TRADE FINANCING AND COVID-19

Priming the market to drive a rapid economic recovery

Around 80% of world trade relies on trade finance—a market that has proven particularly vulnerable to previous financial shocks. Reduced access to reliable, adequate, and cost-effective sources of trade financing can significantly inhibit the potential for trade to act as a vector of economic recovery—disproportionately hindering the growth potential of smaller enterprises and developing economies.

In response to the emerging COVID-19 crisis, governments and public-backed institutions are making rapid interventions to support the supply of trade credit to the real economy—but might further action be needed to enable a rapid, trade-driven recovery?

CONTEXT—AN ESSENTIAL YET VULNERABLE MARKET

1. Trade finance is at the low-risk, high collateral end of the credit spectrum and plays an essential role in underpinning circa 80% of world trade. Yet, it has proved particularly vulnerable to previous financial shocks. The global financial crisis is estimated to have presaged a US$1 trillion shortfall in trade finance—resulting in the G20 agreeing on a package of US$250 billion in the form of guarantees and insurance to support trade flows at the 2009 London Summit.

2. Despite this unprecedented intervention, data suggest that the provision of trade credit did not return to normal in main trading routes until 2012. Moreover, micro-, small- and medium-sized enterprises ("MSMEs") have faced sustained challenges accessing trade credit over the past decade. Data from a recent survey by the International Chamber of Commerce ("ICC") shows that around 50% of MSME applications for trade finance are rejected by global banks, while the Asian Development Bank ("ADB") has estimated that the global shortfall in trade finance stood at around US$1.5 trillion in 2019—with this gap particularly concentrated in developing and least-developed economies.

3. The COVID-19 crisis therefore risks further exacerbating longstanding constraints in the trade finance market in a number of strategically important segments from an economic development perspective. What's more, we anticipate that the uncertainties created by the pandemic will result in increased demand for trade finance products over the medium term—as use of these products by businesses tends to increase proportionate to perceived commercial risks. It is anticipated that this effect will be greater than following the global financial crisis owing to the broader and deeper economic effects of COVID-19.

4. With the WTO estimating a potential decline in global merchandise trade in the order of 13–32% in 2020, we hypothesise that something in the order of **US$1.9–5.0 trillion** capacity in the trade credit market will be required to enable a rapid V-shaped recovery as demand returns to the global economy. This will potentially encompass an estimated **US$0.8–1.9 trillion** of required capacity in the bank-intermediated market alone (encompassing products such as letters of credit and guarantees) if merchandise trade volumes are to return to close to 2019 levels in 2021.

5. COVID-19 has also uniquely exposed an additional vulnerability in the provision of bank-intermediated trade financing: specifically, its reliance on paper-based processes. Due to the necessary public health measures taken in response to the pandemic (such as "social distancing" or teleworking), banks face growing difficulties processing paper-based transactions which, by their very nature, require significant levels of in-person "back office" staffing.

6. Such paper processes are required by national law in most jurisdictions, with electronic equivalents not accorded legal effect. Some banks have responded with pragmatism, using electronic equivalents and relying on ad hoc indemnities—yet this approach carries significant legal risk that banks can ill afford in the current climate. This operational disruption may have significant implications for global trade flows—particularly if trade volumes start to rebound while public health restrictions remain in place in some economies.

7. In this context, we believe it is vital that all governments: (i) remain alert to potential/emerging shortfalls in trade financing; and (ii) take proactive coordinated action at the appropriate scale to enable a trade-driven recovery from the economic impacts of COVID-19. This memo reviews some of the initial interventions made to address the early effects of the crisis and sets out a mid-term policy agenda to ensure that trade finance is primed to support a rapid economic rebound in the months to come.

THE RESPONSE TO THE EMERGING CRISIS

8. We welcome the decisive early actions taken by governments, development banks and regulators to provide support for trade credit as the economic impacts of the pandemic have become clear in recent weeks. We believe that these interventions have already played an important role in stabilising market confidence, avoiding delays to the processing of transactions and providing vital additional coverage for trade lines.

9. Examples of important interventions include:
   i. deferral of the full implementation of Basel III to ease any potential capital constraints faced by banks in responding to the crisis, together with helpful technical clarifications provided by the Basel Committee to ensure that banks reflect the risk-reducing effect of government guarantee programmes when calculating regulatory capital requirements;
   ii. voiding of pre-existing legal requirements for key trade documents to be presented in hard-copy paper format by governments including Algeria and India;
   iii. temporary expansion of the mandate of export credit agencies in the European Union to provide broader geographical coverage of short-term trade transactions;
   iv. a total of US$4 billion additional capacity for the IFC's Global Trade Finance Program and Global Trade Liquidity Program;
   v. inclusion of trade lines in development banks' emergency COVID-19 response funds by, for example, the Inter-American Development Bank, ADB and Islamic Development Bank—including priority allocations for trade in essential medical products; and
   vi. expansion of on-line training to banks to underpin support for companies in trade and supply chains, such as by the ADB and the European Bank for Reconstruction and Development.

10. Commercial banks have also been quick to respond to the early impacts of the crisis, working to actively support clients and adopting novel working practices to limit disruptions to the processing of transactions. ICC has also issued guidance to help banks manage COVID-19 related disruptions by adapting the application of its widely used rules for key trade finance products.

PREPARING FOR THE RECOVERY: TIME TO PRIME THE PUMP?

11. Notwithstanding these impressive actions to date, we believe that it is vital for policymakers to proactively assess the need for further interventions in the trade credit market given the scale of trade credit that will be needed to support a rapid economic rebound.

12. To this end, we recommend that all governments, regulators and development banks consider taking steps, as applicable, in the months ahead to:

i. **Enable a rapid transition to paperless trading** by: (a) immediately voiding all existing legal requirements for trade documents to be in hard-copy paper format; and (b) facilitating fast-track adoption of the UNCITRAL Model Law on Electronic Transferable Records to provide a sound legal basis for the use of e-documents in the processing of trade finance transactions.

ii. **Revisit the application of Basel III to trade assets** to mitigate against any potential for capital constraints to hinder the deployment of essential trade finance—particularly to MSMEs. An immediate next step, which Governments and Central Banks can take, is reducing the risk weights for exposures to MSMEs from 100% to a range between 75% and 85% as proposed by Basel III. We recommend consideration be given to adjusting risk calculations for key products, as appropriate, in line with the established low-risk profile of this asset class and benchmarked against performance data in the ICC Trade Register.

iii. **Consider large-scale government/central bank purchases of trade assets and/or guaranteeing trade exposures** to free up banks' balance sheets to service additional MSME demand for trade financing. Such purchases or the issue of guarantees could be enabled at scale via the use of existing technologies and techniques, including securitizations—which are classified as Simple Transparent and Standardised (STS) under regulations applicable to securitization transactions. Such interventions should carry relatively low risk to public finances given the self-liquidating nature of trade finance transactions.

iv. **Ensure all export credit agencies are equipped to provide adequate support for short-term trade transactions** with appropriate coverage limits and geographical scope.

v. **Further scale development bank schemes** to provide risk mitigation and liquidity for trade finance transactions as demand returns to the economy and/or as reports of financing gaps emerge.

13. Given the scale of financing required to support a rapid rebound in global trade flows—potentially as much as US$5 trillion—we encourage all actors to take proactive steps to prime the trade finance market to ensure it can play a central role in driving a post COVID-19 recovery. Timely interventions will be especially vital to ensure that MSMEs have continued access to reliable, adequate and cost-effective sources of trade financing—not only to weather the crisis, but hopefully to emerge from it stronger than ever. ICC stands ready to assist governments, regulators, development banks and the trading community toward that end.

For further details on ICC's global campaign to ensure effective support for small businesses through the COVID-19 crisis, please visit: sos.iccwbo.org.

ABOUT THE INTERNATIONAL CHAMBER OF COMMERCE (ICC)

The International Chamber of Commerce (ICC) is the institutional representative of more than 45 million companies in over 100 countries. ICC's core mission is to make business work for everyone, every day, everywhere. Through a unique mix of advocacy, solutions and standard setting, we promote international trade, responsible business conduct and a global approach to regulation, in addition to providing market-leading dispute resolution services. Our members include many of the world's leading companies, SMEs, business associations and local chambers of commerce.

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