trade Finance Programme at ITC, please contact: Mr. Carlo F. Cattani, Senior Adviser on Trade Finance, ITC [E-mail: [cattani@intracen.org](mailto:cattani@intracen.org)].

#### INSTRUCTIONS FOR FILLING OUT THE ITC TRADE FINANCE SURVEY:

1. Please indicate sources and dates of information as you fill out the questionnaire.
2. Please stay as objective as possible when you provide evaluations.
3. Please feel free to add comments as you see fit (use additional sheets if necessary).
4. Please do not change the contents of the questionnaire.

#### ITC TRADE FINANCE SURVEY – PART I

**Country surveyed:**

**Dates of survey:**

**Name of Consultant:**

#### A. On the Foreign Exchange Availability in the Country – Composite Index 4

- 4b What is the level of foreign exchange availability in the country and at what cost levels? Please check appropriate answer.
- Easily available for unlimited amounts
- Available only upon request for all purposes
- Available upon request for most imports (please indicate up to what amount) and payment service (broad range of services)
- Available upon request for specific imports (please indicate up to what amount) and payment service (narrow range of service)

- Available for limited goods/first-priority commodities
- Practically, not available

Cost levels and comments:

**B. On the Legal Environment in the Country – Composite Index 7**

7a How efficient is the legal system in resolving legal disputes quickly and enforcing court decisions? Please check the appropriate answer.

- Legal disputes resolved within six months, rather impartially and enforcement follows rapidly
- Legal disputes take longer (between 6 and 18 months) to resolve; or entrepreneurs have a feeling of partiality and enforcement is difficult
- Legal disputes take years to resolve; courts are subject to external influence or enforcement is very difficult
- Legal disputes take many years to resolve; courts can be manipulated and in most cases decisions are not enforced
- Little or no recourse to legal settlements; court decisions are either non-existent, or inefficient, or partial; enforcement impossible

Comments:

7b How long does it take to fulfil legal requirements such as registering a loan, preparing and registering the charges, paying the relevant duties?

7c What are the average legal costs required of a transaction, as a percentage of the total transaction, e.g. for preparation of loan agreement, plus registration, plus the security, plus stamp duty? What about for L/Cs, or for investment agreements?

7d What is the mandatory cost on average associated with stamping financial agreements?

7e How effective are the bankruptcy law and related procedures from the banks' standpoints (seizing and liquidating recovered assets), rated from 1 to 10 with 1 representing complete ineffectiveness and 10 full effectiveness?

7f Is there an obligation to adopt auditing standards of international reputation? (When a survey is available, please kindly state so.)

**C. On the Financial Environment in the Country – Composite indices 8 & 9****Institutions currently existing in the country at the time of this survey****Commercial Bank**

8a	How many financial institutions are there in the country offering a full range of high-street banking services, including the opening of deposit and cash accounts, payment services, and credit facilities?		
8b	Are they operating satisfactorily, based upon the percentage of applications accepted out of all received (assuming applications are all for projects or transactions that are bankable)?	Yes <input type="checkbox"/>	No <input type="checkbox"/>
8a	Do they offer export/import credit facilities?	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Comments:			

**Import/Export Banking**

8a	How many financial institutions are there in the country offering specific export/import financial services, including, for instance, trade credit insurance, guarantees, bills discounting, opening and confirming L/Cs?		
8b	Are they operating satisfactorily, based upon the percentage of applications accepted out of all received (assuming applications are all for projects or transactions that are bankable)?	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Comments:			

**Specialized SME Banking**

8a	How many financial institutions are there in the country offering financial services specifically designed for SMEs, with or without the support of donors or the government?		
8b	Are they operating satisfactorily, based upon the percentage of applications accepted out of all received (assuming applications are all for projects or transactions that are bankable)?	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Comments:			

**Development Bank**

8a	How many financial institutions, public or private, are there in the country offering project finance, i.e. facilities longer than one year for capital expenditure or medium-, long-term development?		
8b	Are they operating satisfactorily, based upon the percentage of applications accepted out of all received (assuming applications are all for projects or transactions that are bankable)?	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Comments:			

**Agricultural Bank**

8a	How many financial institutions are there in the country offering farmers and other producers a wide range of banking services including advances and facilities for the procurement of agricultural inputs and possibly warehousing finance or structured finance secured by commodities?		
8b	Are they operating satisfactorily, based upon the percentage of applications accepted out of all received (assuming applications are all for projects or transactions that are bankable)?	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Comments:			

**Credit Insurance Schemes**

8c	Is there a national or regional trade credit insurance agency operating in the country?		
8d	Is it operating satisfactorily, based upon the percentage of applications accepted out of all received (assuming applications are all for projects or transactions that are bankable)?	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Comments:			

**Guarantee Schemes or Funds**

8c	Is there a national or regional guarantee scheme or fund operating in the country? (Guarantees, in this context, refer to instruments provided by a specialized institution to enable an enterprise, particularly exporting enterprises, to obtain credit facilities from a commercial or development bank.)		
Comments:			



**Credit Rating Agency**

8c	How many credit rating agencies are operating in the country?	
Comments:		

**Forfaiting Companies**

8c	How many forfaiting companies are operating in the country? (A forfaiter is an institution that purchases receivables at a discount without recourse to the seller.)		
8d	Are they operating satisfactorily, based upon the percentage of applications accepted out of all received (assuming applications are all for projects or transactions that are bankable)?	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Comments:			
8e	Does the Central Bank provide or authorise banks to provide hedging against commodity and/or exchange rate movements? Are these instruments easily available?	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Comments:			
8f	Please indicate the average number of days it takes banks to transfer money from the account of a customer to the account of its supplier, i.e. the financial system payment transfer delay.		
Comments:			
8h	Ratio (%) of non-performing loans to total credit outstanding of banks:		
Comments:			
8i	Are there risk management systems in place? If so, what methodology is used (i.e. value at risk, scenario analysis, etc.)?	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Comments:			
8j	Do banks practice securitisation? (i.e. issuance of bonds or similar market traded instruments secured by underlying assets such as loans or facilities to companies)	Yes <input type="checkbox"/>	No <input type="checkbox"/>
Comments:			

**D. On the Availability of Funds in the Country – Composite index 9**

Please choose the answer that you think suits the situation in the country. Please explain when possible.

Indicator Code	No restrictions apply, except for objectively prudential requirements	Partial restrictions exist of a non-prudential nature	Excessive non-prudential restrictions apply
9b restrictions on derivatives and other instruments. (Derivative products include: futures and options on commodities and foreign currency and interest rate swaps.)			
9c restrictions on export financing. (Export financing refers to the existence of specific export financing regulations that may limit the financing options of residents to conclude private contracts.)			
9d restrictions on capital and money market instruments. (These instruments refer to the public offering or private placement on a primary market or listing on a secondary market, for example, the issuance of shares, bonds or other debt securities, certificate of deposits and bills of exchange.)			
9e restrictions on direct investment. (The liquidation of direct investment, through the repatriation of initial investment plus capital gains is included in this.)			
9f restrictions on credit operations. (Credit operations refer to operations linked to international trade transactions, including guarantees, sureties and financial backup facilities.)			

**General Comments (if any):**

**ITC TRADE FINANCE SURVEY – PART II**

Note to National Consultants:

Please find below questions on the general trade finance environment of the country for which you are conducting the Trade Finance Survey Part I. Your detailed answers are greatly appreciated. Please feel free to add any other relevant information, including explanatory brochures, extracts from official texts, etc. Thank you very much!

**A. On the activities of financial institutions:**

1. Does the Central Bank run specific schemes in areas such as trade promotion or SME development? If so, give details.
  
2. Does the Central Bank offer rediscount facilities to other banks? Give details
  
3. Distribution of bank loan portfolio by size of enterprise: state percentage by number of borrowers and by outstanding loan amounts:

<i>Category of borrower</i>	<i>% number of borrowers</i>	<i>% amount outstanding loan</i>
-----------------------------	------------------------------	----------------------------------

Micro enterprises

Small enterprises

Medium enterprises

Large enterprises

*Note: Please obtain exact data, or failing that, estimates from the Central Bank or individual banks. As there is no accepted international definition for micro, small, medium or large enterprises, use local practice (if any) and state how the Authorities or the banks themselves define size of enterprises (e.g. by Sales, Number of Employees, Net Asset Value, Total Net Assets, etc.).*

4. Distribution of bank loan portfolio by sector of activity: please state the share of borrowers and of outstanding loan amounts of each sector out of the total for all sectors:

<i>Sector</i>	<i>% number of borrowers</i>	<i>% amount outstanding loan</i>
---------------	------------------------------	----------------------------------

Primary sector:

(agriculture, fishing, forestry,  
mining, quarrying, etc.)

Secondary sector:

(manufacturing, processing)

Tertiary sector:

(services, tourism, hotels,  
transport, maintenance, trade, etc.)

5. What typical forms of collateral do banks demand?

- Fixed assets, such as real estate or property:
- Fixed assets such as machinery and equipment:
- Current assets such as stocks of raw materials or finished products:
- Current assets such as accounts receivable:
- Other:

6. Are there any financial institutions providing Structured Finance facilities to commodity producers or traders? (e.g. for commodities stored in third-party warehouses and for which warehouse receipts have been issued)

7. Non-bank or institutional investor capital: what is the estimated share of equity and loan finance enterprises obtain from friends and relatives?

8. Banking services: give details of the main current services, facilities and products offered by banks and other financial institutions in the following main categories:

- Loan facilities, advances, trade credit
- Bills discounting, forfaiting
- Trade credit insurance
- Trade credit guarantees
- Guarantees
- Deposit and savings accounts
- Payments systems
- Investment and brokerage services
- Others

**B. On the activities of other institutions:**

1. Are there any specialized trade promotion agencies? What is the range of their activities and services and who benefit from these?

2. Are there any tax or other incentives for exporters? If so, please give full details.

3. Are there any leasing companies operating in the country? Do they run specific schemes for SMEs?
4. Are there business service professionals or firms operating in the country such as business advisers, legal & tax advisers, and professional auditors? Give details of the services offered and the profiles of their clients.
5. Are any technical assistance schemes (i.e., non-financial schemes) currently available to businesses? If so, give details of the size of the fund, the origin of the fund, the scope of services offered, eligibility criteria and the number of enterprises that have benefited from the scheme to date.
6. Do business arbitration courts or entities operate in the country? What are the main institutions involved in the process? How do you assess the effectiveness of this practice? Are there any promulgated laws, rules, or regulations thereon?

Figure 5.3. Kazakhstan 2002 Trade Finance Pointers chart

Composite index	Indicators	Kazakhstan 2002	Benchmarks 2002: median (critical quartile)	Flag	Result	Weight	Total	Composite Total <sup>a)</sup>
1. Trade indicators	a) total trade as a per cent of GDP	93.39	81.94 (59.74)		3	▲▲	6	(20 out of 21) x 10 = 9.52
	b) net barter terms of trade (1995 = 100) (year <sub>t</sub> /year <sub>t-1</sub> )	NA	95.83 (83)	NA	2	▲	2	
	c) cover ratio as a per cent	101.94	88.89 (68.15)		3	▲▲	6	
	d) change in total trade (year <sub>t-5</sub> to year <sub>t</sub> ) as a per cent	43.43	15.25 (-1.93)		3	▲▲	6	
2. Net resources	a) net flows of long term debt as a per cent of GNI	11.92	4.16 (8.22)		1	▲	1	(12 out of 21) x 10 = 5.71
	b) net FDI flows as a per cent of GNI	-1.07	-0.02 (-1.08)		2	▲▲▲	6	
	c) net portfolio investment flows as a per cent of GNI	-0.05	0 (0)		3	▲	3	
	d) net official development assistance and official aid as a per cent of GNI	0.80	4.28 (0.81)		1	▲▲	2	
3. External debt & liquidity	a) total external debt stock as a per cent of GNI	74.30	69.52 (93.40)		2	▲▲	4	(28 out of 39) x 10 = 7.18
	b) total external debt service as a per cent of goods & services exports	34.42	10.67 (19.49)		1	▲▲▲	3	
	c) reserves in months of goods & services imports	2.97	4.08 (2.59)		2	▲▲▲	6	
	d) current account balance as a per cent of GNI	-2.95	-3.72 (-8.65)		3	▲▲	6	
	e) short term debt as a per cent of long term debt	7.24	14.84 (24.30)		3	▲▲▲	9	
4. Exchange rate policy & availability	a) exchange rate arrangement	MF	none		2	▲	2	(17 out of 21) x 10 = 8.10
	b) foreign exchange availability	See note	standard		3	▲▲▲	9	
	c) exchange rate volatility (year <sub>t-5</sub> to year <sub>t</sub> )	NA	29.39 (45.59)	NA	2	▲▲	4	
	d) real effective exchange rate index (1995 = 100)	NA	105.43 (90.38)	NA	2	▲	2	
5. Monetary & financial system	a) Deposits as a per cent of GDP	0.05	0.05 (0.02)		2	▲▲	4	(15 out of 24) x 10 = 6.25
	b) Financial deepening I: Monetisation of economy as a per cent	19.54	37.47 (24.97)		1	▲▲	2	
	c) Financial deepening II: Quasi money as a per cent of narrow money	89.52	126.72 (69.77)		2	▲▲	4	
	d) Turnover ratio of a stock market	26.54	10.00 (0.00)		3	▲	3	
	e) Market capitalisation as a per cent of GDP	NA	19.79 (10.78)	NA	2	▲	2	
6. Credit market	a) Crowding out of private investment as a per cent	-0.35	-2.41 (-16.36)		3	▲	3	(17 out of 27) x 10 = 6.30
	b) Moody's sovereign LT debt rating	Baa3	A (C)	NA	2	▲▲	4	
	c) Standard & Poor's sovereign LT debt rating	BB+	A (C)		2	▲▲	4	
	d) Forfeiting rates	3.99	3.55 (3.24)		1	▲▲	2	
	e) Export credit risk (Coface)	5.00	3.00 (6.00)		2	▲▲	4	
7. Legal environment	a) Aptitude of legal system in solving trade disputes	See note	standard		2	▲▲	4	(16 out of 21) x 10 = 7.62
	b) Efficiency in fulfilling legal, admin procedures	8	6.00 (12.00)		2	▲	2	
	c) level of legal cost	0.5	2.00 (4.00)		3	▲	3	
	d) stamp duty for agreements	NA	0.005 (0.01)	NA	2	▲	2	
	e) effectiveness of bankruptcy laws	6	7.00 (5.00)		2	▲	2	
	f) international auditing standards	See note	standard		3	▲	3	
8. Financial institutions	a) completeness of banking system	See note	7.00 (5.00)		3	▲▲▲▲	12	(53 out of 81) x 10 = 6.54
	b) running of banking system	NA	standard	NA	2	▲▲▲	6	
	c) completeness of non-banking system	See note	7.00 (5.00)		1	▲▲	3	
	d) running of non-banking system	See note	standard		1	▲▲	2	
	e) hedging instruments	See note	standard		1	▲▲▲	3	
	f) operational efficiency of banking system	See note	6.00 (14.00)		3	▲▲	6	
	g) financial efficiency of banking system: interest rate spread	NA	8.31 (13.00)	NA	2	▲▲▲	6	
	h) non-performing loans	38.90	15.00 (25.00)		1	▲▲▲	3	
	i) risk management systems	See note	standard		3	▲▲	6	
	j) securitisation	See note	standard		2	▲▲	4	
9. Capital & credit restrictions	a) domestic credit to the private sector as a per cent of GDP	18.61	20.68 (10.36)		2	▲▲▲▲	8	(29 out of 33) x 10 = 8.78
	b) restrictions on derivatives and other instruments	No restriction	standard		3	▲▲	6	
	c) restrictions on export financing	No restriction	standard		3	▲▲	6	
	d) capital & money market instruments	No restriction	standard		3	▲	3	
	e) restrictions on direct investment	No restriction	standard		3	▲	3	
	f) restrictions on credit operations	No restriction	standard		3	▲	3	
10. Cost of borrowing	a) prime bank rate	7.50	7.38 (15.31)		2	▲	2	(16 out of 21) x 10 = 7.62
	b) real interest rate	NA	9.73 (15.25)	NA	2	▲▲▲▲	8	
	c) collection delays in months	2.00	2.00 (5.00)		3	▲▲	6	

Note: The colour reflects the result of the national survey, which are expressed frequently into text form, i.e. not in figures. See the annex for the questionnaire form used for national surveys.

a) The column at the right end of the table reports the composite values, which are obtained by multiplying the nominal value of each flag by the weight of the indicator and dividing this aggregate result by the maximum score attainable. The total result is then multiplied by 10. The maximum score is simply the sum of all possible maximum values, i.e. 3, for each indicator, multiplied by the indicator's weight. In case there is no value because of missing data, the maximum result considered is 2.

## VI. Institutions for trade finance development

### A. Introduction<sup>17</sup>

On the basis of a review of trade-finance-related institutions in Asian countries, a generic model of a national trade finance institutional structure (TFIS) has been developed for possible adoption and implementation in countries with economies in transition in the South Caucasus and Central Asia.

A country's national TFIS is part of its overall financial sector structure. Developing countries with fairly well-developed financial sectors appear to have adopted a two-tier banking system, where one central bank or monetary authority conducts monetary policy and regulates the banking system. Most of these countries also feature financial market institutions at different stages of development, such as stock markets and foreign exchange and derivative markets as well as non-banking financial institutions and domestic credit rating agencies. More importantly, at least from a trade finance perspective, these countries also feature a number of specialized institutions, among which trade finance and development finance institutions (see the example in figure 6.1). The TFIS model proposed below is mainly based on this last observation.

### B. A national trade finance institutional structure model

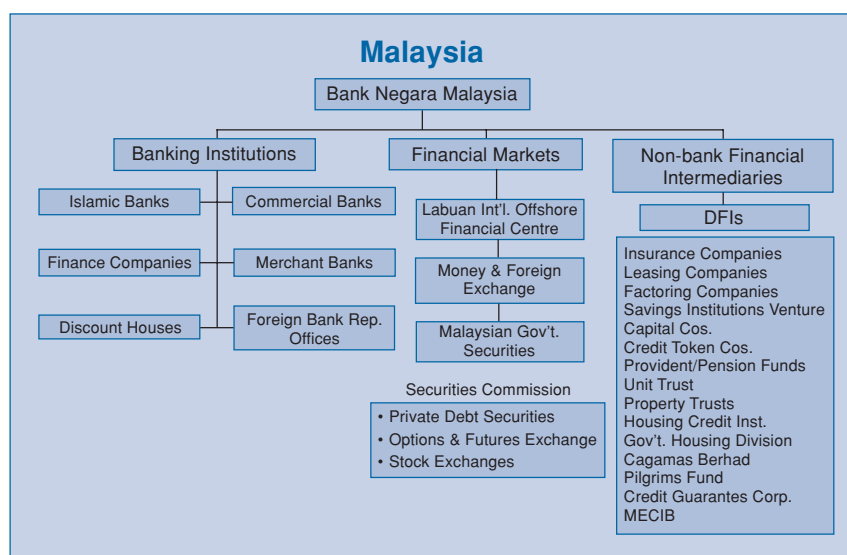
While many developing countries have increasingly left commercial banking to the private sector, they have retained ownership of special-purpose banks, such as development and industrial banking institutions, and trade-related financial institutions such as export credit insurance and guarantee companies, or export-import banks (EXIMs). This is also true in most developed countries, including the United States, with its government-owned EXIM Bank. While recent trends have shown a willingness to make these organizations more independent (self-financed), most countries have been reluctant to privatize them as they provide Governments with some tools to address perceived market failures in the financial and trading sectors.

The suggested TFIS model is presented in figure 6.2. In this model, the institutions are grouped into three categories based on the level of government ownership and control. While the level of government control over trade-finance-related organizations varies significantly from one country to another, the model presented here is arguably representative of the basic TFIS of many middle and high-income countries. Note that the financial

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<sup>17</sup> This chapter is mainly based on Yann Duval and Urmi Sengupta, "Trade finance institutions for trade and small and medium-sized enterprise development in South Caucasus and Central Asia", in ESCAP, *Current Issues on Industry Trade and Investment, No. 2* (United Nations publication, sales No. E.04.II.F.6), 2003 (available online at [www.unescap.org](http://www.unescap.org)).

**Figure 6.1. Institutional structure of the financial sector in Malaysia**



Source: Association of Development Financing Institutions in Asia and the Pacific, 2003.

market institutions (e.g., bond markets, stock markets and securities markets) and other institutions indirectly linked to trade finance are not included in the model, given the limited scope of this chapter. Domestic credit rating agencies and institutions necessary for the development of warehouse receipt financing are also omitted (please refer to chapter IV).

The role of each of the institutions in the model, as well as the relationship between these institutions, is discussed in more detail below.

#### *Level I institutions*

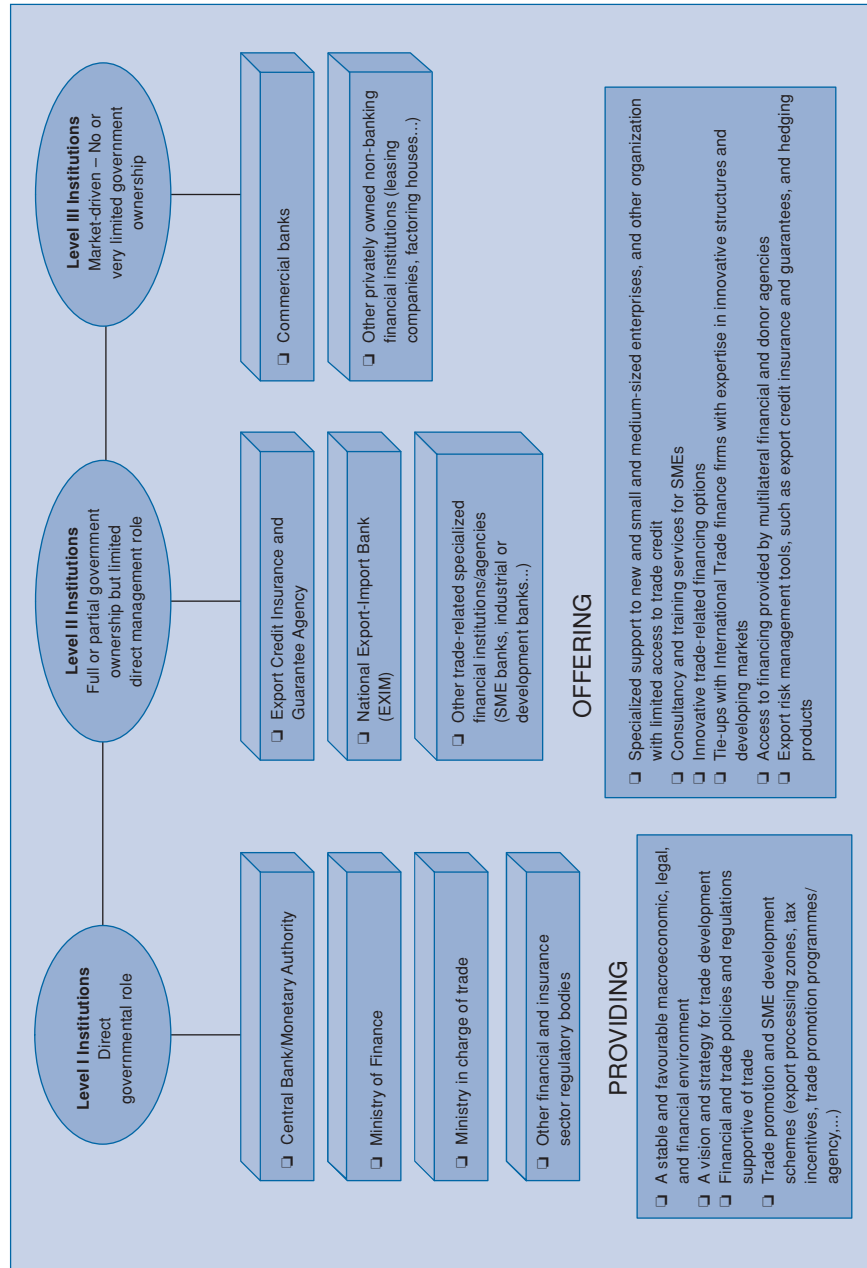
##### (i) Central banks and monetary authorities

Most countries now have a central bank or a monetary authority. These institutions are typically responsible for managing the money supply as well as the regulation and oversight of the financial system, particularly the banking system. Often, they also act as the banker to and the financial agent of the Government.

Central banks can influence the availability of trade finance through regulations as well as through refinancing schemes. For example, the Reserve Bank of India administers interest rates on export credit, specifies the export finance provision requirements for commercial banks and provides these banks with a rediscounting facility for their lending activities in the private sector. In addition, it issues directives regarding the implementation of new rules and regulations on trade and develops procedures regarding the financial



Figure 6.2. Proposed national trade finance institutional structure model



### Box 6.1. Reserve Bank of India and Trade Finance

The Reserve Bank of India, India's central bank, plays an active role in promoting and supporting trade, as shown below.

“Trade finance is a crucial element in the design of trade policies. From time to time, the Reserve Bank has undertaken several measures to ensure adequate and timely availability of credit for exports at competitive interest rates. The Reserve Bank's export credit refinance schemes have played a pivotal role in this area. Commercial banks have been providing credit to exporters at pre-shipment and post-shipment stages, both in rupees as well as foreign currency. The rupee export credit has been generally available at rate of interest linked to the Prime Lending Rate (PLR). The export credit in foreign currency is provided at internationally competitive interest rates linked to London Inter-Bank Offer Rate (LIBOR) or similar interest rates. The Reserve Bank has been adjusting interest rates on rupee export credit from time to time taking into account the need to maintain competitiveness by looking at interest rate differentials, as also other factors like inflation and developments in financial markets.

The Reserve Bank has also taken measures to support institutional arrangements for export promotion, such as policy initiatives to provide a liberalised environment for the operations of Special Economic Zones (SEZ) units. These measures include: (i) exemption from interest rate surcharge on import finance; (ii) release of foreign exchange to Domestic Tariff Area (DTA) units for buying goods from Export Oriented Units/Export Processing Zones/Special Economic Zones (EOU/EPZ/SEZ) units; (iii) permitting 100 per cent retention of foreign exchange in Exchange Earners Foreign Currency (EEFC) accounts; (iv) permitting overseas investment by SEZ units from the EEFC accounts through the automatic route, write-off of unrealised export bills and (v) permitting SEZ units to enter into a contract in overseas commodity exchanges or markets to hedge the price risk in the commodity on export/import provided that the contract is made on a 'stand alone' basis.”

*Source:* Currency & Finance Report, Reserve Bank of India, 2002-03 ([www.rbi.org.in](http://www.rbi.org.in)).

aspects of the trade transactions, including requirements for foreign currency dealings and eligibility criteria for financing schemes developed for the promotion of exports (see box 6.1 for more details).

#### (ii) Other level I institutions

**Ministries of finance** can also play an important role in trade development. For example, the Export-Import Bank of Thailand (a level II institution) is under the Ministry of Finance and was established jointly by the Bank of Thailand and the Ministry of Finance. In some countries, ministries of finance also play a role in providing tax incentives or tax holidays so as to encourage trade development. Depending on the needs and strategies of Governments, these tax incentives may be limited to specific groups of traders (e.g., SMEs) or/and products (e.g., handicrafts). Finally, customs departments, often under the finance ministries, can greatly affect the cost of trade transactions and the time it will take

for goods to reach their final destination. This will, in turn, affect the financing needs of traders.

**Ministries in charge of trade** are typically in charge of regulating trade as well as developing and implementing an overall trade development strategy. Most ministries in charge of trade oversee TPOs, such as trade and investment promotion agencies. These agencies provide export support services, which may include trade facilitation and trade finance services.<sup>18</sup> One important role of the agencies in charge of trade development is to correctly assess the needs of the private sector and to coordinate with other ministries, including the finance ministry, to develop policies, regulations and programmes that will facilitate trade. From that perspective, the ministry of trade, based on regular interactions with traders and other stakeholders in trading activities, should be proactive in the development and implementation of laws and regulations that affect trade, even if these laws and regulations are not under the direct responsibility of the ministry (as is typically the case for trade finance regulations and many other trade facilitation-related measures).

**Other government institutions** may also play an important role in making trade finance tools and instruments available. Indeed, in some countries, the central bank does not oversee all financial institutions. For example, in Malaysia, securities markets are supervised by the Securities Commission, while insurance companies in the Philippines are under the supervision of the Insurance Commission. In order to facilitate trade finance infrastructure development, all the regulations and provisions of financial sector regulatory bodies should be scrutinized to ensure that they do not unnecessarily impede trade.

#### *Level II institutions*

##### (i) **Export credit insurance and guarantee institutions**

Credit insurance is insurance against non-payment of an export contract. Such insurance typically covers the exporter and its bank against the risk of buyers' fraud or bankruptcy and sometimes political risk. Export credit insurance makes it easier for exporters to safely extend credit to buyers (often a key factor in obtaining an export contract) and to obtain needed working capital from their bank because some of the risk associated with the export transaction is shifted to the insurer.

Institutions providing export credit insurance and guarantees can take different forms. Some of the first such institutions established were government-backed organizations (part of the trade or finance ministries) for which export growth was the only priority. Increasingly, however, export credit insurers are government-owned corporations tasked with encouraging exports as well as making a profit.

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<sup>18</sup> For more information on the role and structure of TPOs, see ESCAP, *Export Promotion for Economies in Transition: Central Asia and South Caucasus*, Studies in Trade and Investment No. 45 (ST/ESCAP/2107), 2001.

Export credit insurers may also take the form of a private partnership between banks, insurance companies and other related organizations. In these organizations, Governments assume the political risk either through a department or through an appointed agent.<sup>19</sup> Given the prevailing conditions in CIS economies, a private credit insurer in which the Government only takes on the role of official reinsurer of all political risk on exports, as in Zimbabwe, may be particularly appropriate.

### Box 6.2. Facts about COFACE, EFIC and ECGC

**COFACE**, the French Export Credit Insurance and Guarantee Company, is one of the leading export credit insurance companies in the world and is active in over 91 countries around the world. It started as a State-owned company in 1946, with the goal of supporting the export of French products to a wide range of destinations. COFACE was privatized in 1994 and listed on the stock market in 2000. In 2002, Natexis Banque Populaire, a French bank, took majority ownership of COFACE. While most of the business of COFACE revolves around providing its own credit insurance and risk management products, it remains in charge of providing public insurance and guarantees for exporters on behalf of the Government of France.

**EFIC**, Australia's Export Finance and Insurance Corporation, was established as an integrated Government-owned corporation. At the end of 1996, it had a paid-in capital of \$A 6 million, supported by \$A 200 million of callable capital and a comprehensive government guarantee, and accumulated reserves and profits of \$A 177 million. On the basis of this capital structure, EFIC had been able to support \$A 5 billion worth of credit insurance annually, as well as \$A 1 billion of medium-term lending and guarantees for banks. This represented about 10 per cent of Australia's exports at the time.

**ECGC**, the Export Credit Guarantee Corporation of India Ltd., originated from the Exports Risk Insurance Corporation (ERIC), created by the Government of India in 1957. In 1964, ERIC was transformed into the ECGC, a company wholly owned by the Government of India. ECGC functions under the administrative control of the Ministry of Commerce of India. A board of directors comprising representatives of the Government, the Reserve Bank of India and the banking, insurance and exporting communities manages the organization. ECGC is the fifth largest credit insurer in the world in terms of coverage of national exports. However, in the context of the liberalization of the Indian economy and in view of the opening up of the insurance sector within the purview of the Insurance Regulatory and Development Authority (IRDA), the role and position of ECGC in the Indian insurance market is going to be challenged and ECGC is repositioning itself as a multi-product organization servicing the export sector of the small-scale industry segment. The recent initiatives of ECGC include insurance cover on losses from discrepancies in documents under letters of credit.

*Sources:* www.coface.fr; ITC; ECGC Annual Report 2001-02; and various other sources.

<sup>19</sup> For more details, see ITC, *Export Credit Insurance and Guarantee Schemes: A Practical Guide for Developing and Transition Economies*, 1998 (reprinted 2003).

While the cost of establishing an export credit insurance agency needs to be weighted against the export potential of a country, it is important to recognize that domestic traders will likely be at a disadvantage in comparison with foreign traders whose transactions can readily be insured.

(ii) **Export-import banks**

EXIM banks are typically Government-owned banks established to facilitate and encourage the development of trade. They are often conceived as a one-stop shop for export-import financing, taking over some of the responsibilities of what may have been distinct units or departments within ministries of trade or finance or even the central bank, as was the case with the Thai EXIM bank (see box 6.3 for more details). The activities of a previously established export credit insurance agency may sometimes be merged into the newly created EXIM bank.

**Box 6.3. The EXIM Bank of Thailand**

The success of Thailand's economic development efforts during the second half of the 1980s prompted many economists to believe that Thailand could further this success by adopting an export-led growth strategy that would provide SMEs with an opportunity to participate in international trading. To support this strategy, Thailand consolidated and/or created a number of institutions specializing in foreign trade, among them the EXIM Thailand (EXIMT).

EXIMT was established in 1993 by promulgation of the Export-Import Bank of Thailand Act, B.E. 2536. EXIM Thailand was established as a 100 per cent Government-owned corporation with start-up capital of 2.5 billion baht (US\$ 100 million at the time) provided by the Bank of Thailand and the Ministry of Finance. The Board of Directors of the EXIM Bank comprised high-level representatives from all the trade-related ministries as well as private sector representatives.

The packing credit facilities (subsidized pre-shipment and post-shipment financing facilities provided for exporters mostly through commercial banks) was transferred from the Bank of Thailand to the newly formed EXIM Bank. The Bank complemented this facility with a standard pre-shipment (unsubsidized) facility directed at small and new exporters and began offering export insurance and L/C facilities.

The purpose of the EXIM Bank was to provide financial services in support of imports, exports and foreign investment beneficial to the Thai economy. The Bank was mandated and authorized to provide a wide array of financial services, ranging from export refinancing to export credit insurance. An amendment to the Export-Import Bank of Thailand Act also promulgated in 1993 further broadened the mandate of the Bank to allow it to support export-related domestic investment. As a result, the Bank added to its product portfolio a credit facility for business expansion.

The number of products and services offered by the EXIM Bank increased over time and became more sector- and SME-specific. It began offering foreign investment advisory services as well as export advisory services in 1999. In recent years, the Bank has developed an SME Financial Service Centre offering streamlined products and services and a faster response time. The Bank recently discontinued its subsidized packing credit facility in order to comply with WTO rules but also because the facility had become unnecessary owing to the high level of market liquidity and falling interest rates.

After more than 10 years of operation and a major financial crisis, a review of the experience of the EXIM Bank of Thailand indicates that:

- An EXIM bank can be effective in stimulating the development of trade finance, by introducing new products and services (such as export credit insurance) and by disseminating relevant information to potential exporters. Once an EXIM bank has acquired good experience in evaluating the export potential of SMEs, the bank may use this experience to offer credit in connection with longer-term business expansion.
- An EXIM bank will typically have a sovereign credit rating because it is backed by the Government. Such a rating may make it easier for the bank to access international credit markets as compared with domestic banks.
- An EXIM bank should focus on complementing the offerings of commercial banks and should provide credit for small and new exporters as well as SMEs with export potential, or additional credit lines in the case of large exporters that are unable to secure additional credit from commercial banks.
- Offering a wide array of products and services makes it easier for an EXIM bank to market its services and satisfy the needs of its clients (and be profitable).
- An EXIM bank can help to regulate the cost of the trade finance services offered by commercial banks, especially when there are few commercial banks offering international banking services.
- While an EXIM bank is not expected to finance a large share of exports and foreign investment under normal circumstances, it can be an effective backup financing source during a major financial crisis (the activities of the EXIM Bank of Thailand doubled during the Asian financial crisis of 1997).
- An EXIM bank should be managed as a self-sustainable organization, without subsidized interest rates, but with a modern and creative risk assessment and management programme to support small and new enterprises with export potential.

Many of the larger EXIM banks are members of the Berne Union ([www.berneunion.org.uk](http://www.berneunion.org.uk)), whose goals are to promote sound practices in export and investment financing and to facilitate the exchange of information and expertise among members. While new export credit agencies (EXIM bank as well as export credit insurance institutions)

do not qualify for membership, the Berne Union, in cooperation with EBRD, has established the Prague Club to support export credit agencies in developing their export credit and investment schemes. Many export credit agencies from transition and emerging economies, including the EXIM Bank of Thailand, meet regularly during the Club's meetings.

### *Level III institutions*

#### (i) Commercial banks

In most countries, commercial banks are by far the largest providers of trade finance services. The main role of banks is to act as facilitators and/or intermediaries between savers and borrowers. Banks provide short-term financing for trade transactions by various means, including advances against (or discounting of) export bills. They also help to reduce the risk inherent in trade transactions by providing documentary credit (e.g., letters of credit) services or alternative methods of payment and by facilitating access to foreign exchange markets to hedge against a possible currency risk.

While private commercial banks make up the largest share of trade financing activities in most countries, they generally favour lending to well-established and larger firms, or to the government, in order to reduce their risk exposure. As a result, small and medium-sized enterprises may find it difficult to secure trade financing through traditional commercial banks. In the case of transition economies, where the private sector mostly consists of small firms with a short corporate history, trade financing through commercial banks typically involves very high collateral requirements (e.g., 150 per cent of the value of the loan in Mongolia), which severely limits the ability of these firms to export and grow.

#### (ii) Non-bank financial institutions

Non-bank financial institutions are an important part of the trade finance infrastructure. While they are typically not authorized to take deposits (as opposed to banks), they can play an important role in trade finance. A non-exhaustive list of non-bank financial institutions includes export houses and factors, as well as agencies specialized in leasing or countertrade arrangements.

**Export houses** are non-bank institutions that traditionally provide confirmation services only, typically acting on behalf of overseas buyers. However, over time, they have often extended their services to cover trade financing. Many export houses may provide finance to cover the gap between the time when the goods leave the factory and the time that they are purchased by the end user. Credit is provided for periods of 30 to 180 days and is available for all types of goods (the export of capital goods can often be covered for periods of up to five years). The commissions charged by export houses are based on the period of credit, average invoice value, volume of business and the amount of other services provided.

**Factors** are organizations that buy outstanding book debts from traders. In practice, the exporter will send all invoices at specified intervals and will receive a cheque for an

agreed initial percentage of the total invoice value usually in the range of 80 to 85 per cent. As payments are made, the balances of sums due are credited to the exporter.

**Leasing** may be described as an agreement whereby the lessor (e.g., a leasing company) conveys to the lessee (e.g., a wine producer and exporter), in return for a payment or series of payments, the right to use an asset (e.g., a harvesting machine) for an agreed period of time. It has been estimated that leasing companies satisfy about one eighth of the world's annual equipment financing requirement. Leasing can allow small firms to finance their growth and/or survival in a difficult environment, and should therefore be encouraged in countries of the South Caucasus and Central Asia.<sup>20</sup>

**Countertrade** can be considered a viable alternative in countries where capital or funding is limited. Some financial institutions specialize in arranging countertrade deals by assisting exporters to negotiate and dispose of the goods that they will receive as payment for their exports.

In most countries, the services offered by non-bank financial institutions may also be offered by commercial banks and some level II institutions. For example, the Export Credit Guarantee Corporation of India, Ltd. (ECGC), offers factoring services to exporters.

### C. Financial sector dynamics in newly independent States

In order to understand whether the above model is adaptable for countries in the South Caucasus and Central Asia, it is useful to review the evolution of the financial sectors in these and other transition economies. From experience with the development of financial sector of those countries since 1990, three basic stages may be identified and are shown in figure 6.3, which is an attempt to represent graphically the typical financial sector dynamics of the newly independent States, although wide variations exist from one country to another.<sup>21</sup> The figure was designed on the basis of information gathered during advisory missions to Mongolia and Georgia as well as a report on the evolution of banking supervision in the Czech Republic.<sup>22</sup>

In the first stage, the countries convert their banking system into a two-tier system, with one central bank in charge of monetary policies and financial sector regulations, and introduce new banking legislation, authorizing the establishment of private commercial banks. This typically results in the creation of a large number of small undercapitalized

<sup>20</sup> Meziare Lasfer and Mario Levis, "The determinants of the leasing decision of small and large companies", *European Financial Management*, vol. 4, No. 2, July 1998, pp. 159-184. For more information on leasing, see [www.leaseurope.org](http://www.leaseurope.org).

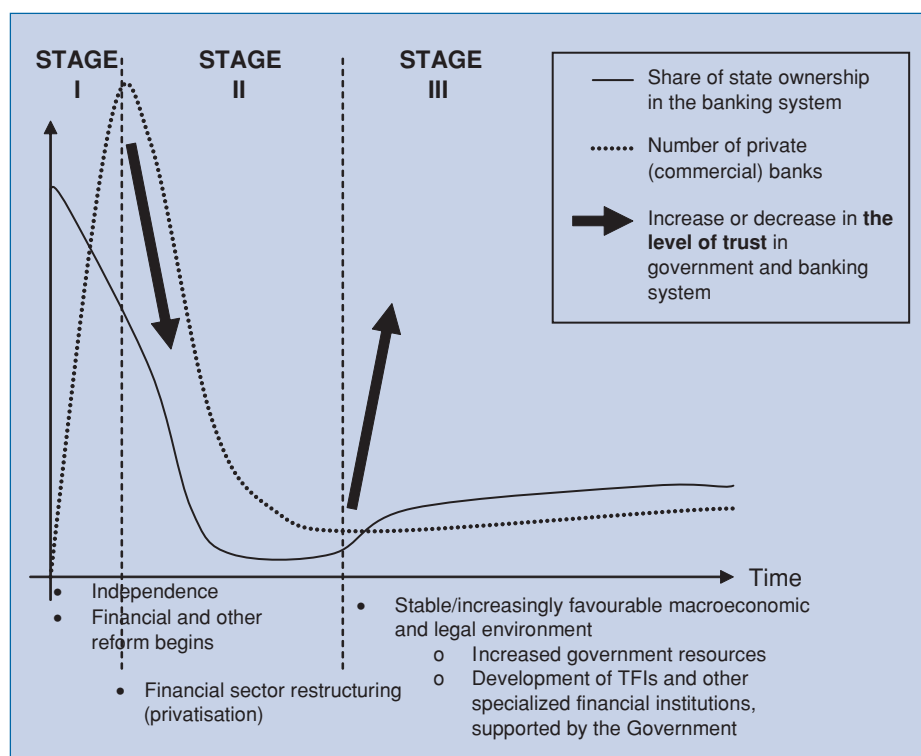
<sup>21</sup> Indeed, this representation is highly stylized and does not readily take into account the effect of the Russian financial crisis, which adversely affected all CIS economies, but to varying degrees. Financial sector dynamics can also be expected to vary somewhat depending on whether or not a country preferred a slower, more progressive approach to transition reforms as opposed to a quicker, more radical transition process.

<sup>22</sup> Czech National Bank, *Banking Supervision 1999* (Prague, Czech National Bank, 1999) (available online at [www.cnb.cz](http://www.cnb.cz)).



banks (over 400 in Georgia, a country with a population of less than 5 million), owing to weak or inexistent prudential regulations. The share of State ownership in banks starts falling sharply as a result.

**Figure 6.3. Stages in the development of banking sector and trade finance institutions in transition economies**



In the second stage, the development of banking supervision mechanisms (including such prudential rules as minimum capital requirements) and the unravelling of “pyramid schemes” established by smaller banks, as well as the high level of inflation in the newly created currencies, result in bankruptcy for most private banks, and the need to privatize some or all of the State-owned banks. In particular, some of the specialized trade development banks, typically State-owned, disappear or cease activity.<sup>23</sup> At this stage, trust in the banking system falls in many countries because of (a) the failure of many recently

<sup>23</sup> Extreme policies sometimes had to be adopted, such as an agreement between the World Bank and the Government of Georgia suggesting that the Government not be allowed to maintain direct ownership of any of the banks (source: David Chkhartishvili, National Training Workshop on Trade Finance Infrastructure Development, Tbilisi, 15-16 October 2003).

established and undercapitalized private banks and (b) high inflation and instability in the newly created national currencies drastically reducing the value of deposits (originally in rubles) in State-owned banks. Trust in the Government also falls as a result.

The third stage, arguably, is characterized by the stabilization of a number of banks, an increase in domestic deposits, and an increase in government involvement in the banking and financial sector through specialized financial institutions, including EXIM banks and/or export credit insurance and guarantee agencies (level II institutions).

This last stage has arguably been reached in some transition economies, especially those being considered for early entry into the European Union. The following economies in transition have active export credit agencies: Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Lithuania, Macedonia, Poland, Romania, Slovakia, and Slovenia.<sup>24</sup> In addition, (only) two countries in the South Caucasus and Central Asia appear to have active State-owned trade finance related institutions: Uzbekistan, whose export credit agency (Uzbekinvest) is a member of the Prague Club; and Kazakhstan, whose recently established Development Bank of Kazakhshtan is expected to become the Government's primary vehicle for promoting exports in the non-extracting sectors of the Kazakh economy.

#### **D. A favourable macroeconomic environment as a prerequisite to the implementation of the TFIS model**

What can be concluded from the experience of the countries that have made the most progress in their transition to market economies and their financial sector dynamics (e.g., the Czech Republic or Estonia)? Probably that the simple TFIS model presented above has been adapted to the economies of the South Caucasus and Central Asia in which the level of trust in both public institutions and the banking system is increasing, as measured by the reduction in the level of corruption, the willingness of the private sector to move activities from the informal to the formal sector of the domestic economy, and the growth in government revenue and the overall economy.

Indeed, the main feature of the model is to create fully or partially State-owned trade finance institutions (level II) to support traders. If the State, as represented by its officials, is not trusted, relevant private sector participants are unlikely to become clients of the new institutions. Perhaps more importantly, governments will, in most cases, lack sufficient resources to establish and sustain the operations of new institutions since many of the income-generating activities will remain in the informal sector of the economy.

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<sup>24</sup> Based on the list of the Prague Club members in the *Berne Union Yearbook 2003* (available online at [www.berneunion.org.uk](http://www.berneunion.org.uk)).

The level of foreign and domestic trust in the Government is often reflected in, and dependent on, the macroeconomic and legal environment. The countries of the South Caucasus and Central Asia typically have macroeconomic performance indicators that are below those of most developing countries, and far below those of the most successful Eastern European countries (this is especially true for those that have limited oil and gas resources to boost export and government revenue). The very large interest spreads (the difference between interest rates on savings and borrowings) and real interest rates, as well as the very low amount of domestic credit channelled to the private sector, are particularly noteworthy.

The proposed TFIS model may not be fully implemented before there is improvement in the macroeconomic situation in many of the economies of the South Caucasus and Central Asia. Proceeding with the establishment of (likely weak) State-owned trade finance institutions to support SMEs before the macroeconomic environment shows signs of improvement may be counterproductive. Indeed, as argued in the case study of the EXIM Bank of Thailand (see box 6.3), one of the key advantages of State-owned export credit agencies over private commercial banks is that they often have the same international credit rating as the Government (sovereign debt credit rating). While this is a clear advantage in countries that enjoy a high sovereign debt credit rating, this may not be the case in many of the countries of the South Caucasus and Central Asia, where the sovereign credit ratings are often well below investment grade (with the exception of Kazakhstan). Creating or maintaining State-owned trade finance institutions under these conditions may mobilize (or even drain) government resources unnecessarily, with no tangible benefits for SMEs.

## E. Conclusions and recommendations

In contrast with most middle- and high-income countries, transition economies in the South Caucasus and Central Asia, for the most part, have not yet developed the trade finance institutions needed to support SME international trade activities. National TFISs in many developing export-oriented Asian economies seem to feature three categories of institutions, characterized by their relation to the Government. The recommendations that appear below therefore correspond to each of the three categories of institutions in countries with economies in transition.

Level I institutions (direct government control)

- The central bank or monetary authority should take into account the needs of SMEs and trade development when establishing financial system regulations, including the simplification of export-related financing rules and procedures. Enforcement of prudential and other regulations should be strengthened so as to rapidly stabilize the banking and financial system.
- The ministries of finance should also adopt, whenever possible, policies that encourage the development of SMEs, including possible tax incentives for export-oriented SMEs and the streamlining of customs procedures.

- The ministries in charge of trade should play an active role in promoting and supporting SME trade. The establishment of a TPO able to provide expert advice on trade financing would be a possibility. More importantly, these ministries should be able to actively negotiate the removal of trade obstacles raised by other administrative or regulatory bodies.

Level II institutions (full or partial government ownership and limited direct management role)

- A careful needs and feasibility analysis should be done before establishing level II institutions.
- In particular, level II institutions should not be established if the Government cannot readily support them in their early stages of development (proper capitalization is essential).
- Another key issue is whether these institutions should be established under the Ministry of Finance and/or Ministry of Trade, and whether they should have to comply with all the regulations imposed on similar private entities.
- The strengthening of the macroeconomic and legal environment (by level I and other responsible institutions) is a *prerequisite* for establishing or strengthening these institutions.
- As many countries in the South Caucasus and Central Asia lack resources, some of the functions of level II institutions could be performed by level I institutions (the Central Bank and the Ministry of Trade, in particular) at the early stage.
- Level II institutions most adapted to the countries of the South Caucasus and Central Asia may take the form of public-private partnerships, as in the case of the export credit agency of Zimbabwe.
- Progressive implementation of the institutional model is recommended. A first step may be to establish a credit insurance and guarantee agency with limited products and scope, perhaps as an extension of an existing trade and investment promotion agency under the ministry in charge of trade. The establishment of an EXIM bank or other specialized banks (such as SME banks and industrial banks), could come much later, only after a thorough needs assessment has been done, and when the Government has enough resources to support and maintain such institutions properly.

Level III institutions (market-driven, zero or very limited government ownership)

- Clear and transparent legislation (developed in cooperation with level I institutions) would be needed to encourage the development of private non-banking financial institutions, including leasing companies.

- Specialized training and education programmes should be made available domestically to upgrade the skills of commercial bank personnel to international standards.

If only one conclusion had to be drawn from this chapter, it would be that creating Government-backed trade finance institutions when the Government is too weak to support or manage them may be counterproductive. As a country's macroeconomic conditions improve, as measured by international credit ratings as well as trade ratios and other relevant indicators, Governments may implement an export-led growth strategy that includes the development of level II institutions to support the emerging private sector.

In the meantime, a country with a limited ability to provide SMEs with trade finance may request support from a number of international financial institutions, many of which have been increasingly active in extending loans to SMEs through existing commercial banks.<sup>25</sup> Many such institutions are also offering useful technical assistance services on trade and SME finance.<sup>26</sup> Countries in the South Caucasus and Central Asia, most of which receive significant amounts of overseas development aid, could also request that part of this aid be redirected to assistance programmes related to SMEs financing for trade development, or to conduct feasibility studies and needs analyses on national trade finance institutions.

The simple national TFIS model proposed herein could be extended to include relevant financial markets (foreign exchange and securities markets) and perhaps an institutionalized working group on trade finance issues, composed of relevant institutions, including private sector trade-related associations. Regional trade finance institutions could also be included in the model, as regional initiatives could be a more effective way to support trade and SME development in many of the smaller economies of the South Caucasus and Central Asia.<sup>27</sup>

## F. For further reading

- ITC, *Export Credit Insurance and Guarantee Schemes*, 1998 ([www.intracen.org](http://www.intracen.org)).
- UNCTAD, "Report of the Expert Meeting on Improving the Competitiveness of SMEs through Enhancing Productive Capacity: Financing Technology" (TD/B/COM.3/50), 27 November 2002.

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<sup>25</sup> Major international financial institutions with active SME and trade-finance-related programmes include the World Bank, the Asian Development Bank and the European Bank for Reconstruction and Development. Please refer to chapter I.

<sup>26</sup> For example, the Asian Development Bank is implementing technical assistance for trade and SME development in Pakistan, which may be replicated in some of the countries of the South Caucasus and Central Asia.

<sup>27</sup> The Islamic Corporation for Insurance of Investments and Export Credit (ICIEC), a subsidiary of the Islamic Development Bank (IDB), is one option for many Central Asian countries (see [www.iciec.com](http://www.iciec.com)).

- Economic Commission for Europe, *Trade Finance for Small and Medium-sized Enterprises in CIS Countries*, (Trade and Investment Guides, No. 7), United Nations publication, sales No. 03.II.E.17, 2003 (see [www.unece.org](http://www.unece.org)).
- Yann Duval and Urmi Sengupta, "Trade finance institutions for trade and small and medium-sized enterprise development in South Caucasus and Central Asia", in ESCAP, *Current Issues on Industry Trade and Investment, No. 2* (United Nations publication, sales No. E.04.II.F.6), 2003 (available online at [www.unescap.org](http://www.unescap.org)).
- ESCAP, *Export Promotion for Economies in Transition: Central Asia and South Caucasus*, Studies in Trade and Investment No. 45 (ST/ESCAP/2107), 2001.

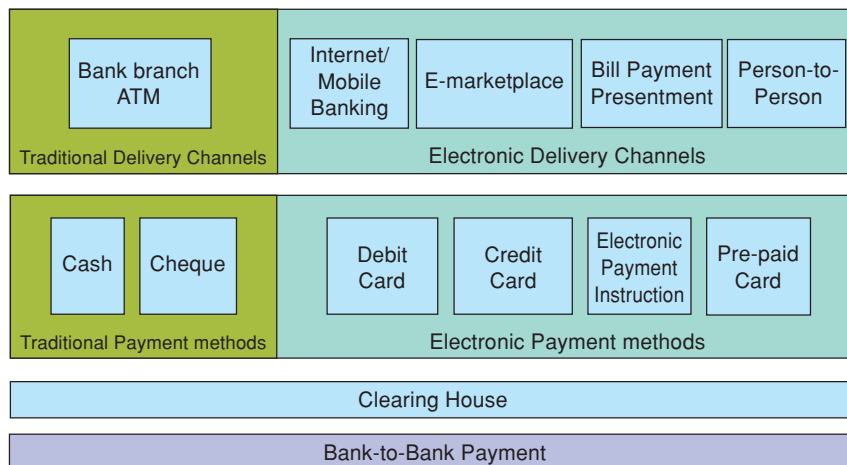
## VII. Payment system development

### A. Introduction

A payment system is a set of institutions, laws, regulations and other mechanisms needed for a buyer to make a payment and a seller to receive that payment. An effective payment system should be designed to meet the financial needs of both buyers and sellers. For importers and exporters, this means that the payment system must be capable of providing for accurate, secure, efficient and affordable international payments.

A payment system can be broadly divided into four components: the delivery channels, the methods used to deliver payments; the clearing and settlement process and the actual transfer of funds between institutions (or bank-to-bank payment).

**Figure 7.1. Payment system infrastructure overview**



As shown in figure 7.1, delivery channels are the main interface between the bank and its customers. They are contact points, either physical or virtual, from which customers can send payment instructions to the bank.

Payment methods are the instruments (or types of instructions) used to make the payment. Traditional payment methods include cash and cheque. However, with the introduction of the Internet and e-commerce, the electronic payment has become more pervasive.

All payment methods other than payment by cash require settlement by at least two banks as there is always a debit from one bank account and a corresponding credit in

another bank's account. A clearing house is therefore required. The clearing house role is to sort the instructions and transmit them to the correct bank. If international payment is involved, special arrangements are required in order to identify a clearing bank.

After the clearing is done, actual transfers of funds between banks will be made. In this segment, bank-to-bank payment is made either in real time or on a "net off" basis (i.e., at the end of the day).<sup>28</sup>

## B. Delivery channels

### *Traditional channels*

Both bank branches and automated teller machines (ATMs)<sup>29</sup> are now considered traditional delivery channels. Bank customers visit bank branches or ATMs to make payments to sellers. At a branch, the customers will use one of the payment methods discussed in the next section.

Traditional delivery channels suffer the limitation of high maintenance costs as they require a physical set-up and substantial manpower. They also have a geographical limit in terms of market reach. However, in developing countries where telecommunication infrastructures are not fully developed and where labour costs are not an issue, traditional delivery channels can still play an important role in facilitating trade finance (see box 7.1).

#### **Box 7.1. The electronic funds transfer services of the Tunisian Post**

The Tunisian Post has developed a number of electronic services to make the transfer of funds easier, faster and more convenient. Using its current outlets at post offices, the Tunisian Post is able to provide business with international electronic payment services. Some of the innovative funds transfer services they offer include:

*Minute Money Order:* this is an electronic money order service that enables customers to send money in a *quasi-instantaneous* manner from any post office.

*EuroGiro electronic money orders:* this service enables customers to send and receive funds internationally and automatically via their accounts with the Tunisian Post (the Tunisian Post is a member of EuroGiro).

*Source:* [www.poste.tn](http://www.poste.tn)

<sup>28</sup> Net-off is a settlement system whose settlement operations are completed on a bilateral or multilateral net basis.

<sup>29</sup> ATMs are used mainly for cash withdrawals as an alternative to visiting bank branches.



### *Electronic delivery channels*

Electronic delivery channels include Internet banking, e-marketplace websites and other electronic portals, such as bill payment/presentation and person-to-person payment portals.

E-banking is currently one of the main electronic delivery channels and offers various payment methods. Banks have also started to provide trade finance services online, such as applications for L/C and applications for guarantees and insurance, as well as accounts receivable financing (see box 7.2).

#### **Box 7.2. OCBC Bank's Velocity online banking service**

The OCBC Bank in Singapore has developed a new financial product through Velocity@ocbc – an Internet banking service for SMEs.

Under its *Business Cash Financing* service, the Bank offers SMEs financing of up to S\$ 500,000 on outstanding accounts receivable with a financing quantum of up to 75 per cent of the eligible accounts receivable. This results in a revolving working capital loan based on accounts receivable and functions on a non-notification basis. The service is similar to factoring but requires no physical invoices to be presented once the loan account has been activated.

This service has been very well received by SMEs, the majority of which are family businesses disconcerted because their business partners were made aware that they had pledged their purchase orders to the bank (as in factoring or forfaiting). This online service allows for SMEs to collect payments directly from their business partners.

*Source:* [www.ocbc.com.sg](http://www.ocbc.com.sg)

E-marketplaces are virtual portals that enable buyers and sellers to negotiate their transactions and often include payment services. An example is Standard Chartered Bank's B2BeX website ([www.scb2bex.com](http://www.scb2bex.com)), where bank customers can establish a virtual shop to market their products and obtain trade finance services.

Electronic bill payment service providers are another emerging delivery channel. This channel is useful for companies that supply products to large overseas buyers. These buyers usually have large electronic procurement systems that can generate electronic order forms. E-bill payment service providers enable suppliers to deliver their invoices electronically to buyers, who can then authorize their bank to make payment.

New electronic delivery channels are continually emerging. For example, because of the increasing need for person-to-person payment in North America arising from Internet-based auction sites, alternative payment mechanisms between consumers, and between consumers and small businesses, have developed (e.g., PayPal in the United States).

New delivery channels are also expected to emerge as a result of the increasing use and sophistication of mobile telephones.

Apart from banks and financial institutions, electronic delivery channels can also be operated by non-financial institutions. The role of these institutions is then supposed to be limited to operating a delivery channel that links customers with banks (see box 7.3). However, Governments need to enact appropriate regulations and policies to safeguard the overall stability of the payment system.

### **Box 7.3. NETS, an electronic payment service provider in Singapore**

In Singapore, one of the key payment service providers is Network for Electronic Transfers Singapore Pte. Ltd. (NETS). The local banks formed NETS in 1986 to provide electronic fund transfer at point of sale (EFTPOS) service. Currently, NETS owns more than 20,000 EFTPOS terminals, with approximately 9,200 merchants in over 12,000 outlets.

The main reason that banks, normally competitors, joined forces to form the NETS consortium was to take advantage of economies of scale. NETS enables the participating bank's customers to enjoy the benefits of EFTPOS payment at any of its 20,000 EFTPOS terminals. In turn, merchants can accept EFTPOS payment from any participating banks. The banks, while cooperating in forming the consortium, still compete with each other to acquire the merchants' accounts.

In 1996, NETS, together with its shareholder banks, launched the MPSVC cash card to enable cardholders to pay for purchases through an offline channel. In developing the cash card, the concept of cooperation and competition between participating banks was preserved by introducing two types of cash cards: common bearer cards and bank-specific cards.

NETS issues the common bearer cards, with the participating banks sharing the cash float in the cards. Bank-specific cards are issued by the respective banks, with the issuing bank managing the cash float in its cards.

Until 1997, bank customers had to prepare payment instructions manually and deliver them personally to bank branches. In 1997, NETS introduced financial electronic data interchange (FEDI) service. This electronic message switching facility enables corporate customers of NETS shareholder banks to authorize payments through the Interbank GIRO system.

Since 1997, NETS has developed many more e-payment delivery channels targeting mainly consumers. The main focus has now moved to Internet and mobile payments.

*Source:* [www.nets.com.sg](http://www.nets.com.sg)

## C. Payment methods

### *Traditional payment methods*

Cash and cheques are the two traditional payment methods. Cash has been used in business transactions because it ensures complete anonymity. However, one of the main limitations of cash is that it requires the transacting parties to be present.

Cheques are another payment method used in businesses and are generally acceptable in payment involving local parties. However, for international payments, cheques are usually not accepted as they involve the risk of non-acceptance upon return to the issuing country for clearing. Non-acceptance may occur either because a cheque has been improperly drawn or because there are insufficient funds in the account.

Neither cash nor cheques are effective methods for international payment, as uncertainty over the fulfilment of the financial obligation is invariably present and cannot be mitigated.

### *Electronic payment methods*

Long before the introduction of the Internet, electronic payment was already available through such payment instructions as telegraphic transfers (TT) and SWIFT messaging (see box 7.4). These are proprietary payment instructions initiated by banks through a closed network. Customers, through a delivery channel such as a bank branch or even a telephone, can instruct their bank to debit their account and remit the amount to another account in other countries through TT or SWIFT. Once the instruction is accepted, the customer's bank debits the account and sends a message through TT or SWIFT to the receiving bank. The final bank-to-bank payment is usually made through the nostro account of the foreign bank.

#### **Box 7.4. SWIFT messaging system**

The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is an industry-owned limited liability cooperative established under Belgian law.

The business of SWIFT is to supply secure messaging services and interface software, to contribute to greater automation of financial transaction processes and to provide a forum for financial institutions to address issues of common concern in the area of financial communication services.

Messaging services are provided for banks, broker/dealers and investment managers, and for market infrastructures in payments, treasury, securities and trade.

*Source:* [www.swift.com](http://www.swift.com)

Electronic payment methods have since developed further to include card-based and non-card based methods. The following are examples of the payment systems used extensively in Singapore.

#### *GIRO (offline payment system)*

Launched in Singapore in April 1984, the GIRO system is an offline payment system for bulk payments. GIRO allows the customer of a participating bank to transfer funds, through direct debit or credit, to or from the accounts of customers of any other participating bank.

In GIRO, the payee instructs his bank to collect payment from the paying party, often on a recurring basis. Direct debit payments are pre-authorized by the paying customer, who gives his bank permission to debit his account upon receipt of instructions initiated by the specified originator. Examples of such pre-authorized recurring payments include utility bill payments or payments for telecommunications services.

This payment method can be used by agencies providing services for exporters and importers, for example to automate the payment of customs declaration fees by an importer. The importer would only have to sign a one-time authorization letter instructing his bank to debit his account upon receipt of an instruction initiated by the banker of the customs department.

#### *Credit cards*

With a credit card, charges can be paid in full or financed within the credit limit authorized by the card issuer.

Credit card payment is not limited to consumers. A corporate equivalent is the purchasing card. These cards allow employees to purchase small items either in a retail store or on the Internet. The bill will be invoiced monthly to the company for settlement. Unlike the consumer credit card, a company can restrict the type of purchases that may be made with the card.

#### **Box 7.5. Purchasing cards for the United Kingdom**

In the United Kingdom, the Office of Government Commerce, which is responsible for central procurement policy, has awarded a five-year contract to for the provision of corporate and purchasing cards.

The new system streamlines the procurement procedure, reducing the steps involved, cutting down on administration and simplifying the Government's audit trail. Many transactions are now virtually paper-free, greatly reducing the need for paper-based purchase orders, requisition forms and multiple payments – the cost of which often exceeds the value of the purchase being made.

*Source:* Visa International, May 2003.

### Debit cards

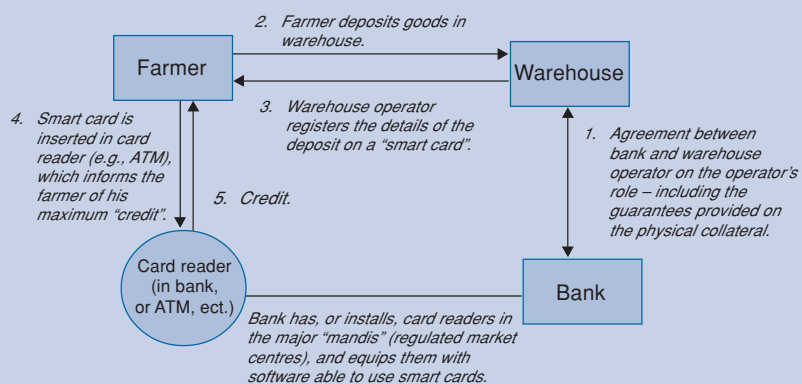
Debit cards are cards that are linked to customers' own bank accounts. When the customer uses the card, the amount is debited immediately from his bank account. It is commonly called an ATM card, as it is primarily used at the ATM to withdraw cash.

In Singapore, the use of the debit card has extended beyond the ATM. It is also used at retail outlets with EFTPOS terminals. With an EFTPOS terminal, a consumer can make a purchase with a debit card. The amount of the purchase is debited from his account immediately, and the merchant receives the payment the next working day.

While debit cards have no direct application in trade finance, the debit card system can be a useful tool if combined with other technologies. An example may be found in India, where the debit card function is combined with warehouse receipt financing using smart card technology. As shown in box 7.6, some Indian farmers obtain financing from banks using a smart card, which can then be used to withdraw the loan amount from an ATM.

#### Box 7.6. Using debit cards for warehouse receipt financing in India

Using smart cards as a "shortcut" for warehouse receipt finance



*Source:* Lamon Rutten (UNCTAD), "Innovative vehicles for mobilizing domestic funds for agricultural development", paper submitted at the ESCAP-ADB Joint Workshop on Mobilizing Domestic Finance for Development: Reassessment of Bank Finance and Debt Markets in Asia and the Pacific, Bangkok, 22-23 November 2001 (available online at [www.unescap.org](http://www.unescap.org)).

*Note:* This scheme only applies to selected commodities, which have a ready market (that is, can be easily sold) and a reliable price reporting system. The smart card contains details on the quality and quantity of the products deposited. The card reader is connected to a system with up-to-date price information, and programmed to calculate the current value of the products; the farmer can take up to, say, 60 to 70 per cent of this value as a short-term (say, up to 180 days) credit. The credit is registered on the smart card, and delivery from the warehouse is only possible after its reimbursement. The scheme has the added value of providing an up-to-date central registry of charges over products, and allowing to create "track records" for individual farmers. With general use of the smart cards, warehouse could also use them to provide inputs on credit.

### *Virtual debit cards*

A virtual debit card operation is similar to that of a traditional debit card, except that there is no physical card. A transaction is effected through the Internet or a mobile telephone with a user ID and password for authentication. Customers need to sign up with a service provider to link their virtual debit card to their bank account.

An example of such a payment method is eNETS ([www.nets.com.sg](http://www.nets.com.sg)), a method now extensively used in Singapore e-government services. Businesses that need to apply for licences can make payment using eNETS. The process has cut down business turnaround time as approval can be immediate upon payment (in the past, businesses needed to send a cheque to the relevant government agencies and approval usually took 1 to 2 weeks as the agency needed to wait for the cheques to clear).

### *Stored-value cards (prepaid cards)*

There are two types of stored-value cards: single purpose stored-value cards (SPSVCs) and multi-purpose stored-value cards (MPSVCs). SPSVCs can only be used to pay for goods and services offered by the issuer (e.g., prepaid phone cards, transportation cards). However, a MPSVC allows cardholders to pay for goods and services offered by other merchants or organizations. A payment service operator usually issues and manages the MPSVC.

As shown in box 7.6, smart card technology, when combined with other payment methods, can provide useful trade finance services, especially in the area of loan disbursements.

## **D. Clearing house and bank-to-bank payment**

A clearing house is generally a nationwide institution that processes large volumes of electronically originated credit and debit transactions. It is usually established as an association with the participating banks as members. As clearing houses perform the important financial functions of clearing and settlement, they are typically supervised by the central bank.

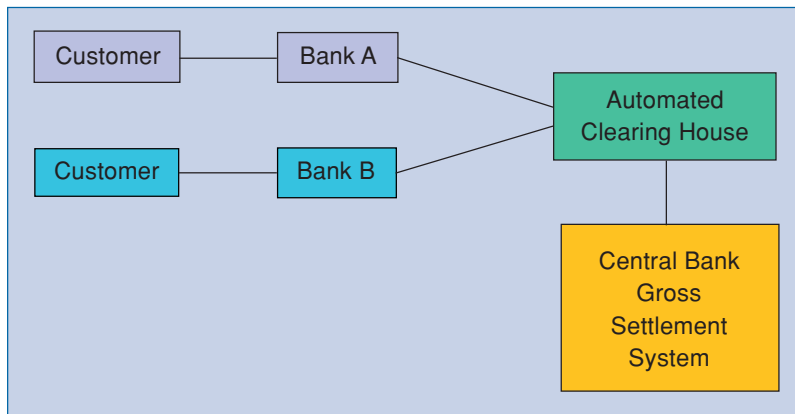
As shown in figure 7.2, participating banks send their consolidated payment instructions to the clearing house. This is usually done through secure electronic messaging. Once the clearing house receives the instructions, it sorts them and sends the data to the receiving banks for processing.

Settlement will only be complete when the actual funds are transferred between banks. This is usually done through the banks' accounts with the central bank or in some cases, a clearing bank. Most banking systems now settle on a real-time gross settlement (RTGS)<sup>30</sup> basis rather on a net-off basis. RTGS systems effect final settlement of interbank

<sup>30</sup> A real-time gross settlement (RTGS) system is a settlement system in which processing and settlement take place on an order-by-order basis without netting in real time and continuously.

funds transfers on a continuous, transaction-by-transaction basis throughout the processing day.

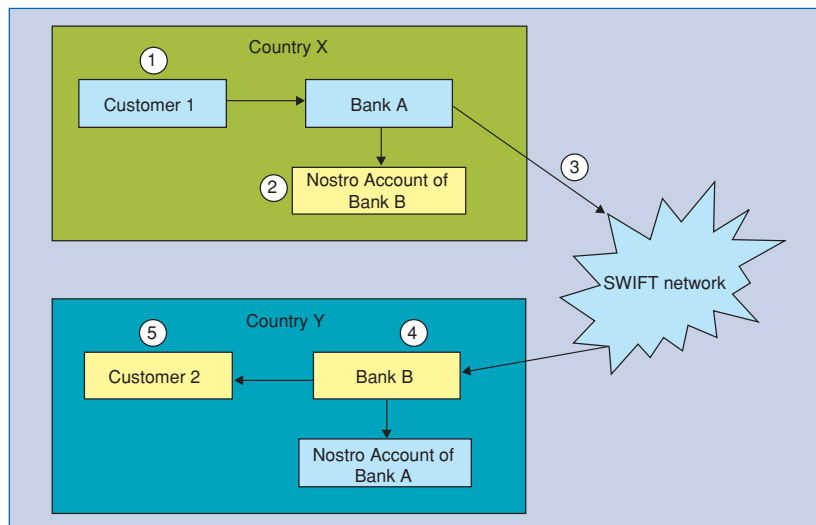
**Figure 7.2. A typical clearing house scheme overview**



The clearing and settlement processes described above provide only local clearing of payments. For international payments, such as SWIFT transfers, the final bank-to-bank payments are made through the nostro account of the correspondent bank.

As illustrated in figure 7.3, if customer 1 from country X wants to pay customer 2 in country Y, customer 1's bank A starts by debiting customer 1's account, and then making

**Figure 7.3. Typical SWIFT payment using correspondence banking**



a bank-to-bank transfer to credit the amount into the nostro account of bank B. Bank A also sends a SWIFT message to bank B requesting that a given amount be paid to Customer 2. After receiving the SWIFT message and obtaining confirmation that a corresponding amount has been credited into its nostro account in bank A, bank B credits the fund into customer 2's account.

The above example shows that, to make cross-border payments, banks need to establish correspondence banking relationships. Establishing these relationships may be quite challenging for domestic commercial banks located in countries with economies in transition.

#### Box 7.7. Singapore Automated Clearing House

Singapore banking regulations require that the clearing and settlement of cheques and GIRO items be processed by the Automated Clearing House. Banks need to join the Singapore Clearing House Association (SCHA) and abide by its rules and regulations.

The Banking Computer Services Pte. Ltd. (BCS) operates the clearing systems provided by SCHA. BCS was established in 1976 by two banks, the Hong Kong and Shanghai Banking Corporation Ltd. (HSBC) and the Overseas-Chinese Banking Corporation Ltd. (OCBC BANK), originally to provide data processing services to themselves.

In 1981, the Singapore Clearing House Association (SCHA) awarded BCS a contract to establish and operate the Singapore Automated Clearing House (SACH). SACH clears Singapore dollar cheques, United States dollar-denominated cheques and Interbank GIRO transactions for the banking industry in Singapore.

*Source:* BCS, [www.bkgcomsvc.com/corporate](http://www.bkgcomsvc.com/corporate)

In an effort to increase the efficiency of the cross-border clearing process, attempts to link clearing houses and central banks in different countries have been made. For example, the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET) is a euro payment clearing system that comprises 15 national RTGS systems in the European Union and the European Central Bank.<sup>31</sup> Such linkups enable bank-to-bank payment to be effected with the respective central banks rather than with individual banks.

ACU also attempts to facilitate cross-border payments at the regional level by providing a common platform whereby the members settle payments for intraregional transactions among the participating central banks on a multilateral basis. Given the geographic coverage of its current membership, the expansion of its membership to Central Asian countries with economies in transition might be welcome (see box 1.3).

<sup>31</sup> For more information, see the website of the European Central Bank at [www.ecb.int](http://www.ecb.int).



## E. Payment system legislation

To safeguard the banking and financial systems, legislation and by-laws need to be developed to ensure that only authorized organizations are involved in the country payment system. Such legislation will also enable the regulator to monitor and supervise the development of e-payment in the country (see box 7.8).

It is important for a regulatory body to be assigned oversight of the payment system in the country. The regulatory body will have to develop and enforce, in consultation with banks and service providers, rules and standards that will ensure the safe and efficient operation and development of all four components of the payment system, as discussed above. In particular, regulators will need to ensure that enough safeguards are put in place by the banks and institutions providing payment systems (some of the security issues are discussed in chapter VIII).

### Box 7.8. Laws and by-laws in Singapore on payment systems

#### Cheques and GIRO transactions

- **Section 59 of the Banking Act** allows MAS, in conjunction with banks and other financial institutions, to establish a clearing house to facilitate the clearing of cheques and other credit instruments and to ensure its smooth operation.
- **Banking (Clearing House) Regulations**, Cap. 19, Regulation 1, subsidiary legislation administered by MAS, set the framework with respect to clearing with the Automated Clearing House.
- The Bills of Exchange Act governs how cheques are drawn, accepted and paid.
- The by-laws of the Singapore Clearing House Association (SCHA) state the rules and regulations for participation in the clearing of cheques and GIRO transactions.

#### Stored value e-money

- **Section 77A of the Banking Act** states that only banks authorized by MAS can issue stored value instruments that have multiple payment capabilities.

#### Real-time gross settlement

- **Section 59A of the Banking Act** makes provision for MAS to establish and operate one or more RTGS systems. MAS is responsible for the smooth operation of the RTGS system and ensures that participants comply with the rules and regulations.

#### Issuance of notes and coins

- **The Currency Act (Chapter 69)** established the Board of Commissioners of Currency, Singapore (BCCS) in 1967. The Act conferred on BCCS the sole right to issue currency in Singapore.

#### Digital signatures

- **The Electronic Transactions Act** was enacted to provide for the legal recognition of digital signatures and establish the framework for facilitating electronic commerce transactions in Singapore.

#### Electronic payment

- **The Payment Systems (Oversight) Act** provides a uniform basis for MAS oversight of payment systems and stored-value facilities in Singapore.

*Source:* MAS, Singapore.

## F. Conclusion

Payment systems form an integral part of the overall banking and financial system and are an essential part of the trade finance infrastructure.

Electronic payment systems are necessary for the effective settlement of cross-border payments. Given the costs and complexities involved in developing a robust, secure and efficient payment system, government leadership and cooperation between banks are essential, as is regional cooperation among central banks and clearing houses.

## G. For further reading

- Basel Committee on Banking Supervision, *Risk Management Principles for Electronic Banking*, July 2003 (Basel, Bank for International Settlements, 2003) (available online at [www.bis.org](http://www.bis.org)).
- Basel Committee on Banking Supervision, *Management and Supervision of Cross-Border Electronic Banking Activities*, July 2003 (Basel, Bank for International Settlements, 2003) (available online at [www.bis.org](http://www.bis.org)).
- Committee on Payment and Settlement Systems, *Payment Systems in Singapore*, November 2001 (Basel, Bank for International Settlements, 2001) (available online at [www.bis.org](http://www.bis.org)).
- NETS website: [www.nets.com.sg](http://www.nets.com.sg).
- BCS website: [www.bkgcomsvc.com.sg](http://www.bkgcomsvc.com.sg).
- Asian Clearing Union website: [www.asianclearingunion.org](http://www.asianclearingunion.org).
- ESCAP, *Harmonized Development of Legal and Regulatory Systems for E-commerce*, Studies in Trade and Investment No. 54, (ST/ESCAP/2348) (available online at [www.unescap.org](http://www.unescap.org)).

## VIII. E-trade finance infrastructure development

### A. Introduction

Trade finance, a traditionally paper-based and labour-intensive process, has undergone tremendous changes. Many banks and financial institutions have developed e-trade finance systems and services. In this *Handbook*, the term “e-trade finance” refers to trade finance services delivered through the Internet. E-trade finance will therefore include loan applications, foreign exchange, letters of credit, factoring, credit rating services, cargo insurance and other financial services offered or available online. It may be viewed as a subset of e-finance, which covers the whole spectrum of financial services delivered online.<sup>32</sup>

Banks have been traditionally early adopters of technology. Well before computers became household items, banks already had mainframe computers that ran millions of calculations per second. Before the advent of the Internet, banks had been using “private networks” to transmit data across the region securely and in real time.

Now, banks and financial institutions are moving aggressively to introduce new web-enabled and mobile services with a view to expanding their customer contact points beyond the traditional brick and mortar branches. Their motivations are clear: the increasing sophistication of their customers, the relatively lower cost of customer acquisition and the potential to reach a wider customer base anytime and anywhere.

Online trade finance services are no longer limited to wealthy individuals or large corporations. SMEs can also make use of these online services owing to the relatively low cost of implementation. In fact, many of the online banking services do not require sophisticated equipment: a simple personal computer with a dial-up Internet connection may be sufficient.

E-trade finance and Internet-based financial services are gaining more and more ground and at a remarkable pace. The reason is simple: when Internet trade business grows, the demand for corresponding financial services increases accordingly.

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<sup>32</sup> For an overview of e-finance, see UNCTAD, *E-Commerce and Development Report 2002* (UNCTAD/SDTE/ECB/2) (New York and Geneva, United Nations, 2002). Some sections in this chapter draw heavily on information provided in that publication.

## B. Main features of e-trade finance systems

A typical e-trade finance system includes the following:

- (a) *An application template:* a user-friendly web interface featuring a full set of online forms for both importers and exporters to initiate a transaction. A well-implemented application template would include business rules and validation checks so that the online forms can be validated without the need to send the information back to the bank system;
- (b) *Transaction authorization:* this system allows users to create a signature matrix designating the individuals authorized to make and approve applications by means of digital signatures. The e-trade finance system needs to be flexible and customizable enough to fit the managerial and financial requirements of individual companies. For example, some companies will require only one authorizer to approve the financial transaction while other companies will have different authorizers depending on the amount or value of the financial transaction;
- (c) *Application tracking and reporting:* this feature enables users to track all of their banking activities and generate reports and analyses. Analysis and reporting are important for both the user and the bank, as they can be used as an effective tool for managing the risks associated with trade financing. One feature consistently found in many successful e-finance systems is the ability for customers to download a report in comma-separated value (CSV) format, enabling them to import the data to other software, such as their accounting system;
- (d) *Security feature:* users are usually given a smart card to store their digital signature. Security is usually maintained through public key infrastructure (PKI);<sup>33</sup>
- (e) *Seamless integration:* the e-trade finance system must be able to integrate into the back office system of larger companies, including their enterprise resource planning (ERP) systems and their existing electronic data interchange (EDI) systems.

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<sup>33</sup> PKI is a combination of software, encryption technologies and services to protect the security of business transactions on the Internet. It comprises digital certificates, public-key cryptography and certificate authorities. For more information, see [www.verisign.com](http://www.verisign.com).

### C. Benefits of e-trade finance

ICT and the Internet have the potential to greatly reduce financial transaction costs<sup>34</sup> and to increase the speed at which financial services are delivered. Some of the more specific benefits of e-trade finance are as follows:

- (a) *Easier access to financial services and information:* in general, large enterprises have greater access to finance on competitive terms than do smaller ones. Banks and financial institutions are not keen to service SMEs for such reasons as lack of credit information, small financial needs and high servicing costs (since they usually engage in transaction-based banking activities). SMEs in emerging economies, which represent most of the productive capacity in these countries, face an even more severe lack of access to finance. However, e-finance enables banks and other financial institutions to offer ubiquitous financial services regardless of the size of their customers as the cost of operating the system is almost fixed;
- (b) *New financial products:* with e-finance, banks are in a better position to assess the financial standing of their customers. Through the use of sophisticated data-mining tools, banks can better profile their customers and thus better manage their risk exposures. As a result, the banks can develop more sophisticated financial products for different customers with different risk levels;
- (c) *Improved accuracy and approval speed:* most e-trade finance systems now use “straight-through processing”.<sup>35</sup> The once-only data-entry process eliminates the need for repeated checking of information, reducing the need for error tracing and correction procedures. This has significantly reduced the average time necessary for approval of financial documents (see box 8.1). For example, a bank in Singapore takes just three minutes to approve an application for L/C through its e-trade finance system compared with three to five days turnaround time if the application is processed in the traditional manner using paper forms;
- (d) *Integration of trade finance processes with other trade systems:* most e-trade finance systems, if developed on the basis of global standards, can be integrated easily with other trade systems. For example, the e-trade finance system of a bank may be integrated into the country’s electronic trade documentation system, resulting in faster customs clearing times and a shorter business cycle;

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<sup>34</sup> Industry figures show that a typical transaction involving a teller costs about \$1 and a typical ATM transaction 25 to 30 cents. The cost of a typical Internet transaction is about one cent.

<sup>35</sup> “Straight-through processing” or STP, is a process whereby a customer enters the data or request and the information is sent directly to the bank for processing without any human intervention.

### Box 8.1. Online loan services for SMEs in Hong Kong, China

SMEloan serves the needs of SMEs in Hong Kong, China. The company offers “express loans” up to about US\$ 128,000, which are approved within one minute after an online application is submitted. However, although it is not specifically a microfinance institution, SMEloan ends up lending modest amounts to most of its loan applicants. More information on this company may be found at [www.smeloan.com](http://www.smeloan.com).

*Source:* International Trade Forum, April 2002.

- (e) *“Any time anywhere” convenience:* in countries with high ICT literacy rates and well-developed telecommunications networks, customers can make financial arrangements wherever they are and at any time;
- (f) *Low barriers to entry:* the cost of establishing an online banking system is generally much lower than the cost of establishing a physical branch outlet. In countries where there are restrictions on the number of branch outlets that a bank may have, e-banking will make this restriction ineffective, as any personal computer with an Internet connection may become a virtual “branch”. The low barriers to entry, while certainly requiring that Governments develop new regulations and supervision mechanisms, may be expected to lower the cost of and improve access to trade finance services.

## D. E-trade finance models

While e-trade finance services are provided solely by banks and financial institutions, many different implementation models have been developed. Some banks have decided to retain their core competency by providing e-trade financing alone. However, some have collaborated with e-marketplace operators to integrate their e-trade finance services with them. Some banks have also gone beyond their core competency by creating their own e-marketplaces to provide an integrated service for their customers.

### *Standalone e-banking service*

The standalone e-banking service model refers to the case of a bank offering trade finance services and products on its own website as part of a larger e-banking service for corporate clients. The bank customer will have to use the bank website to apply for the service.

### *E-marketplace with integrated e-banking*

Some banks have integrated their online banking service with e-marketplace providers. The advantage of this model is that companies now do not need to go through a separate login process with the bank after transacting business in the e-marketplace. Trade and

**Box 8.2. DBS Bank – IDEAL**

DBS IDEAL is a short name for Integrated Direct Electronic Access Link. It is an integrated web-based cash management gateway that helps companies manage their cash flow more efficiently. DBS IDEAL is a standalone e-banking service.

Online services include: bank account information and management; foreign exchange and telegraphic transfer service; monitoring of credit line utilization and status of various credit transactions with the bank; online payments (or through file transfer); applications for trade financing; applications for shipping/airway guarantees to clear cargo in the absence of transport document; applications for bank guarantees to secure advance payments or as performance or tender bonds; applications for import financing (trust receipts/bills receivable purchased) and submission of payment instructions for the settlement of L/C documents or collection-related transactions. Bank statements and other return files containing the results of transactions can be downloaded into the customer's financial system for reconciliation.

*Source:* DBS Bank, Singapore ([www.dbs.com.sg](http://www.dbs.com.sg)).

banking information can be consolidated and viewed within a single platform that provides better information management and greater transparency.

The main issues here will be that of protecting the confidentiality of the banking information of clients. Sufficient security measures must be implemented to prevent the unauthorized disclosure of banking information.

Standard Chartered Bank has established a trade platform called B2BeX ([www.scb2bex.com](http://www.scb2bex.com)). Unlike many other bank platforms, B2BeX is an ambitious web-based system designed to manage every aspect of the trade process. Buyers can search for products online, place orders with suppliers, process documents, coordinate logistics, negotiate insurance and arrange financing. The system can be sliced and diced, however, giving users the option to choose just one or a couple of the available services. Standard Chartered has said the platform transforms its role from that of a provider of trade finance to that of a facilitator of international trade. Placing importers and exporters on the same platform makes them all more competitive and efficient, according to the bank, which claims that companies using the platform have experienced between 25 to 50 per cent efficiency gains in their paperwork and administration.

*Full-service global trade portals*

While integrated e-marketplaces help to speed up financing for companies, they do not provide a total solution for exporters or importers. Labour-intensive documentation and trade procedures will still surface once the goods leave the port. Some service providers have attempted to develop full-service global trade portals that would allow all aspects of a trade transaction (e.g., financial, logistical and even regulatory aspects) to be managed from a single online platform with little or no need for paper-based documentation. Three such global platforms are briefly described below:

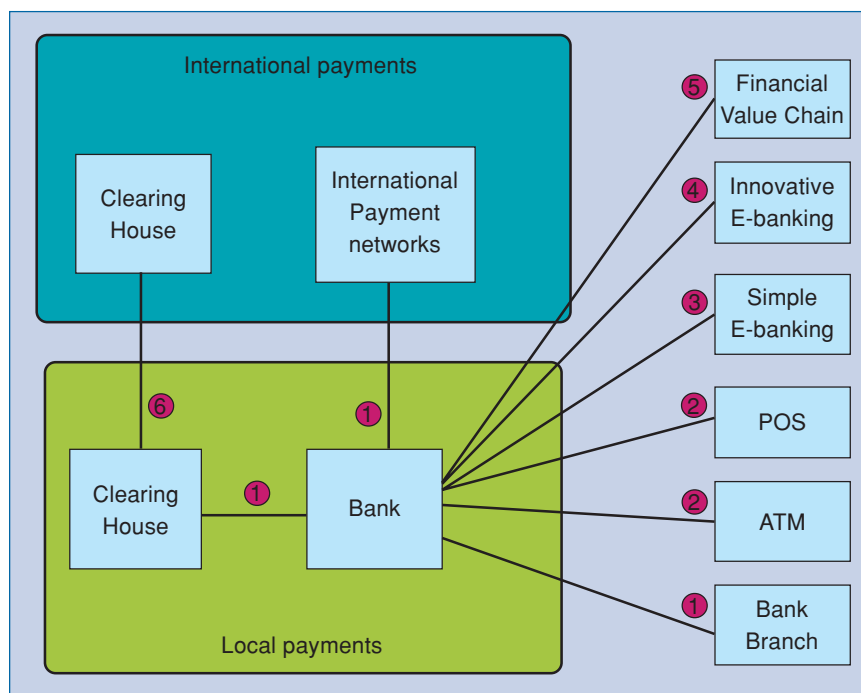
- (a) *TradeCard*: TradeCard automates trade transactions from procurement through payment. The TradeCard solution provides the documentary and financial requirements of a domestic or international trade transaction with the physical movement of goods, eliminating time-consuming and error-prone manual processes. The system allows a buyer to connect the flow of physical goods with the flow of electronic funds by handling both through the same electronic document. By streamlining and enhancing the processes necessary for purchase order approvals, payment decisions and settlement, TradeCard strives to provide a cost-effective, practical and patented service for financial supply chain management. In addition to integrated financial and logistical services, TradeCard also provides integrated inspection services. It reported a 230 per cent jump in the volume of business between 2003 and 2004; ([www.tradecard.com](http://www.tradecard.com)).
- (b) *Bolero*: Bolero.net is a neutral, global platform owned jointly by SWIFT, a bank-owned cooperative, and the Through Transport Club, which provides insurance for a multitude of ports and terminals, and two thirds of the global container fleet. The Bolero initiative addresses a glaring lacuna in the area of trade finance automation – the issue of security and authentication – by providing a secure service for the exchange of documentation that is supported by strong authentication and audit trails; ([www.bolero.net](http://www.bolero.net)).
- (c) *GlobalTrade Corporation (GTC)*: GTC is a service provider to financial institutions involved in international merchandise trade. The company services trade transactions that are conducted using documentary credits, standby letters of credit, documentary collections, open accounts, and cash in advance. Users are able to conduct their business over the Internet, thereby maximizing available credit, reducing transaction fees and dramatically simplifying all aspects of the process, including the issuance of documents and the tracking of transaction progress. The company launched its @GlobalTrade platform in 2002 and has built strategic partnerships with Adobe, Cap Gemini Ernst & Young, SITPRO and Visa International. While retaining the existing rules and banking practices to which the trading community is accustomed, it tried to create simplified electronic versions of a letter of credit and to streamline the flow of electronic trade-related documents. ([www.globaltradecorp.com](http://www.globaltradecorp.com)).

## E. Phases in e-trade finance infrastructure development

The development of the infrastructure for e-banking and e-payment is a prerequisite for e-trade finance. A country usually goes through the phases described below in e-enabling its financial services (see figure 8.1).



Figure 8.1. Stages in e-enabling financial services



*Phase 1: Linking banks with a central clearing house*

Usually initiated by the central bank, this involves the establishment of a central clearing house through which payments between banks are cleared. The clearing house generally provides the settlement of funds between member banks for the following services:

- Cheque clearing
- Crediting employees' wages directly into their accounts (GIRO)
- Processing of transfers and payments of bills
- Execution of other debit and credit transactions

The electronic linkages of banks with a clearing house will speed up local payment processes. However, in order to provide international payments, banks need to have a means to link up with international payment systems.

In the past, international payments were usually made through correspondence banking relationships. Such relationships help banks to establish an arrangement under which one bank will provide payment and other services for another bank that does not have a presence in the country. Payments through correspondents are often executed

through reciprocal accounts (nostro or loro accounts), to which standing credit lines may be attached. Correspondent banking services are primarily provided across international boundaries but are also known as agency relationships in some domestic contexts. A loro account is the term used by a correspondent to describe an account held on behalf of a foreign bank; the foreign bank would in turn regard this account as its nostro account.

One example is the use of SWIFT. A SWIFT payment message is an instruction to transfer funds; the exchange of funds (settlement) subsequently takes place through correspondent banking relationships, as explained in chapter VII (see box 7.4).

#### *Phase 2: Deployment of ATMs and point-of-sale systems*

The deployment of ATM and point-of-sale (POS) terminals to retail outlets is local in nature and has no direct impact on trade finance. However, it has long-term implications as the banks can make use of this phase to prepare their customers to accept electronic payment.

Debit and credit cards are also introduced in this phase. Issuing such cards will typically deepen a country's international payment services as banks start to join international payment organizations such as Visa and MasterCard.

#### *Phase 3: Simple e-banking*

In this phase, corporate e-banking becomes an important service, including the provision of cash management services and L/C, D/C and guarantee applications through the Internet.

#### *Phase 4: Innovative e-banking*

The degree of development varies between banks and from one country to another. Some banks simply transfer their traditional banking services from their branch onto an e-banking platform.

However, some banks, by leveraging the unique strength of the Internet, have managed to develop new financial instruments. Indeed, Internet banking usually allows banks to collect additional and detailed information about their customers, especially in terms of the financial services they use and how they use them. This information can help banks to design new, customized products and services for their clients.

#### *Phase 5: Financial value chain integration*

In this phase, banks now go beyond merely providing banking services. They integrate their services with the business value chain of their customers. This may include integration of their banking system with electronic trading communities, customs offices, freight forwarders and others.

In this phase, intermediary organizations are often used to facilitate integration. These intermediaries (e.g., TradeCard) generally provide a platform to link the banks with the other participants in the trade value chain.

#### *Phase 6: Regional and international collaboration*

Going beyond their own territory, banks will begin to work with other banks and financial institutions in countries and regions where their customers trade. Collaborations will see the possible linking of clearing houses, e-payment systems and other electronic documentation systems.

#### **Box 8.3. NETS and China Union Pay linkup**

Singapore's electronic payments provider, Network for Electronic Transfers Singapore Pte. Ltd. (NETS) launched a strategic linkup with China Union Pay (CUP) in January 2005.

The linkup will enable millions of Chinese visitors to use their credit and debit cards to make purchases and withdraw cash from ATMs throughout Singapore. According to the Singapore Tourism Board, Singapore receives an average of more than 600,000 business people and holidaymakers from China annually. It is estimated that Chinese visitors to Singapore spend on average around S\$ 300 each.

Founded by Singapore's leading banks in 1985 to operate payment networks and drive adoption of electronic payments, NETS has been at the forefront of Singapore's cashless revolution for 20 years.

CUP was established in March 2002 by 80 leading Chinese banks. It is similar to NETS in that it supports electronic transactions for banks throughout China and cards bearing its logo are as ubiquitous in China as NETS is in Singapore.

The linkup enables CUP to provide NETS retail merchants with access to a cardholder base of more than 300 million, which is 75 times greater than the entire Singapore market.

*Source:* [www.nets.com.sg](http://www.nets.com.sg)

## **F. E-trade finance development challenges**

In developing an e-trade finance system as part of a holistic trade development strategy, a country may have to address a number of issues. The possible challenges to e-trade finance development are briefly discussed below.

#### *Internet access*

E-trade finance can only be successfully implemented in a country if there are widespread access points at affordable prices. The Government would therefore need to

support the development of a sound Internet infrastructure. This may be achieved through public investments as well as by liberalizing the Internet service provider market to drive down the cost of Internet access.

#### *Acceptance of e-commerce and e-trade services*

Transacting online requires some behavioural change from traders, as they are often used to face-to-face negotiations and transactions. A concerted effort must be made to educate and train people and businesses in transacting online. Promoting simple online banking and payment may play an important role in setting standards and encouraging the use of more advanced and complex e-finance services, such as e-trade finance.

For example, the Government of India created the Small Industries Development Bank (SIDB) alongside the larger Industrial Development Bank. SIDB then introduced a full range of information technology facilities, including Internet cafes and mobile telecommunications, and made them available to small enterprises.

#### *Initial investment costs*

While it is true that online transactions cost less than manual face-to-face transactions, the economic value of online transactions may not be very obvious to smaller companies. For a start, companies need to invest in a computer with a modem and a telephone line with Internet connection. For security reasons, banks may require companies to invest in other equipment, such as smart cards and associated readers. Online transaction fees might also be payable. SMEs may therefore be deterred by such investment costs.

#### *Implementation issues*

While e-trade finance could increase customer service, some bankers feel that their role is being reduced to that of a simple processing agent. The personal contact between banker and client is diminished, and the banker loses some influence over his clients.

It may be possible to overcome by making sure that the environment encourages banks to provide innovative online services that cannot be provided offline. An example is the provision of microfinance by traditional banks through the online consolidation of the loan requirements of many SMEs. This was done by Pride Africa, a microfinance network providing credit to more than 80,000 African SMEs in Kenya, Malawi, the United Republic of Tanzania, Uganda and Zambia.

#### *Supervision of non-bank financial institutions and foreign e-banks*

From a bank's perspective, e-trade finance opens up an opportunity to expand its business with virtually no limits. However, it also creates some challenges that government regulators should be aware of in order to facilitate the wider use of legitimate e-banking and enable the transition of banking services to e-trade finance.

Because of the lower barriers to entry, there will be more service providers in the market. These service providers may take different forms. They may be existing banks from other countries, new banks that operate purely on the Internet or third party web portals that act as an intermediary to banks.

Third party non-bank institutions can pose a serious challenge to existing banks as many of the banks' services may be turned into commodities. For example, DollarDex, an Internet company based in Singapore that does not belong to any bank, offers a consolidated view of the unit trusts and other investment and loan services of banks and offers them to its customers. To banks, DollarDex is a re-seller or service agent. To DollarDex customers, it is a provider of an unbiased view of the various bank products listed on its website. Customers can obtain better service, as they are able to purchase unit trusts and other investment funds offered by different banks from just one source. DollarDex has since expanded to Taiwan Province of China and Hong Kong, China.

To mitigate the risks associated with the rapid entrance of new financial service providers, regulatory authorities (e.g., the central bank) need to re-examine current laws and policies to ensure that these new entrants, including third party non-bank financial institutions and foreign e-banks providing services to local residents,<sup>36</sup> are also regulated. For example, DollarDex was required to obtain a financial advisor licence from the Monetary Authority of Singapore, the de facto central bank of Singapore.

Generally, it should make no difference whether banking services are provided via traditional channels, such as branch offices, or over the Internet. A country may, however, consider issuing regulations that differentiate between traditional and e-banking, depending on its desire to promote e-banking. In Singapore, a set of guidelines was established in 2000 for the establishment of IOBs. IOBs are required to have a practical business plan, disclose undertakings and set out the rights and obligations of customers. In order to obtain a licence, traditional banks must have paid-up capital of at least S\$ 1.5 billion, but their subsidiary IOBs only need paid-up capital of S\$ 100 million under the new guidelines.

Owing to the open nature of the Internet, government regulators may find it difficult to supervise and monitor e-banking services, particularly cross-border e-banking ones. Closer collaboration between financial sector regulatory authorities and other government agencies may be needed. For example, the Dutch Insurance Board and the Securities Board of the Netherlands entered into a cooperative agreement with the National Police Services Agency (Korps Landelijke Politiediensten, or KLPD) and the Dutch Economic Investigation Service (Economische Controle Dienst, or ECD) to develop new methods to track those whose actions on the Internet are in breach of financial regulations.

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<sup>36</sup> This refers to cross-border e-banking, defined as the provision of transactional online banking products or services by a bank in one country to residents of another country. See Basel Committee on Banking Supervision, *Management and Supervision of Cross-Border Electronic Banking Activities*, July 2003 (available online at [www.bis.org](http://www.bis.org)).

### *E-commerce legislation*

A legal framework that recognizes electronic documents and contracts is needed to support the development of e-trade finance. Many developing countries have yet to pass electronic commerce or electronic signature laws. In this regard, the 1996 UNCITRAL Model Law on Electronic Commerce<sup>37</sup> and the 2001 UNCITRAL Model Law on Electronic Signatures<sup>38</sup> remain the two main references in this area.

### *Security*

While governments should encourage the widespread use of e-trade finance, regulators should also recognize the risks associated with network technology. Owing to the open and complex nature of the Internet, banks should take into account the accentuated risks associated with using this infrastructure in their management process.

One risk relates to the security of systems and transactions, including data confidentiality and authentication of the parties involved. Another risk relates to the continuous availability of the Internet as a medium for financial transactions. This availability is prone to serious hazards, such as computer viruses and hackers.

It is important that banks set appropriate control and security benchmarks for their Internet operations. The level of Internet-related risk is directly related to the type of services provided online. Better security features are required for transactional and third-party integration services, to ensure authentication of parties, data integrity and privacy, as well as non-repudiation of transactions.

Many banks have adopted PKI to secure their online e-trade finance transactions, and rely on digital certificates issued by certification authorities to validate transactions. Because of the key role played by certification authorities in ensuring the integrity of financial transactions, some degree of supervision and regulation of these institutions by the Government may be necessary (see box 8.4).

#### **Box 8.4. Certification authorities: the experience of Singapore**

A certification authority (CA) is an organization that issues digital certificates and vouches for the authentication of the data in a certificate. The Government of Singapore adopted the Electronic Transactions (Certifications Authority) Regulations 1999.

These regulations establish a Controller of Certification Authorities for the purposes of licensing, certifying, monitoring and overseeing the activities of certification authorities. However, the licensing of CAs is not compulsory, as Singapore opted for a voluntary scheme in order to avoid overregulation and stifling the CA industry and e-commerce.

<sup>37</sup> General Assembly resolution 51/162, annex.

<sup>38</sup> General Assembly resolution 56/80, annex.

The voluntary licensing programme aims to promote high-integrity trustworthy CAs. Indeed, licensed CAs have to meet stringent requirements in various areas, including financial soundness, personnel integrity and strict security controls and procedures.

Licensed CAs enjoy the following benefits:

- Evidentiary presumption for digital signatures generated from the certificates issued by the CA. With the presumption, the party relying on the signature merely has to show that the signature has been correctly verified and the onus is on the party disputing the signature to prove otherwise. Evidentiary presumption hence assures online merchants of the security of their transactions when they use such signatures to validate electronic contracts and transmit them over the Internet (or by other electronic means).
- Limited liability under the ETA. The CA will not be liable for any loss caused by reliance on a false or forged digital signature of a subscriber as long as the CA has complied with requirements under the regulations. The CA will also not be liable in excess of the reliance limit amount specified in the certificate, even if it failed to observe some of its obligations.
- Public recognition that the CA has met stringent regulatory requirements and is therefore trustworthy.

*Source:* Infocom Development Authority of Singapore ([www.ida.gov.sg](http://www.ida.gov.sg)).

## G. Conclusion

The Internet has provided a new medium for financial institutions to offer innovative products in electronic form to meet the varied needs of their customers. E-trade finance is increasing competition and forcing standardization, adding speed and reducing the costs of international trade. These changes can help developing countries to improve their international trade competitiveness.

Governments and the international community have an important role to play in making e-finance a reality in developing countries. The first effort must be to provide affordable Internet access, as well as to increase the awareness of the business community, especially SMEs, of the opportunities associated with changing their way of doing business.

Effective government supervision of activities and institutions involved in e-trade finance will also be needed to address the many new challenges raised by the provision of financial services via the Internet. However, while new regulations and legislation will likely be required, regulators will have to avoid the pitfalls associated with overregulating this emerging industry.

## H. For further reading

- “Trade services: global visions required”, a supplement to Trade Finance, April 2005 ([www.tradefinancemagazine.com](http://www.tradefinancemagazine.com)).
- UNCTAD, *E-Commerce and Development Report 2002*, chapter 6 (available online at [www.unctad.org](http://www.unctad.org)).
- Stijn Claessens, Thomas Glaessner and Daniela Klingebiel, “E-finance in emerging markets: is leapfrogging possible?” *Financial Markets, Institutions & Instruments*, vol. 11, pp. 1-125, 2002.
- UNCTAD, “E-finance and small and medium-size enterprises (SMEs) in developing and transition economies” (UNCTAD/SDTE/Misc.48), background paper prepared for the UNCTAD Expert Meeting on “Improving Competitiveness of SMEs in Developing Countries: Role of Finance Including E-finance to Enhance Enterprise Development”, Geneva, 22-24 October 2001 (available online at [www.unctad.org](http://www.unctad.org)).
- Carlo F. Cattani, “Innovation, specialization and e-finance for SMEs” *International Trade Forum*, January 2002 (available online at [www.tradeforum.org](http://www.tradeforum.org)).
- Singapore, Electronic Transactions (Certifications Authority) Regulations 1999 (available online at [www.ida.gov.sg](http://www.ida.gov.sg)).



## IX. Towards a framework for trade finance infrastructure development

SMEs in developing and transition economies often cite access to credit as one of their major difficulties. Trade finance, working capital finance and ancillary capital expenditure finance are all essential to the successful development of cross-border transactions. SMEs do not readily obtain such finance, however, because of deficiencies or shortcomings in their country's financial sector.

As discussed in chapter V, deficiencies within the financial sector that directly affect the development of trade and trade finance include the following:

- (a) Incomplete range of facilities and services available to traders and producers (e.g., absence of an export credit guarantee agency, inadequate leasing possibilities);
- (b) Lack of an effective and efficient financial system to encourage savings and encourage better liquidity of financial institutions;
- (c) Ill-adapted legislation, regulations or jurisdiction (e.g., absence of tax regulations on depreciation of leased equipment, inadequate or unenforceable laws on property, lack of judicial independence, which affect the availability of finance.

Table 9.1 lists the steps suggested for carrying out a diagnosis of the financial sector and implementing appropriate remedial actions to address the deficiencies mentioned above.

The proposed steps taken together constitute a generic framework for trade finance infrastructure development. Based on its knowledge of the national environment, the trade finance development body (TFDB) would need to define substeps and actions to be taken within each step, specifying the responsibilities, resources and timing involved for each of them. Standards, conventions and best practices related to each of the substeps may also need to be identified to guide the TFDB in its implementation of the detailed road map, as was done by the group of experts, who developed the ESCAP Trade Facilitation Framework.<sup>39</sup>

It is apparent, from the scope of the tasks described in the road map, that the exercise will extend further a field than the activities commonly delineated by the term "trade finance". This is natural and stems from the fact that trade finance cannot be dissociated from financing as a whole, including the requirement for producers of goods for export to invest in plants, machinery and equipment and finance working capital needs that go beyond the strictly trade related portion of an export transaction.

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<sup>39</sup> The ESCAP Trade Facilitation Framework has been developed to provide a guide for Governments to identify the problems and bottlenecks within a country's trade facilitation system and to identify remedial action. See ESCAP, *ESCAP Trade Facilitation Framework, 2004*.

**Table 9.1. Diagnosis of the financial sector for trade finance**

<p><b>Step 1</b> Establish a Trade Finance Development Body (TFDB)</p>	<p><i>Establish an appropriate public-private collaborative body and related working procedures for the implementation of the financial sector diagnosis. Such a body should have balanced representation from the institutions in charge of trade and financial sector policies and the ministries in charge of transport and ICT, as well as relevant private sector institutions. It might be established as a subcommittee of either an existing trade and transport facilitation committee or a financial sector reform committee.</i></p>
<p><b>Step 2</b> Implement Trade Finance Pointers methodology</p>	<p><i>Collate data on the 52 pointers that make up a TFP chart (request independent local experts to conduct the necessary financial sector survey). Analyse available TFP charts, preferably for the preceding three years, and identify the areas most propitious for more in-depth diagnosis and analysis. (Please refer to chapter V)</i></p>
<p><b>Step 3</b> Conduct detailed diagnosis of selected areas</p>	<p><i>Prepare detailed terms of reference for studies to be carried out by specialists in the areas identified as being in need of further research. These studies should provide detailed recommendations based on established international standards and practices.</i></p>
<p><b>Step 4</b> Draw up proposals for changes and reforms</p>	<p><i>TFDB reviews studies and recommends measures to be implemented by government and financial institutions. Government and financial sector constitute working groups and appoint bodies to formulate necessary policy and draft legal texts for implementation of changes.</i></p>
<p><b>Step 5</b> Implement changes and reforms</p>	<p><i>Parliament enacts recommended legislation and regulations. Government takes all necessary steps to ensure effective implementation and enforcement of related policies, procedures and practices.</i></p>
<p><b>Step 6</b> Review and assessment of results</p>	<p><i>Review, monitoring and evaluation of the implementation of changes and reforms. Verification of impact using TFP and other pre-established performance indicators.</i></p>

In addition, as already discussed in chapter I, any effort to promote the development of trade finance should be implemented as part of an overall trade development and/or trade facilitation strategy. The trade finance development effort should also be coordinated with the ICT infrastructure development plans, given the ever increasing importance of electronic payment systems and transactions in international trade and finance (see chapters VII and VIII).

In particular, if the TFDB decides to make e-trade finance and e-payment development one of its priorities, it will need to carefully consider the following:

- (a) The current state of ICT development in terms of existing telecommunication infrastructure, ease of access to the Internet, ICT literacy of the population (especially exporters and importers), availability of ICT professionals, and ICT knowledge and capacity in the financial services sector;
- (b) The need to develop or to improve the operations of the central clearing house and other settlement and electronic payment system establishments;
- (c) The existence of an electronic trade documentation system or online customs declaration system, and their possible linkages with e-trade finance and payment systems;
- (d) The current state of development of e-commerce and related laws and regulations, such as digital signature, security and online trade taxation;
- (e) The need to develop specific rules and policies to address e-finance, electronic payments and cross-border e-banking issues.

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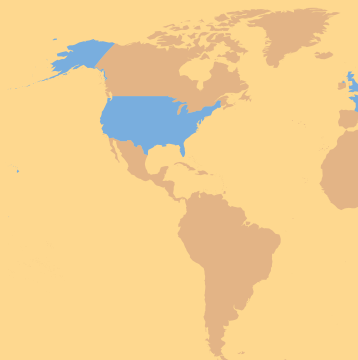
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