A global architecture for international trade: a collaborative approach

Olivier Paul sheds light on the unprecedented changes facing the trade finance industry, and explains how ICC aims to positively shape the global trade landscape

The global economic system is going through a period of significant change, while also facing numerous and complex challenges – particularly when it comes to global trade. Indeed, the value of trade to emerging markets and companies trading in these regions is widely acknowledged. What is less clear, however, is the intrinsic value of trade finance in driving that trade.

Through financing orders and mitigating payment and supply risks for buyers and sellers, players can transact with distant and often unfamiliar counterparties with confidence. But in order to secure future stability and growth, the global trade architecture needs reassessing and reshaping. It needs to evolve – not least because the trade finance industry is facing a period of unprecedented technological innovation.

Such change throws up some challenges, for sure. But the opportunities for growth and development far outweigh any concerns. Given this, we at the International Chamber of Commerce (ICC) Banking Commission have an important role in helping prepare the industry for the future: advocating and influencing changes such as regulation, digitalisation and the entry of new players. Moreover, shared principles around regulation and compliance also help level the trade landscape and support those operating in the trade finance industry across the world.

A period of transformation

Certainly, the global trade environment is experiencing a period of transformation around policy, risk, and the provision of finance. As the ICC Banking Commission 2017 survey *Rethinking Trade and Finance* highlights, there are some major changes ahead for trade finance, involving regulatory changes, technological evolution and the entrance of new non-bank sources of liquidity.

At the same time, since the 2008 global financial crisis we have witnessed the growth of protectionist forces against trade – a global phenomenon that, while emerging in sometimes surprising ways, knows little with respect to geographic or developmental boundaries. This is of significant concern considering that trade generates macro-level benefits, such as helping turn startups into global companies generating employment.

Such rhetoric impacts the trade landscape and has a direct and indirect consequence on cross-border flows. In fact, despite the clear benefits, protectionism has translated into real measures, with new trade restrictions in 2016 reaching their highest levels since pre-crisis, and G20 economies adopting more trade-restrictive measures than trade facilitating ones. As a result, while trade growth is on the rise it has not yet reached pre-crisis levels with respect to outpacing global GDP growth.

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Meanwhile, the trade finance industry has experienced dramatic shifts in the regulatory landscape. In the immediate aftermath of the financial crisis increased regulation was, justifiably, deemed imperative to the health and sustainability of the global financial system. However, the industry continues to search for the optimal balance between the need to foster global growth and implement efficient, risk-aligned, trade finance regulations.

For example, Basel III capital requirements have reduced the amount of lending a bank can offer at each level of capital reserves. According to the 2017 *Rethinking Trade and Finance* survey, financial institutions have reported both anti-financial crimes regulations and Basel III regulatory requirements (80% and 71%, respectively) as major impediments to trade finance provision.

Fortunately, efforts to refine Basel III regulations to better align to the trade finance industry are underway. Certainly, recent changes – aimed at reducing disparities in the way in which the internal ratings-based model is applied by banks – should help reduce regulatory complexity. Yet the impact of Basel III on lender appetite is undeniable.

Similarly, compliance requirements relating to anti-money laundering (AML) and know your customer (KYC) have unintentionally increased the costs and complexity of trade finance transactions for banks, requiring banks to employ additional capacity for new oversight responsibilities. This – along with reputational risks and concerns over low profit – is contributing towards banks de-risking and reducing correspondent relationships, particularly in emerging markets. The International Finance Corporation's 2017 *Survey on Correspondent Banking* found that, globally, 27% of survey participants noted a reduction in correspondent banking relationships in 2016, while several regions reported reductions with significant frequency.

This is subsequently impacting the amount of trade finance available in these markets and primarily affecting small and medium-sized enterprises (SMEs). In fact, de-risking and the loss or potential loss of correspondent banking relationships limits the positive impact that banks can make in maximising a country's macroeconomic growth and stability.

So, what does all this mean for the trade finance landscape? The latest *Rethinking Trade and Finance* report revealed that 61% of respondent banks reported more demand than supply for trade finance, while the Asian Development Bank (ADB) also reported a US$1.5 trillion gap between supply and demand for trade finance. Furthermore, SMEs experience the most difficulties accessing trade finance – impacting their growth, and ability to expand internationally.

Adding to this complex picture, the trade finance industry is also adjusting to the entry of new players – such as challenger banks, fintechs, pension funds, hedge funds and insurers. While these entrants should be encouraged – they provide additional sources of liquidity and foster innovation – they must also decide whether they want to purely disrupt the trade finance landscape or to complement it.

Efforts underway

While there are various challenges in the trade finance industry, these must be balanced by the considerable efforts aimed at improving the global trade environment. Limiting any negative impacts of protectionism should, of course, be a priority. This is precisely why ICC is working with the World Trade Organisation (WTO) to establish new trade recommendations for all nations. Both organisations sincerely believe that a level playing field for trade helps reduce negative perceptions of trade.

ICC's annual Open Markets Index (OMI) provides a useful tool, representing 90% of trade and investment worldwide and highlighting the levels of trade openness in different economies. The four main components of the OMI consist of: observed openness to trade, trade policy settings, foreign direct investment openness, and trade-enabling infrastructure. Despite pledges to enable trade as a driver of growth and job creation, the 2017 OMI report found that G20 economies are failing to demonstrate global leadership on trade openness, with only Canada placed among the world's top 20 open markets.

Yet in order encourage trade growth and help close the financing gap, we must also foster financial inclusion: in this respect defined as including SMEs in the global financial landscape (both in developed and emerging markets). While there are multiple reasons behind the financing gap, one of the key causes is the regulatory environment for trade and the constraints this places on banks financing of trade, especially for SMEs. Raising awareness around the low risk profile and true characteristics of trade finance to regulators is therefore a key area of advocacy for the Banking Commission.

For instance, ICC Banking Commission's annual *Trade Register* surveys bank default rates on trade instruments – providing an evidence-based support for our advocacy efforts geared towards a greater risk-aligned treatment of trade finance. The *Trade Register* highlights the favourable risk profile of trade finance instruments when judged against comparable asset classes, such as corporate lending. It also aims to further increase the attractiveness of trade finance to banks – helping maintain and even add to bank-supplied liquidity for cross-border commerce.

What's more, the *Trade Register* findings reinforce the case for trade finance to be increasingly recognised as a reliable and investible asset class to institutional investors – potentially providing further funding and support for the industry.

Levelling the playing field

In an increasingly complex landscape, the importance of guidance – with respect to compliance and its application – is critical. To this end, ICC, the Wolfsberg Group and BAFT formed the Trade Finance Principles Drafting Group in

April 2014. The group aims to provide guidance on a broad range of trade finance compliance areas, such as control mechanisms (eg. customer due diligence). The group benefits from diverse expertise and perspectives, considering the combined member base from all three partner institutions.

In particular, the *Trade Finance Principles* outline the role of financial institutions in managing processes addressing financial crime risks, as well as compliance with national and regional sanctions and embargoes. Such a collaborative effort ensures that practices around financial crimes compliance for trade transactions are standardised, and that all banks operate on a level playing field. This is crucial considering the global nature of the industry, as well as the fact shared principles need to consider variations in cultures and sizes of all banks involved in trade finance.

The Group updated these *Principles* earlier this year, since changing regulatory expectations made it necessary to identify where expectations have also changed, and where the basic principles, or their application, needed readdressing.

The digital revolution

Meanwhile, much of the industry's focus is currently around the digital revolution, as the digitalisation of trade finance is now widely understood to provide benefits around efficiency, costs and transparency – as well as in encouraging new entrants and wider collaboration.

As this year's *Rethinking Trade and Finance* report highlights, the digitalisation of the trade finance industry is influencing business models and strategies for corporates and banks, primarily due to its power to simplify and reduce costs. Indeed, through increased transparency and reduced risk, digitalisation can potentially help trade banks meet their regulatory and compliance requirements. In turn, this allows banks to better serve SMEs and stimulate trade flows.

Clearly, industry players should focus on accelerating the benefits of digitalisation in line with wider trade finance goals, particularly as increased collaboration will enhance progress. This is precisely why ICC Banking Commission launched a Working Group on Digitalisation earlier this year, with a focus on helping the industry *"accelerate the digital journey".*

The Working Group aims to do this specifically through assessing the 'e-compatibility' of ICC rules for trade finance – developing a set of minimum standards for the digital connectivity of service providers, and examining the legal and practical issues related to the validity and value of data and documents in digitised form.

Still, while digitalisation has the potential to bring benefits and transform the trade finance industry, its success relies on a rules-based approach as well as the development of standards. We aim to prepare the industry for the significant technological changes underway and ensure that today's rules – used by 90% of the banking industry – remain up to date.

Eventually, the Group intends to create standards to on-board third-party providers, attracting non-bank providers and fintechs while ensuring harmonisation across the industry. This will aid efficiency while also bringing transparency and reducing operational risk.

Collaboration is key

Ultimately, with a host of new changes around regulation, compliance, digitalisation, and new players entering the industry, effective collaboration between banks, pension funds, fintechs and all industry players will be key for the development of the trade finance industry.

It is here that international organisations such as ICC can work together with other multilateral organisations in order to drive the industry and support such collaboration. Such efforts go a long way in helping to prepare the trade finance industry for future developments and positively shape the trade landscape – strengthening the global economy and increasing prosperity for communities worldwide. ■

Olivier Paul is International Chamber of Commerce (ICC) Banking Commission's Head of Policy